River Valley Asset Management

July 2014
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The "hidden hand" supporting US markets – the US corporates

Conventionally a company buying back its own stock was a good sign. It indicated the confidence of management in its own future outlook and also indicated an ability to generate good free cash flow. But this logic has also fallen prey to the "low interest rate" environment whereby old incentive structures have been corrupted.

Today (even after a 4-year bull run) the largest buyer of US equities are the companies themselves. More alarmingly this is being funded by borrowings. Increasingly this is secured bank borrowings (unlike the past where it was funded by unsecured bond borrowings).

The environment incentivising this consists of a few salient points:

- Availability of cheap debt funding
- A poor outlook for growth leading to less expense on capital expenditure, R&D or salary increase
- Continuous pressure on management to show EPS growth to justify high valuations. Also, top management compensation is linked to EPS growth.

Some interesting anecdotes to support this observation are:

- **In 2013 corporate America returned 5.75% of starting market cap to investors:**
  In 2013 the stocks in the Russell 3000 (which is 98% of the total listed market in the US) bought back 3.33% of the market cap on January 1, 2013. In addition the dollar value of the dividend paid out in 2013 was another 2.4% of this starting market cap. This is a large return of capital to investors and is a strong support for the market.

- **This trend was more pronounced for larger stocks:**
  Doing the same exercise for the Dow 30 stocks, the buyback is 5.5% of the starting market capitalisation. Another 2.7% was given out as dividend. The point we are making is that for the larger stocks (which drive the index), the support from buy backs and cash dividends is even larger.

- **Cisco, AT&T, Pfizer are typical examples of such large caps**:
  Large cap companies like Cisco got a board authorisation to buy back USD 15 bln of stock. The incentives for this were the same as mentioned above. To put this in perspective, the market cap of the company at that time was only USD 105 bln. Its profit for FY2013 was USD 10 bln and free cash generation was USD 11.7 bln. Also, its annual R&D spend was USD 6 bln. This is a "technology company" which claims to be at the cutting edge of innovation but these numbers look more like that of a low growth monopolistic utility. Company after company like AT&T, Pfizer and others have a similar story to tell.

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- **Many are borrowing to fund this return to shareholders**:
  Of the three companies mentioned above, two - AT&T and Cisco - have already started seeing an increase in net debt while they are returning cash to shareholders. Thus this return to shareholders is being debt funded. This, as far as the impact on the market is concerned, is not very dissimilar from promoters in emerging markets borrowing against their shares to buy back their own stocks.

- **Smaller companies are more dangerous, for example Tupperware**:
  A smaller company that we were (initially excitedly) looking at recently – Tupperware – showed a more alarming trend. This was a USD 3 bln market cap company on January 1, 2011. In the following three years (2011-13) the company bought back USD 924 mln of stock and gave out an additional dividend of USD 267 bln – a total return to shareholders of USD 1.191 bln. This was nearly 40% of its starting market cap. More importantly how was this funded? The company, over these three years, generated USD 661 mln of free cash flow and funded the rest by increasing its net debt by USD 530 mln. It turned from a safe company with net debt/capital of 15% in 2010 to a riskier one with 65% net debt/capital at the end of 2013. This is possibly symptomatic of many mid-sized companies in the US.

- **Cheap funding and low growth driving this**:
  What made this possible? It is simply a carry trade between earnings yield of the stock and its cost of borrow. The average cost of borrow for Tupperware is about 5.5%. With its forward earnings yield between 6-9% over the 2011-2013period, this equity to debt swap was an EPS enhancing activity. But as the cost of borrow starts rising over the next few years and with the current earnings yield already below 6.5%, this carry trade will make less sense. Consequently the largest buyer of Tupperware stock over the past three years will suddenly have stepped out of the market. What will happen then?

Conclusion

Over the past few years corporate America has been the largest buyer of its own stock. Combine this with the money returned as dividend (part of which is reinvested in the market) and the funds used to purchase each other's stocks (in the form of M&A) and we conclude that corporate America has been the supporter of the US market in the last three years.

The liquid corporate balance sheet, which the Fed was hoping would be used to start an investment cycle, was instead used to support the stock market.

This partly explains the strong performance of the US markets in spite of consistent negative surprises on GDP growth and corporate earnings.

With interest rates potentially rising and corporate leverage now higher than it was two years ago, this support for the market is going to reduce, if not vanish.

Hence our cautious view on developed markets' equity returns.

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