IHS Markit Perspectives III (March 31, 2020)

Shifting appetite for capital allocation strategies

IHS Markit's Perception Analytics team engages in in-depth discussions with investors and analysts daily. Given recent market volatility and significant economic uncertainty, IHS Markit will be speaking to investors and analysts on a regular basis over the next few weeks to assess how the current situation with COVID-19 is impacting their evaluations of and engagement with corporate issuers.

As stock prices continue to fluctuate dramatically on a daily basis and there is growing concern about a global recession, it is more important than ever for companies to understand how investors and analysts are changing their assessment of capital strategies. **The third topic we elicited feedback on is how the current market downturn is changing views on companies' approaches to capital deployment decisions.**

Most investors believe that companies that ignored the potential for a downturn by stretching their balance sheets during the 10-year economic boom will rightfully suffer the consequences of those decisions now that the market has quickly and unexpectedly turned.

- "The current market environment has changed my view in terms of the way that companies should approach capital allocation decisions. The first thing that we did in the last week or two when it became apparent that this is not only the Chinese province that is going to be impacted, was that we looked at any company that told us that it was fully funded where we knew that they were probably lying and got them out of the portfolio. I preach this to management teams all the time that a money-losing, micro-cap company with any amount of debt on the balance sheet is a bad thing. I do not care if you have $100M of cash, you should not have $20M of debt. **They go back to the financial textbooks in terms of what a beautiful thing leverage is and that bankers told them this and how it is not dilutive. But, it is highly dilutive because when something like this happens, your revenue, EBITDA, and cash flow get hit. Then all of a sudden you have less cash and you still have the debt.** There is no such thing as non-dilutive financing for money-losing micro-caps. When they need money, they should issue stock and get money. They should not do anything else. This has been my message forever but perhaps it will resonate more now with management teams than it has in other times." *Portfolio Manager, US investment manager ($800M EAUM)*
- "When it comes to assessing companies based on the debt they have on their balance sheets, one thing investors should focus on is the nature of that debt. It depends on the upcoming

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maturities and coupon for example. In 2009, the cost of debt for a lot of companies who raised capital between then and 2005 was very high because of the coupon being around 5-8%. But there has been so much refinancing and debt issued since then that if you are an investment grade borrower, or even almost a high yield type borrower, although I do know they offer shorter maturities, then the cost of debt in somewhere around 1-3%. **It is therefore more important to focus on more than just the overall level of leverage. Things such as interest rate coverage ratios are probably more relevant.** I do not think this situation is going to freeze the credit markets, but if companies need to roll their debt they will just have to do so at higher cost and take their medicine. Even if an investment grade borrower has to roll over at 200bps higher, it still might only be paying 2.75%, and this is not the same as having to pay 8%." *Analyst, US investment manager (>$1B EAUM)*

- "I do not cover oil and energy companies, but you can see them dropping because they are highly levered. With oil prices coming down, people are talking about the probability of bankruptcies. I think that is an extreme scenario right now and hopefully the COVID-19 situation passes by summer. More broadly, I suspect that higher levered companies are facing more scrutiny in general. **I believe that oil companies are good examples of where things could go for an average company that is highly levered if the industry it is in sees a downturn.**" *Analyst, Boutique US sell-side firm*

- **"There is definitely more investor hesitancy towards the highly-levered names in this current environment.** It is hard to identify a threshold because it is more of a relative thing. There are going to be a lot of nuances but overall, the less-levered names in my universe are faring better. But to avoid leverage is a kneejerk recession fear type of move." *Analyst, Boutique US sell-side firm*

- "We have always had a general bias toward companies that have less levered balance sheets. In this type of environment, the ability to handle leverage and have financial flexibility is increasingly important. Levered companies should be hit because of the reduced financial flexibility. That is a clear trend in the market. The companies with less leverage are favored. Companies should be trying to increase liquidity now and drawing down credit lines. **I believe that what is happening in the market today will finally force companies and shareholders to not stretch balance sheets. I think this is finally the inflection point for leverage on corporate balance sheets."** *Analyst, Canadian investment manager ($16B EAUM)*

- "Clearly people are concerned and companies with more debt are getting punished. Companies that have both financial debt and operating leverage get punished. It is a lot to ask of investors to carry both of those things. If you have a lot of operating leverage and if you have any cyclicality in your end markets, you cannot carry any financial leverage. That is a good rule of thumb, but it is easy to forget about that when times are good**. It is a simple equation with three variables, cyclicality, financial leverage, and operating leverage, and you cannot have all three.** But it is kind of too late for these companies that have a levered balance sheet." *Analyst, US investment manager ($10B EAUM)*

- "Everybody gets scared of leverage in situations like these. Every time we have a situation like this where there is uncertainty in fundamental outlook, investors will not like leverage. Companies need to decide what kind of capital structure they want, and it needs to be appropriate for the nature of the business you are in. **If you are levered, you get the benefit for it during bull**

runs, but you also get the drawback from it now. You have to match the leverage with the nature of the business. Some businesses generate cash flow in tremendous ways in a downturn and can have a little more leverage. Some businesses are non-cyclical and can have leverage. If you are small, levered, and cyclical, that is not a good position to be in today." *Portfolio Manager, US investment manager ($4B EAUM)*

- "The more levered names are getting punished. In general, companies should be aware that when things go bad, they can be a lot worse than you think. Focus on covenants. **There is also scrutiny on those balance sheets and companies that just deployed a lot of capital to big deals. One, you have a stretched balance sheet now. Two, you likely just overpaid for something.** It is a combination of both, but it has affected companies with worse balance sheets. If it looks okay on covenants even in a really bad situation, there is good liquidity, and no near term to maturity, then investors will come back faster. That is not some of the stuff that we watch, but some investors will just screen for metrics. Companies who meet these criteria, should be highlighting this." *Analyst, US investment manager ($800B EAUM)*
- "In the current market environment, the more highly-levered names are getting destroyed. It shows you how tricky it is because you could buy back shares but it is awfully hard to buy back shares when you do not know if there is going to be a stable financial system anymore. **Sometimes these massive opportunities come but you do not have 'dry powder' so they just go by and perhaps that is not the worst thing in the world. Some companies could probably carry more debt if they wanted to or they could easily buy back 20% of the company, but it is probably not wise to do so.** Companies are forced by their debt position to steer the course. Some people are complaining about the airlines getting a bailout but rightly so. If you spend 10 years buying back shares and then you need a bailout, that is shocking." *Analyst, US Boutique sell-side firm*

Some investors suggest that times like these are a good reminder for why it is important for companies to be thoughtful about opportunistic buybacks and temper expectations when discussing the upside of capital allocation initiatives.

- "I work primarily in the small cap sector and small-cap companies tend to be constrained to begin with. Therefore, I am not sure that they have the kind of flexibility that they would like to have in an optimal world. There are not that many good companies. But good CFOs build in extra cushion and spend more time worrying about what could go wrong than dealing with what is going right. However, small-cap companies do not necessarily have that luxury. **Ultimately, many companies had made capital allocation decisions assuming that your cost of capital is 2% higher than you tell everyone and that your returns are 2% lower than you tell everyone.** If you can still make money, that is phenomenal but that does not happen all the time." *Portfolio Manager, US investment manager ($800M EAUM)*
- "You can most definitely see that the higher levered companies are being punished. That is typical of these downturns. It is easy to screen things for debt and make a move first then ask questions later and so there are a lot of irrational moves in these types of markets. At times like

these it is actually very difficult to differentiate between the companies that are legitimately distressed and those where there may just be an overreaction. **It is a tough situation and will be hard for management teams to address. But, if companies were being prudent ahead of the storm, they will get through to the other side.**" *Analyst, US investment manager ($1T EAUM)*

- "I think that buybacks are often ill thought out at the best of times. For example, I believe the buyback activity within the S&P 500 peaked between July and August 2008. When the credit market was on its back and share prices were heavily depressed, nobody was buying back any shares anyway. **In other words, regarding share buybacks, management teams are open to the same kind of irrational exuberance as investors. What I would prefer is a more flexible approach which has less focus on buybacks unless there is a very clear and well-articulated view on where the buyback adds value and where it does not.** One company in my universe has a CFO that in their interim statements will tell people the extent to which buybacks are accretive to shareholders or not. But, generally speaking, I tend to prefer buybacks and dividends or special dividends as the way to return capital to investors. Everything else regarding capital allocation has to be focused on building the business." *Analyst, UK investment manager (>$100B EAUM)*

Similar to their expectations for the companies they invest in, a few respondents take a long-term approach to evaluating capital allocation decisions, and therefore do not overemphasize short-term influences (such as COVID-19) in their assessments.

- **"I am a long-term investor so what is happening in the market does not change my view on the way that companies should approach capital allocation decisions.** We expect this to be a few months effect and not a long-term issue. Therefore, companies have behaved appropriately. But I am always generally wary of companies that have leverage that is too high." *Portfolio Manager, US investment manager ($30B EAUM)*
- **"We always look for high quality companies that we believe are below fair value.** From that perspective, it does not change our view of how companies should approach capital allocation decisions. But everyone is obviously being a little more conservative than usual." *Analyst, US Hedge fund ($100M EAUM)*