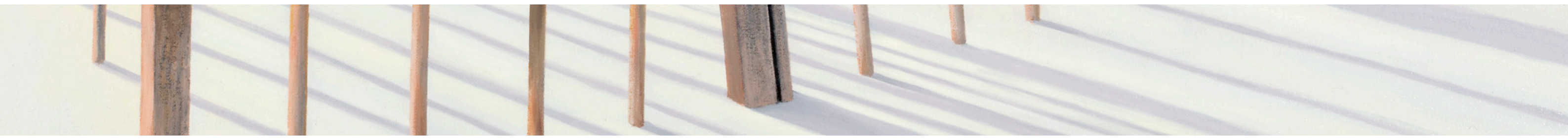
A QUESTION OF BALANCE

FIRST PUBLISHED 13 MARCH 2020

Raising debt may seem like a logical response to an environment where interest rates are at record lows. Walter Scott Investment Director Charlie Macquaker assesses the risks within that all-too-common assumption.

CHARLIE MACQUAKER
Executive Director – Investment



At Walter Scott, one of the tenets by which we judge the companies we meet is whether they have control over their own destiny. In a rapidly changing world, such businesses are hard to find. To have that control they need to be market leaders, they need to be adaptable and, critically, they need to be financially resilient.

Excessive gearing can affect that resilience, especially if the debt is ill-used. And when we look around, there is increasing evidence of just that. Leverage used to fund mergers and acquisitions that are based on questionable assumptions about future synergies. Leverage that circumvents traditional lenders, such as banks, in favour of 'shadow banks', whose lending activities are barely regulated. And leverage used to fund share buybacks, which bolster the share price in the short term (and often management remuneration too) but often do nothing for the long-term health of the business.

As a training exercise with younger members of our Research team, we looked in-depth at the group's annual report and accounts, which showed that Thomas Cook's demise was an accident waiting to happen.

This type of borrowing activity may seem logical, when interest rates are low and businesses are ticking along. But it makes companies much more vulnerable when problems arise – and they do.

Take Thomas Cook, the travel and airline group that collapsed spectacularly last year beneath a £1.7 billion debt mountain. This business was geared to tourism trends, geared to the airline industry and heavily geared financially.

Of course, hindsight is a wonderful thing but, as a training exercise with younger members of our Research team, we looked in-depth at the group's annual report and accounts, which showed that Thomas Cook's demise was an accident waiting to happen. The balance sheet was piled high with debt and littered with over-optimistic assumptions around intangibles. Investors were also steered towards adjusted earnings, which often strip out awkward but important elements, such as interest owed.

Thomas Cook was a high-profile case and its end was unfortunate but the group's fondness for debt is widely shared.

As the International Monetary Fund noted in a recent report: "Debt has risen and is increasingly used for financial risk-taking, to fund corporate payouts to investors as well as mergers and acquisitions, especially in the US. In addition, global credit is increasingly flowing to riskier borrowers."

The report singles out the US, where we have certainly seen an increase in buybacks, often unnecessary, in our view, particularly when they are funded through debt. But debt is also rampant in emerging markets, particularly China where the risks are even greater, because data is scarce, the shadow banking sector is vast and the state is heavily involved.

As a global investor, we need to be abreast of all these trends.

That is not to say we are against debt on principle. But we want to know that the money is being wisely used.

Chr. Hansen, the Danish food and healthcare business, is a case in point. Its borrowings have risen – and earnings have been depressed – as the group pursues a substantial capital expenditure programme. But that is investment in the future, which should feed through to stronger growth over time. As such, we believe the money is well spent.

Businesses don't grow in a straight line and if revenues and earnings fall for a time and a company is highly geared, that imposes extra strain on the balance sheet and the P&L.

We take a similar stance on mergers and acquisitions. Some transactions are clearly worth pursuing, if they strengthen a company's market position, for example, or add new beneficial technologies. But the risks and rewards need to be carefully assessed, particularly at the top of the market when the premium paid can often outweigh the growth generated.

Highly leveraged buyouts are particularly risky, especially when they rely on inflated assumptions about future synergies to boost the amount borrowed. When those assumptions don't materialise, the edifice crumbles.

In essence, long-term perspective is in short supply when we look across the corporate universe. Only recently, we met a company that had traditionally been very conservatively managed but had begun to gear up, using the cash to fund buybacks and unproven acquisitions. Management was surprised when we questioned this approach. But we believe that it indicates a lack of discipline and a

focus on the here and now rather than the years to come.

For us, it's a question of balance. Businesses don't grow in a straight line and if revenues and earnings fall for a time and a company is highly geared, that imposes extra strain on the balance sheet and the P&L.

So yes, money is cheap and yes, businesses have benefited but conditions can change. Debt levels have already reached or exceeded pre-financial crisis levels, by some measures. And that creates vulnerabilities in the system. Indeed, there is already evidence in the bond markets of increased investor nervousness and a lack of liquidity at the slightest hint of trouble.

Our investment approach is designed to veer away from such problems. We look for businesses with a conservative approach to gearing, businesses that invest for long-term growth not short-term gain and, crucially, businesses that can withstand shocks, if and when they arise.

This article is from Walter Scott's Research Journal 10 (March 2020).

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WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM