We can all get along

Part I: Why bondholders and long-term shareholders can jointly engage companies

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In this two-part paper, we assert that the shared interests of bond and shareholders in companies provide incentives to jointly engage companies – and generate positive outcomes by doing so. In this first instalment, we dispel the fallacy that the imperatives of bond and shareholders typically diverge, and argue that their common standing as financial stakeholders gives them the legitimacy to engage corporate boards and management teams to encourage sustainable growth and long-term value creation.

To challenge the long-running argument that investors in bonds – and all types of credit instruments, for that matter – and shareholders have diverging interests that preclude them from engaging with companies on the same concerns, we make two key points.

01 **First, the financial stakes** held in companies by bond and long-term shareholders gives them the legitimacy to engage – and, arguably – an obligation to do so.

02 **Second, the interests of financial stakeholders** in the sustainable growth and long-term health of businesses are substantially aligned, enabling them to jointly engage companies.

We believe that companies which undergo successful engagements are likely to achieve a lower cost of capital, which supports investment performance, and impact society more positively. This combination of benefits for investors, companies and society creates the holistic returns that we aim to generate.

For the purposes of this paper, we speak of bondholders' interests for the sake of simplicity, but believe that our argument supports all creditors – whether they manage direct-lending, syndicated-loan, real-estate debt, asset-backed security or other fixed-income strategies. In addition, we assume the case for integrating environmental, social and governance (ESG) risks into investment decisions and engaging with companies has been won. Numerous studies – including several that we have conducted or participated in – show that the integration of ESG analysis, combined with active engagement, benefits multiple stakeholders.[1] In this paper, we aim to advance the discourse on investor stewardship by specifically addressing the concern that there are conflicting interests between shareholders and bondholders that prevent them from engaging with companies on a range of issues in the same way.

Before we begin to address this shared legitimacy, we must first clarify what we mean by engagement. The Principles for Responsible Investment (PRI) defines it as: "…interactions between the investor and current or potential investees on ESG issues. Engagements are undertaken to influence (or identify the need to influence) ESG practices and/or improve ESG disclosure".[2] We agree with this definition, in principle, but believes that effective engagement typically requires much broader and deeper involvement – including on strategy, risk management and operational performance.

In part one of this paper, we will focus on the legitimacy of bond and shareholders to engage, as financial stakeholders, on ESG and other factors influencing a company's sustainable growth and its ability to create value. Because financial policy and the allocation of capital are generally regarded as topics where the interests of bond and shareholders diverge, we consider these arguments and provide some relevant case studies. In part two of this paper, we will focus on the engagement process itself.

1 The financial stakes held in companies give bond and shareholders the legitimacy to engage – and arguably an obligation to do so

The rights of bondholders and other creditors are specified in the contractual relationships set out in bond prospectuses or loan documents. Among these rights are debt service, rights to financial reporting, claims on assets and the ranking priority of claim in an insolvency scenario. In contrast, the relationships that shareholders have with companies are much less comprehensively defined in the contracts between the parties, such as the company by-laws or articles of association. That said, shareholders have formal voting rights as a means of influencing the companies in which they invest, enabling them to elect members of the board and to vote on material transactions. Moreover, they are entitled to the residual value of the company. Given these differences in legal rights, some market participants erroneously believe that only shareholders have a legitimate expectation to engage with companies.

We argue that the legitimacy to engage with companies on ESG issues as well as strategy, risk management and operational performance is predicated on the financial stake possessed by the bond or shareholder. Bondholders – like shareholders – have a financial stake in the companies on

1 See, for example: "ESG Shareholder Engagement and Downside Risk (Working Paper)," by Hoepner A., Oikonomou I., Sautner, Z., Starks, L.T., and X. Zhou, published in January 2018; "Active Ownership," by Dimson, E., Karakas, O., and X. Li, published in 2015 by the Review of Financial Studies, 28(12), 3225-3268; "Activism on Corporate Social Responsibility," by Barko, T., Cremers, M., and L. Renneboog, published in 2017 as an ECGI Working Paper No 509/2017; "How ESG Engagement Creates Value For Investors and Companies," published in 2018 by the Principles for Responsible Investment; and "ESG's Evolving Performance: First, Do No Harm," by Renshaw, A. Ph.D., published in July 2018 by Axioma.

2 "ESG Engagement for Fixed Income Investors: Managing Risk, Enhancing Returns," published in 2018 by the Principles for Responsible Investment.

whose balance sheet their debt resides, and the returns from both debt and equity instruments are ultimately linked to the performance of the underlying company. And, in cases of insolvency, bondholders typically have a stronger claim on the value of the company, providing an incentive to understand and help preserve its drivers of long-term performance. If companies want continued access to the debt markets on reasonable terms, they need to listen to what bondholders have to say about ESG risks and other influential factors.

Moreover, institutional investors that have signed the PRI, or are otherwise committed to investing responsibly across asset classes, aim to integrate ESG and other factors affecting long-term value (reflecting the first PRI principle) and to become active owners once they are invested (to implement the second). As such, we argue that bond and shareholders not only have legitimate cause to engage with companies but also a professional duty to do so.

> **Bond and shareholders not only have legitimate cause to engage with companies but also a professional duty to do so**

2 The interests of bond and long-term shareholders are substantially aligned, incentivising them to jointly engage companies

Sustainable growth and value creation

While there may be tensions on specific issues, and in rare cases conflicts, bond and shareholders broadly seek the same outcomes for companies in which they invest: stable, sustainable growth and value creation for the long term. For shareholders, growth creates value as cash is generated to pay dividends and retained earnings build a company's capital base. After dividend payments, residual earnings shift into the equity account on the balance sheet, serving to strengthen it – which is obviously in the interest of bondholders. As earnings grow and, more importantly, expectations of sustained earnings growth remain, shares increase in value and returns to shareholders accrue as the worth of the overall business grows. At the same time, the company's credit profile will improve, resulting in tighter or more stable spreads.

Figure 1. How value generated by fundamental and ESG factors accrues to bond and shareholders

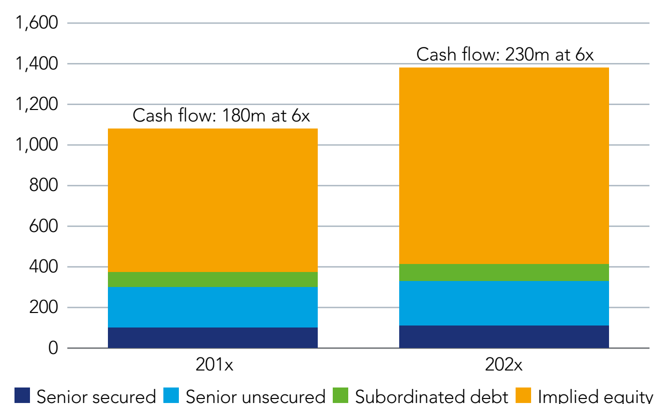
If we combine these two convictions – a shared desire among financial stakeholders for sustainable corporate growth, and the influence of factors, such as ESG issues, in achieving such growth – it becomes clear that all financial stakeholders should prefer companies with improving ESG behaviours. It is in their interests to do so. This alignment should drive them to engage on shared ESG concerns.

The contrasting payoff profiles of equity and debt do not undermine a shared interest in sustainable growth and value creation

The difference in the payoff profile of equities and bonds is sometimes cited as another reason that bondholders engage less on long-term factors, such as ESG issues. The thinking behind this is that because a stock price can theoretically rise in perpetuity, shareholders focus on growth. We do not dispute this. But we do challenge the perception that bondholders are less concerned about growth because their upside is capped by the properties of debt instruments, such as limitations on spread tightening, maturities and call options. Bondholders do seek corporate growth because rising enterprise value increases the difference between financial leverage and the value of the company, creating positive implied equity. This provides a buffer between the full value of the company and nominal value of its debt. In other words, the loan-to-value ratio is falling, therefore decreasing the risk that the nominal value of that debt would somehow be impaired.

