Saturna White Paper: Sustainability Series

On The Same Side, But Not The Same Page

Fixed income and equity investors might share the same side of a company's balance sheet, but they are not always on the same page when defending their interests. What's considered good for equity shareholders isn't necessarily favorable for creditors of the same enterprise. The recent surge in shareholder activism highlights where bondholder and shareholder interests may be diverging. Consequently, fixed income investors will need to heighten their awareness of factors that affect risk, performance, and valuation differently among these asset classes.

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Continuous Tension Between Stakeholders?

Equity shareholders are highly motivated to extract maximum value, but creditors and bondholders are often intent on preserving fiscal integrity. Shareholder demands, such as the popular call for stock buybacks, may brew further imbalances that require creditors to think differently and more broadly about their vested interests. "Bond King" Bill Gross of Janus Capital Group offers a pointed example of a continuous tension between stock and bond owners, noting that, "because of low interest rates, high quality investment-grade corporations have borrowed hundreds of billions of dollars, but instead of deploying the funds into the real economy, they have used the proceeds for stock buybacks." Further, corporations have authorized $1.02 trillion in stock buybacks so far in 2015, surpassing 2007's former record of $863 billion.[1]

Integrated finance, which incorporates close examination of a firm's environmental, social, and governance (ESG) record, can help shed light on risks left in the shadows by traditional bond rating methodologies. This approach precludes the notion that risk is constant across debt and equity issues for the same enterprise.

Long-term investors, regardless of asset class, seek firms that demonstrate favorable fiscal and operating performance while simultaneously employing good stewardship characteristics in matters of corporate governance and broad stakeholder engagement. As equity investors embrace activist tactics designed for short-term gain, the burden of due diligence falls heavily on risk-conscious fixed income investors.

Structural Differences and Respective Interests

The economic benefits accruing to each asset class are subject to different rewards and risks inherent to the asset's legal structuring within an enterprise. Equity shareholders are owners of the firm aligned in maximizing enterprise value. In most instances, they receive shareholder voting and advocacy engagement rights. Shareholders also retain a final claim to any economic value in an enterprise following a bankruptcy. On the other hand, creditors are lenders of capital whose claims are senior to those of equity shareholders in bankruptcy. Creditors' corporate advocacy is limited in scope to fiscal and governance covenants aimed to protect the lenders and their interests.

Unlike equities, which are structured to remain outstanding as long as the company remains publicly traded, fixed income securities can have stated maturities ranging from days to multiple decades. Effectively predicting ESG risks over long periods, such as 10 to 20 years or longer, is elusive, yet creditors fund long-term debt issues without the ongoing governance advocacy or engagement benefits extended to equity stakeholders.

Writing for the Boston Federal Reserve Bank, Charles P. Normandin and Robert E. Scott offer a constructive framework for legal interpretation of how shareholders' and creditors' interests are served differently from a corporate governance perspective. They identify that "to understand the legal regulation of debt and equity in contractual terms, it is useful to think of two different contractual paradigms – discrete or complete contingent contracts on the one hand and relational contracts on the other." Creditors form contractual relationships with the debtor establishing "contract rules," that is, forming specific covenants that embody the tenure of the engagement.[2] While corporations must honor their contractual commitment to creditors and refrain from fraud or other conduct violations, creditors are "not entitled to the corporate fiduciary protections enjoyed by stockholders, and…creditors should protect themselves against self-interested issuer action by bargaining for appropriate contractual provisions."[3] Absent clairvoyance, creditors may find themselves in a difficult position attempting to ensure protection against matters that may develop well down the road.

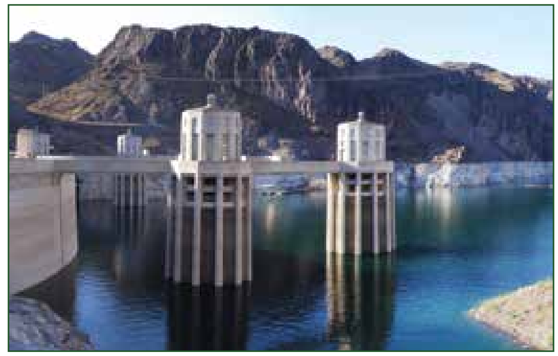
With equity shareholders, the terms of the engagement involve an ongoing contractual relationship best characterized as long-term and open-ended. As such, neither the firm nor its shareholders can appropriately assign risk to all future circumstances. Normandin and Scott point out that future uncertainty invokes a "legal default rule" forming a general fiduciary obligation where managers must act in good faith to maximize the joint interests of equity shareholders and the corporation's governing officers.[4]

In light of the standing legal framework, the authors introduce the notion that creditors' terms of engagement may also have relational qualities: "Creditors are providing a range of equity-like contributions to the firm – contributions that cannot be priced out accurately in the initial debt instrument." This point appears to have added weight, particularly when considering long-dated maturities, which by their very nature potentially increase creditors' exposure to materially adverse ESG and other factors.

Example – Water and ESG considerations

While conceptual discussions help set the stage, examples better explain the relational characteristics present in long-dated debt issues and how ESG considerations can broaden a creditors' risk perspective.

The national credit rating agencies (CRAs), such as S&P, Moody's, and Fitch, aim to provide guidance to investors regarding an entity's fiscal standing and relevant risks but does yet not fully integrate explicit material ESG factors into their rating processes. The utility sector offers a cogent example of the importance of considering environmental factors when assessing municipal debt: with parts of the country experiencing extraordinary drought conditions, some water districts are contending with legislative mandates restricting water consumption.



Lake Mead Reservoir, serving parts of Arizona, California, and Nevada – 2005 (above) and 2015 (below)

Bond Buyer, a national municipal bond association which tracks new issuance trends and offers information on the municipal bond market, notes that utilities issued more than $38 billion in bonds in 2014, and $116.5 billion over the last three years.[5] The CRAs' practice of excluding material ESG considerations unnecessarily places investors in a perilous position of taking on greater risk within an asset class primarily used for preservation of principal.

A few organizations have expressed concerns regarding the CRAs' exclusion of material environmental factors. In its November 2014 communication on water utilities, the US Environmental Protection Agency offered its view:

> *"For investors who purchase utilities' debt obligations, evaluation of a utility's operational risks as they relate to the probability of defaulting on debt repayment, typically over a five to 30-year timespan, is critical to the credit assessment process and their ability to make financially sound investments."*[6]

Ceres, a nonprofit organization offering a collaborative platform that promotes the importance of ESG factors to investment professionals and corporations, also articulated concerns and its own recommendations regarding the elevated financial risks in the utility sector in a 2010 report titled "The Ripple Effect: Water Risk in the Municipal Bond Market."[7]

Intel identifies its water usage as a key material ESG risk of its ongoing operations and maps its own water footprint

– in excess of 8 billion gallons in 2014 –

to include water usage among its supply chain partners and energy providers.

While the CRAs appear to have little concern for material nonfinancial ESG factors, some firms are taking initiative to introduce greater visibility of ESG factors in their corporate reporting. In the semiconductor industry where water is an essential input, Intel offers a sage example by tracking and reporting water consumption in its corporate responsibility reports. The company communicates detailed analysis of its water consumption, recycling, and strategic thinking on how to preserve this precious and essential commodity. Intel identifies its water usage as a key material ESG risk of its ongoing operations and maps its own water footprint – in excess of 8 billion gallons in 2014 – to include water usage among its supply chain partners and energy providers. In 2014 the company internally recycled approximately 3.9 billion gallons of water, the equivalent of approximately 47% of its total water usage.[8] This example underscores the importance of knowing how companies manage externalities as an essential part of a comprehensive financial credit review.

Will creditors begin to engage management on broader ESG considerations if ESG factors can be incorporated into the protections offered under the current legal and contractual framework? Market practices will not likely adopt ESG covenants any time soon, in part because traditional credit analysis has yet to formally accept broad ESG considerations. Such measures may gain greater acceptance – particularly in industries with heightened exposure to risks that affect credit performance.

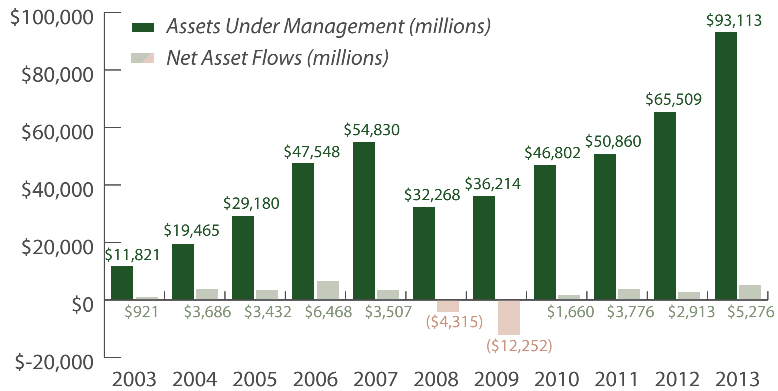
Market Pressures and Decaying Mutual Interests

There appears to be a growing trend originating from the external forces of equity activism, particularly from the hedge fund community, in which shareholders attempt to extract maximum value from a firm while exploiting creditors' inherently passive contractual stature.

A 2014 article by Chris Plath, vice president and senior analyst of Moody's Investors Services, titled "Shareholder Activism, Impact to North American Corporate Sectors," paints a foreboding future for creditors:

> *"Shareholder activism has been gaining ground in North America since about 2011 and shows no sign of losing momentum… Activism is rarely good news for creditors. In the majority of cases those agitating for change are hedge funds that pursue initiatives aimed at carving out value for shareholders."*[9]

Activist Funds Have Been Magnets for New Investor Money



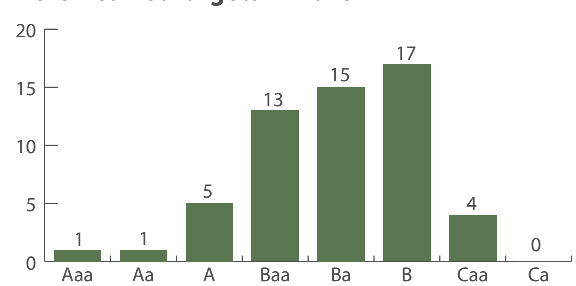
Source: Hedge Fund Research, Moody's Investor Services

Interviewed for a 2015 article published by Bloomberg, Plath further points out that equity activists are lured by the "huge cash pile" on the balance sheets of US nonfinancial companies, which amounted to $1.65 trillion as of October 2014. This year is shaping up as a banner year for equity activism. Investors in 2015 have so far targeted 54 companies, up 25% over the same period in 2014, which saw a record total of 222 companies subjected to activists' demands.[10]

Hedge fund equity activism oftentimes seeks a dramatic shift in a corporation's strategy toward more aggressive tactics aimed to enhance short-term results. This places creditors in a more perilous position than at the time of the debtor's original issuance. Some of the strategies employed include special dividends, increases in share buybacks, divisional spin-offs, or broad-scope changes to corporate governance policies such as compensation.

Typically, activism focuses on speculative-grade companies. However, the combination of growing hedge fund activism and the era of large corporate cash balances in the post-global financial crisis era has attracted some equity investors to engage larger, well-established investment-grade companies. According to Moody's, in 2013 approximately 65% of the activism engagements occurred in the speculative credit group with the remaining engaged in the investment-grade space.[11]

Companies Across the Credit Spectrum Were Activist Targets in 2013



Source: Moody's Investor Services

In an ironic twist, equity activism can put investment-grade creditors at higher risk than high-yield creditors. High-yield bond issues tend to attach more complex and onerous covenant terms to ensure credit performance and the return of creditors' capital than the issues of their larger, more established investment-grade counterparts.

Successful high-profile cases of equity activism embolden shareholders to extract greater value and enhance returns, targeting such large firms as Apple, rated Aa1 by Moody's, which has some $147 billion in cash and cash equivalents.[12] With its large overseas cash position subject to onerous taxes if repatriated, Apple responded to shareholder engagements by issuing its first debt offering to fund share buybacks, along with a dividend.

Other less high profile engagements have led to credit rating deterioration for the firms involved. In 2013 Moody's downgraded ADT Corporation (Ba2 stable), BMC Software, Inc. (Caa1 stable), and Nuance Communications, Inc. (Ba3 stable) in conjunction with responses to activist pressure.[13]

These examples point to a growing trend of external pressure on senior corporate managers to improve equity shareholder performance, a measure often tied to their overall compensation packages. Under these circumstances, the temptation to take on questionable agency behaviors can be overwhelming, often to the detriment of creditors.

In another case, equity shareholders' concerns regarding PepsiCo's poor performance prompted activist investor and hedge fund manager Nelson Peltz to aggressively seek a breakup of the company's snack food and beverage segments. PepsiCo vigorously resisted, opting to pursue an equity-friendly agenda of share buybacks that altered its leverage profile and ultimately led to a Moody's downgrade.[14]

A Viciously Circuitous Trend

As corporate executives seek measures to offset increasing shareholder activism, they engage in defensive strategies aimed to thwart these undesired attacks. As a result, tactics once popular in the 1980s, such as poison pills and golden parachutes used to discourage activism by attaching financial penalties, appear to be back in vogue. Most publicly traded companies incorporate in the state of Delaware where corporate governance laws permit senior managers and board members to enact poison pill policies without a shareholder vote as a quick defense remedy. For example, the famous auctioneer house Sotheby's recently responded to aggressive activism initiated by Daniel S. Loeb and his Third Point hedge fund by forming a low-threshold poison pill that effectively eliminates ownership by any single investor in the company. Sotheby's strategy establishes two threshold limits for ownership — a 20% limit for passive investors, such as mutual funds, and a 10% threshold for activist shareholders. The poison pill lasts only a year, but it can be renewed at will.[15]

In broad terms, research has found corporations that employ a greater number of takeover defenses tend to have poorer equity performance, due in part to the protection they may provide to entrenched management teams. However, there remains limited academic research examining the impact on debt performance. A December 2004 Moody's study titled "Takeover Defenses and Credit Risks" examines equity and credit performance with respect to takeover defenses. While the scope of the article focuses on credit risk, the findings offer a potentially different view of takeover defenses as creditor-friendly. Most defenses, Moody's explains, have been employed by higher risk firms attracting a premium from fixed income investors who seek the presence of these defenses against predatory equity activists. However, the article also points to findings that a higher number of takeover defenses are associated with higher downgrade and default rates.[16]

In the study, the authors examined 1,058 firms and found with statistical confidence that "downgrade rates are likely to be both economically and statistically more meaningful than the results for default rates, especially for the investment-grade firms." In addition, the probability of a downgrade increases as the number of takeover defenses increases for all rating categories. For issuers rated single A or below, as well as for investment-grade and speculative-grade credits in aggregate, "high" firms were more likely to be downgraded than "middle-low" firms.[17] Moreover, firms are less likely to obtain a credit upgrade. The authors do stress the hazard of broadly interpreting a negative credit outlook, because defenses employed by firms continue to change. Results based on previous years might not hold in the future, and a more pragmatic approach would entail a case-by-case examination.

The authors also caution against a carte blanche approach to interpreting the effects of enhanced hedge fund activism and suggest fixed income investors take heed that the post-global financial crisis era is not a creditor friendly environment. The aggressive persistence of equity activists and the defense tactics employed by corporate managers appear to form a vicious cycle at creditors' expense, with each action leading to a potentially weaker fiscal profile from a fixed income investor's perspective.

Conclusion

While fixed income and equity investors share the same side of a company's balance sheet, evidence clearly shows they are not always on the same page when it comes to self-preservation. Creditors do not enjoy the relational benefits offered to equity shareholders, which restricts their ability to adjust effectively to future circumstances and reassign risks throughout the debt contract.

Examination of ESG factors as an essential part of fixed income investment analysis can improve assessment of future risk. Unknown future risks, such as those arising from resource utilization, and their related potential impact on credit performance stresses the importance that creditors seek debt issues where management offers transparent guidance on its strategy. Ideally, management should demonstrate a desire to identify matters likely to create adverse ESG impairments down the road and a willingness to adjust internal operations accordingly. Broad stakeholder engagement strategies that extend beyond equity shareholder engagement may suggest that the respective management team is taking into consideration a more holistic view of enterprise value. The simple added emphasis is identifying firms that do not remain silent on material nonfinancial ESG matters.

The application of integrated finance within the context of ESG fixed income investment management remains nascent. As investors respond to difficult lessons learned, however, they may begin seeking proactive standards that satisfy contractual obligations without the need for expensive legal battles and within such an atmosphere, ESG covenants could become as common as intererst coverage or leverage ratios.

Footnotes

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He holds a BA in economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder (CFA) and a Certified Financial Planner®. Mr. Drum has nearly twenty years of investment experience in serving institutions and private clients.

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