CMi2i RESEARCH & INSIGHTS

2009 VS 2020: THE UNFORESEEN PROBLEMS OF OVER-LEVERAGING

BY ANALYSING WHAT HAPPENED TO OVER-LEVERAGED COMPANIES IN THE FINANCIAL CRISIS OF 2009, WE IDENTIFY AN UNFORESEEN CONSEQUENCE OF HAVING TOO MUCH DEBT

THE UNFORESEEN PROBLEMS OF OVER-LEVERAGING

INTRODUCTION

When Coronavirus began to spread across the world earlier this year, most developed economies found themselves in a status of economic and social "lockdown". As a result, companies – and especially those with highly leveraged balance sheets – faced one of the biggest economic hazards ever experienced. With revenues plummeting, the only viable short-term solution they had was to borrow in order to survive. A recent survey shows that companies are expected to issue $1 trillion of new debt in 2020 alone. These firms include junk or near-junk rated companies in sectors that might never recover from the virus's impact.

While more debt can provide immediate reprieve from liquidity shortages, interest still needs to be paid, and debt continues to mature. The credit rating firm S&P predicts that default rates amongst junk-rated European issuers will more than double by June 2021, reaching 8.5%. This effectively means that at least 62 rated companies will fail to meet their obligations over the next 12 months.

But this is not the first time we have witnessed companies borrow deeply en masse. Past crises have taught us that surviving a crunch by over-leveraging can simply be a prelude to further drama, including activist campaigns and hostile take-overs. In this paper CMI2i examines the of over-leveraging by looking at the Euro Stoxx 50 index constituents pre-2007 financial crisis and compare them to the current constituents. **Our analysis shows that those companies that over-geared during this crisis, not only often under-performed but also faced activist campaigns and in a few cases were either taken over or nationalised. Our analysis also demonstrates why corporate executives should not underestimate the link between debt and equity – and not just during a financial crisis.**

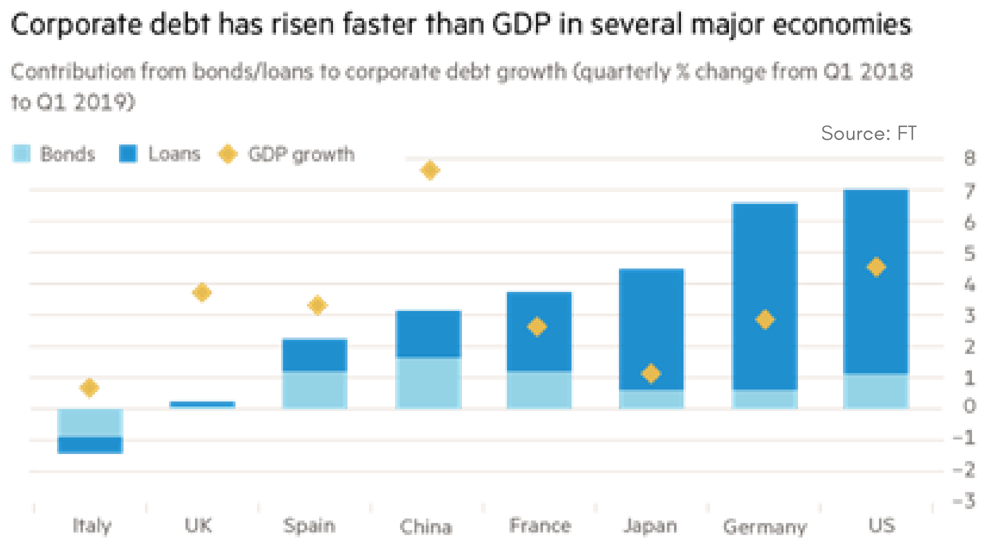
WILL THE COVID CRISIS TURN INTO A DEBT CRISIS?

The corporate borrowing spree throughout the first half of 2020 primarily served to ensure the survival of cash-strapped businesses. Aided by the support of central banks and government stimulus packages that have stabilised market conditions, these corporates have enjoyed surprisingly low borrowing costs.

Nonetheless, for most bond investors this debt binge is worrying. As M&G's famous blog, Bond Vigilantes points out, "conventional wisdom has it, that a bond issuer, when adding financial leverage through debt-financing, becomes more vulnerable, which in turn increases the riskiness of its debt instruments and puts downward pressure on its credit rating". The fact that most of these companies entered this crisis with already lofty levels of debt, only makes it more worrying. A recent OECD report shows that the global outstanding stock of non-financial corporate bonds reached an all-time high of $13.5tn by the end of 2019, double the level in real terms compared to December 2008.

Furthermore, we know that issuing debt to foster liquidity is not a sustainable business model. Over the medium to long-term these issuers must be able to either increase their profitability and deleverage, or struggle with debilitating debt levels that prevent them from reaching their growth potential thus becoming prime **prey for activists or hostile take-overs.**

While most institutional investors still view hedge fund activists as disruptors that should be resisted, there has been a trend towards more passive acceptance of their campaigns. Activists can have a variety of requests when approaching corporates, but one the most frequent demands is for the target issuer to change its capital structure and deleverage.



LESSONS FROM THE PAST – EURO STOXX 50 IN 2009 AND 2020

To better understand the effects of gearing during a financial crisis, CMi2i looked at the constituent companies of the Euro Stoxx 50 in 2007, and compared them to today's constituents using Bloomberg data.

It is notable that half of the 2007 constituents are no longer in the index, suggesting that they have under-performed relatively to their peers. And as expected, the sector hit the most was the financial sector. **Today, the Euro Stoxx 50 constituents are considerably more diverse, and more importantly, less leveraged than before.** The average debt to equity ratio for the EuroStoxx 50 in 2007 was 21.65%, which increased by over 300% to 505.65% by the end of 2009. Those companies from 2007 still have elevated levels of debt, with Bloomberg data showing a debt-to-equity ratio of 202.45%. Conversely, the average debt to equity ratio for today's Stoxx50 constituents is a more modest 152%.

While there are various reasons why so many of the 2007 constituents have dropped out of the index, our data shows that in most cases those who increased leverage significantly during the crisis subsequently dropped out of the index. For example, 8 out of the top 10 companies that had the highest debt to equity ratio by the end of the financial crisis, are no longer members of the index (Table 1). Several of these companies have since tried to deleverage but not all have been successful. Some of these issuers, like HBOS no longer exits, while RBS and Lloyds were forced to accept government bailouts.

Name	31/12/2009	Still in the index	Activist Campaign Recipient*
BT Group PLC	8228.99%	NO	YES
Credit Suisse Group AG	1514.88%	NO	YES
HBOS PLC	1417.03%	NO	Taken over
BNP Paribas SA	1339.05%		
Barclays PLC	1032.63%	NO	YES
Societe Generale SA	890.34%	NO	YES
RBS Holdings NV	828.12%	NO	YES
Deutsche Bank AG	820.85%	NO	YES
Lloyds Banking Group PLC	810.30%		YES
ING Groep NV	760.31%	NO	YES
Average	1764.25%		
Median	961.48%		

Table 1: Top 10 2007 Euro Stoxx 50 ranked by debt to equity ratio (%) end 2009

*Activist Insight defines shareholder activism as the active influence on company policy and practices by a shareholder in that company, including all forms of activist investing and shareholder engagement, from meetings with management to proxy contests.

THE UNFORESEEN PROBLEMS OF OVER-LEVERAGING

Ranking the constituents by their current debt to equity ratio paints a similar picture. Six out of the top 10 issuers are no longer constituents (Table 2).

Name	Today	Still in the index	Activist Campaign Recipient*
Telefonica SA	655.28%	NO	
Societe Generale SA	635.23%	NO	YES
Credit Suisse Group AG	630.24%	NO	YES
UniCredit SpA	532.45%	NO	YES
Banco Santander SA	481.16%		
Deutsche Bank AG	406.16%	NO	YES
BNP Paribas SA	403.84%		
Banco Bilbao Vizcaya Arge	384.97%	NO	
Lloyds Banking Group PLC	370.22%		YES
UBS AG	360.54%		YES
Average	486.01%		
Median	443.66%		

Table 2: Top 10 2007 Euro Stoxx 50 ranked by debt to equity ratio (%) today

*Activist Insight defines shareholder activism as the active influence on company policy and practices by a shareholder in that company, including all forms of activist investing and shareholder engagement, from meetings with management to proxy contests.

THE ACTIVISM CONSEQUENCES OF TOO MUCH DEBT

What is perhaps more interesting, is how many of these companies have subsequently been subjected to activist campaigns.

Using data from Activist Insight shows that 31 out of the Stoxx50 constituents from 2007 have been subjected to activist campaigns. The number of activist campaigns among the most leveraged companies in 2009 is even higher – eight out of ten had to fight an activist campaign, while one further company was taken over (Table 1). From BT to Barclays, several for these issuers have had to navigate very difficult and public campaigns. **Other factors will have influenced activists in deciding which issuers to target, and it is safe to say that companies that are highly leveraged share more than that single characteristic. But there is certainly a correlation between companies' over gearing during a crisis and then subsequently becoming a target for activist campaigns.**

Interestingly, research shows that while activists might not strike during a crisis, they will during the recovery phase. During 2007 crisis, activists went quiet but came back strongly in the immediate aftermath to target the companies left exposed by the crunch, both in terms of performance and governance. According to Activist Insight, DEFC filings, which are seen as the best proxy for activist campaigns, reached new records in the first half of 2009. Lest history repeat itself, companies should continue to be wary of potential activists as the Covid-19 crisis continues to unfold. Especially as the number of current activist campaigns related to balance sheet demands appears to be increasing (in the US, they are now up 2% year on year).

1-YEAR ROLLING TOTAL OF DEFC14A FILINGS

Rolling 365 day total number of DEFC14A filings filed, versus 365 day change in the S&P 500 index.
Source: Activist Insight Online

CONCLUSION

By most accounts 2020 has so far proven to be a quiet year in terms of public activist campaigns. However as with the global financial crisis in 2007-2008, companies should not be complacent nor underestimate the dangers of creating the perfect conditions for shareholder activism. While leveraging can be a short-term fix, it can also create future problems down the line. **Luckily, with a clear understanding of who bondholders and shareholders are, issuers can better control the narrative, help ensure fair valuation, and identify activists before it is too late. Underestimating the relationship between debt, equity and investors across both asset classes, may prove to be none less than a fatal mistake.**

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APPENDIX

1. EUROSTOXX 50 2007 CONSTITUENT LIST

BAgeas SA/NV
BT Group PLC
Credit Suisse Group AG
HBOS PLC
BNP Paribas SA
Barclays PLC
Societe Generale SA
RBS Holdings NV
Deutsche Bank AG
Lloyds Banking Group PLC
ING Groep NV
Natwest Group PLC
Banco Bilbao Vizcaya Argentaria SA
UBS AG
UniCredit SpA
Banco Santander SA
Roche Holding AG
HSBC Holdings PLC
Telefonica SA
Diageo PLC
Daimler AG
Carrefour SA
GlaxoSmithKline PLC
Aviva PLC
Deutsche Telekom AG
Orange SA
Assicurazioni Generali SpA
Tesco PLC
Allianz SE
E.ON SE
BASF SE
Unilever NV
Siemens AG
Societe Lyonnaise Des Eaux Et De L'eclai
Anglo American PLC
Eni SpA
AstraZeneca PLC
Rio Tinto PLC
TOTAL SE
Nestle SA
Vodafone Group PLC
Nokia Oyj
AXA SA
BHP Group PLC
BP PLC
Koninklijke Philips NV
Royal Dutch Shell PLC
Novartis AG
Telefonaktiebolaget LM Ericsson
SAP SE

2. EUROSTOXX 50 2020 CONSTITUENT LIST

Rio Tinto PLC
L'Oreal SA
Vinci SA
Banco Santander SA
ASML Holding NV
TOTAL SE
Air Liquide SA
AXA SA
BNP Paribas SA
RELX PLC
LVMH Moet Hennessy Louis Vuitton SE
Kering SA
Safran SA
National Grid PLC
Royal Dutch Shell PLC
Unilever NV
Iberdrola SA
Unilever PLC
Linde PLC
GlaxoSmithKline PLC
ABB Ltd
Novo Nordisk A/S
AstraZeneca PLC
Reckitt Benckiser Group PLC
Nestle SA
Novartis AG
Roche Holding AG
Intesa Sanpaolo SpA
UBS Group AG
Zurich Insurance Group AG
Diageo PLC
HSBC Holdings PLC
Anheuser-Busch InBev SA/NV
Vodafone Group PLC
British American Tobacco PLC
Sanofi
Enel SpA
Lloyds Banking Group PLC
Schneider Electric SE
Allianz SE
Airbus SE
Bayer AG
BASF SE
Siemens AG
BP PLC
SAP SE
Deutsche Telekom AG
Daimler AG
BHP Group PLC
Prudential PLC

CONTACT

21-26 Garlick Hill
London EC4V 2AU
sales@cmi2i.com
+44 (0) 203 824 1450
www.cmi2i.com

AUTHOR

MASSIMILIANA SMITH
Head of Debt Intelligence Services
massi@cmi2i.com

ABOUT CMi2i

We are specialists in Bondholder ID, engagement and vote solicitation, providing:

- Unparalleled forensic equity and debtholder identification
- Preparatory Risk Analysis
- Governance & Regulatory Analysis
- Share & bondholder outreach, mobilisation and vote solicitation

CMi2i provides the most accurate Bondholder identification available due to our unique methodology. We work closely with institutions, corporates and their advisors and have provided insights on over 1000 Corporate Transactions, Proxy Battles and Activist Defences, where accurate owner & decision maker mapping and technical knowledge is a critical part of success.

CORE TEAM

The CMi2i core team have worked together for over a decade, performing bondholder and shareholder identification and mobilising holders to vote in support of proposed issuer items at AGMs. We have worked for more than 500 of the largest companies across the globe on over 1000 corporate transactions, proxy battles and activist defences, and 1200 general meetings.

MARK SIMMS

Founder and CEO

MASSIMILIANA SMITH

Head of Debt Intelligence Services

NIC BENNETT

Senior Strategic Communications Advisor

RICHARD RACZ-CLARKE

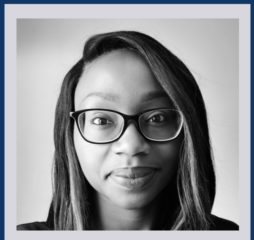
Managing Director
Business Development

AUDRA OLIVER

Head of Communications

ISSY BRIAULT

Head of Institutional Sales



NANCY HAMENI

Head of Proxy Solicitation

LAURENT MUZARD

Senior Debt Analyst

SIMON BRAY

Director & CMI Advisory

DANIEL STROMGREN

Head of Forensic Analytics