This relationship holds for private companies, too. Assuming that the valuation multiple of a business remains the same (or even rises, as might happen with a growing company), any growth in sustainable operating cash flow should result in a higher value for the firm. As with public companies, an increase in implied equity causes credit risk to decline (see figure 2).

Figure 2. Sustainable corporate growth is positive for creditors and shareholders



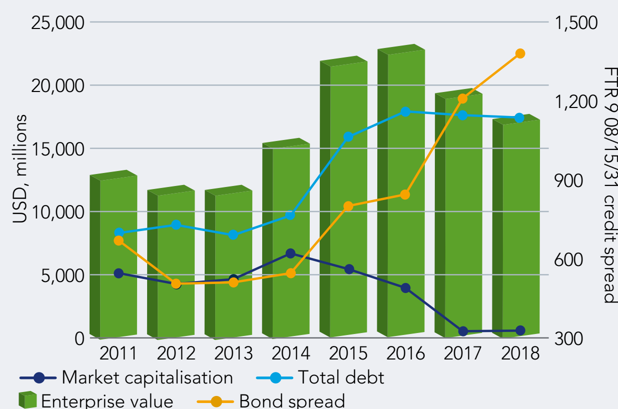
Note: For illustrative purpose only.

In this way, bond and shareholders are mutually interested in a company's growth. That said, any rise in enterprise value must be stable and sustainable: activities that generate growth in a company today must not undermine its future prospects. For example, a debt-driven increase in enterprise value can impair the sustainability of future growth as more and more cash is allocated to servicing debt rather than supporting the company's operations. Telecommunications company Frontier Communications is a case in point.

Inefficient Frontier: Growth of no value

Frontier Communications, a telecommunications provider in the US, has made a series of debt-financed acquisitions in recent years. Throughout this period, the company intended to capture cost synergies through the integration of similar, maturing land-line businesses in an industry undergoing severe secular change. Debt service rose substantially, from $655m in 2014 to about $1.5bn in 2017. As Figure 3 shows, the company's enterprise value is rising. However, this is entirely due to the increase in Frontier's debt burden, as evidenced by its falling market capitalisation. At the same time, the business has not been able to grow into its expanded balance sheet. Today, its market capitalisation is some $500m, having once been nearly $10bn, and the loan-to-value ratio is nearly 100%, having been close to 60% in 2010.

Figure 3. Phantom growth: How debt-fuelled growth in enterprise value can impair both equity and credit



Source: Bloomberg as at 30 June 2018.

Companies may need to lean on their balance sheets to evolve and grow. For example, moderately levered businesses whose operations suffer from structural change in an industry must do what is necessary to evolve and grow again. That may require cash to pay for capital expenditures or an acquisition. In the short term, its new supply of bonds into the primary market could impact the spreads of existing bonds in the secondary market. But if the company generates real growth in the medium-to-long term, those spreads should moderate as the bonds are absorbed and prices reflect the issuer's performance.

Management of ESG and other factors affecting sustainable growth and long-term corporate value

In light of the empirical evidence highlighted earlier, it is imperative for investors to consider the impact of ESG along with other factors affecting the long-term corporate value of underlying companies in their bond and share portfolios, and if necessary to engage companies on these matters.

ESG and strategic factors are relevant to the current and likely future health and value creation of a company, and therefore matter to all financial stakeholders. There is now a convincing body of evidence showing the connection between companies' ESG behaviours and their operating and financial-market performance.[3] Although the cash flows from bonds or loans held to maturity will not alter unless operating cash flows are substantially impaired, unmitigated risks can weaken a company's ability to fulfil its debt-service obligations. That triggers a rise in financial risk, which can put pressure on share prices and, in turn, bondholders as the equity buffer is eroded. So, even if the cash flows remain intact, credit spreads on bonds widen and the prices of the instruments fall, impacting performance. It is therefore clear that poorly managed ESG factors, such as corporate governance, can destroy value for both equity and bond investors, as evidenced dramatically by the financial impact of Carillion's collapse in 2017, which was driven largely by strategic and governance failings.[4]

This is why it makes sense, where possible, to engage companies from the perspective of both the bondholders and the shareholders – both of whom have legitimate cause to engage – and seek a rounded dialogue. While there can be tensions on certain issues and occasional conflicts between these two perspectives – which we will address – the focus of the engagement and its objectives will generally be the same. We engage with companies, not the instruments through which our clients invest in them.

[3] See, for example: "From the Stockholder to the Stakeholder – How Sustainability Can Drive Financial Outperformance," by Clark, G.L., Feiner, A., and M. Viehs, published in 2015; "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," by Friede, G., Busch, T. and A. Bassen, published in 2015 in the Journal of Sustainable Finance & Investment, 5(4), 210-233; and "Pricing ESG Risk in Credit Markets," by Reznick, M. and M. Viehs , published in 2017 by Federated Hermes - International.

[4] For an overview on the causes that led to Carillion's collapse, see "Where did Carillion go wrong?", published on 18 January 2018 in The Economist.

Potential tensions between bond and shareholders

The alignment of bond and shareholders' interests is much stronger than generally assumed. However, there are situations which are often seen as being indicative of a clear difference of interests between the two modes of investment: poison pills and cash outflows from a company.

Poison pills

Poison pills are an anti-takeover protection mechanism common in the US and are also used elsewhere. Traditionally, shareholders oppose them because they effectively preclude a hostile takeover, which can lift share prices in the short term, and the possibility of such an acquisition helps to instill discipline in corporate management teams. In contrast, bondholders may be inclined to support poison pills because they believe that protecting the company from a hostile takeover will prevent further leverage being pumped into the business. We are not convinced that this is an appropriate stance, however. Shareholders do not dislike poison pills simply because they will close the door to a takeover. For long-term investors, the far greater attraction is that removing poison pills ensures that boards are more accountable to their investors and less likely to destroy value within the business. In short, the discipline of more efficiently and effectively managed companies benefits bond and shareholders in the long run.

Capital structure and cash outflows

In our *Responsible Ownership Principles*, we have long argued that "companies should have an efficient capital structure which will minimise the long-term cost of capital."[5] At the same time, we have been clear that determining the appropriate debt-to-equity ratio is a question for the board and not for bond or shareholders, who might of course choose to engage directors on the issue:

> **Companies should seek an appropriate balance of debt and equity. In doing so, they will lower their overall cost of capital, thus helping to improve the returns of shareholders. The appropriate debt-to-equity ratio is a question for the board and depends on the particular business and situation of the company concerned, as well as the wider economic circumstances. Cash-generative businesses may be able to tolerate greater leverage than more cyclical businesses.**

As discussed earlier, as a rule, bond and shareholders are interested in sustainable growth and value creation underpinned by a prudent financial policy. However, there can be exceptions when, within the parameters of an established, stable and sustainable financial policy, they might have opposing or seemingly conflicting views of small changes to its implementation – for example, with regard to the debt-to-equity ratio or dividend policy.

Similar to the arguments regarding poison pills, shareholders welcome dividends as part of a well-communicated financial policy – partly for investment returns but also because of the discipline that the profit distributions impose on management teams. This is particularly true in cases when executives feel pressured to at least maintain the level of a previous dividend payout. Shareholders usually seek dividends when a company's returns are stable and it is capable of reinvesting in its business.

But such pressure is not necessarily against the interests of bondholders. Clearly, in the vast majority of situations, high dividends or excessive share buybacks will be unsustainable – yet this damage will be felt as much by long-term shareholders as by bondholders. The demand for regular dividend payouts is an important discipline for management teams, and it benefits bondholders and long-term shareholders. Clear, stable, well-communicated financial policies imply transparency, reduce uncertainty and benefit all stakeholders.

As investors and engagers, we have seen struggling companies reduce or cancel dividend payments – or even raise fresh capital – to defend their balance sheets and, perhaps, their very existence. Therefore it is prudent from every stakeholder's point of view for companies to cut dividends or raise capital to improve their capacity to meet debt-service obligations – to risk the death of a company during a testing time is not worth a short term pay out.

We engage with companies, not the instruments through which our clients invest in them

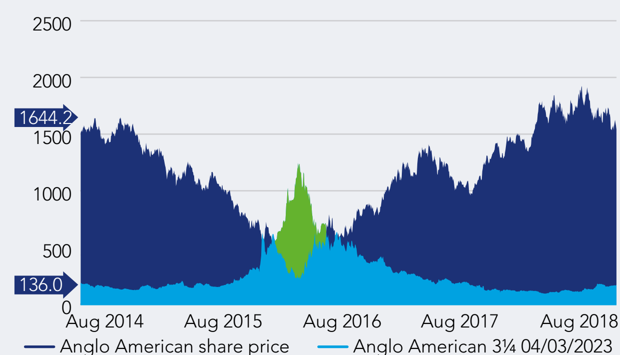
[5] Responsible Ownership Principles, Principle 6: Measuring returns and managing risks, Page 8. To read all of the principles, click here.

Survival mode: Build a strong balance sheet, and performance will follow

In 2015-2016, with commodity prices in free fall, global mining businesses such as Anglo American were struggling to survive. The company opted to cut costs, sell a number of smaller assets, drive operational improvements and cut its dividend: actions aimed at steadying its balance sheet in a tough environment. Such moves are often seen as bondholder-friendly, but when the long-term future of a business is at risk, all stakeholders benefit from this kind of prudence.

The company cut and finally eliminated its dividend per share, from $0.85 in 2014 to $0.32 in 2015 and then to zero in 2016. Since then, its operating profile has recovered, allowing the company to increase its dividend to $1.02 in 2017. Here we can see that the short-term cut in shareholder returns helped strengthen its balance sheet and ultimately contributed to the revival of Anglo American. It regained an investment-grade credit rating in 2017, and its share price has increased more than 400% since its trough. When liquidity becomes a problem, moves that have traditionally been received as bondholder-friendly – chiefly, keeping cash in the company – can lead to higher returns than a one-time shareholder payout which risks the business profile. In extreme cases, taking cash out of the company could ultimately lead to plummeting share prices through insolvency. It follows that prudent financial policy can protect both bond and shareholders.

Figure 4. Kingmaker cash: Spreads on Anglo American's bonds have tightened, and its share price risen, after the company prioritised cash preservation in a tough commodity environment



Source: Bloomberg as at August 2018. Past performance is not a reliable guide to future results.

The debates about poison pills and dividends both highlight the same principle: greater accountability, efficiency and effectiveness is in the interests of bondholders as well as long-term shareholders. Both types of investor do not benefit from having portfolio companies run by executives and boards that do not place the long-term sustainability of the business above all other demands – no matter how alluring it is to yield to the many voices seeking short-term gains. What exactly this means for a particular company is ultimately a matter for its board, and if necessary, a subject for engagement by financial stakeholders.

Rare conflicts: Exceptions to the bond-shareholder alignment rule

In the vast majority of circumstances, bond and shareholders pursue common interests that can be served well by engagement. However, in our experience there are two relatively rare situations where these interests undeniably come into conflict: when a company is near insolvency or insolvent, and when an issuer is subject to a leveraged buyout (LBO), aggressively financed merger and or a corporate transaction that could severely undermine its creditworthiness.

Insolvency: When a company is failing, and its very survival is in doubt, the interests of bond and shareholders can diverge as they compete over what remains for investors. In such a situation, we believe that asset owners – who would have appointed bond and equity fund managers – should assert their interests in order to override any conflicting actions.

LBOs and M&A: An LBO, or a corporate transaction with similar implications for bondholders, is likely to split the interests of bond and shareholders. In a typical LBO, a private-equity fund offers to buy the equity of a company at a meaningful premium, and the source for the cash to finance the buyout will be the proceeds of new debt on the company's balance sheet. In this case, shareholders are generally much better off than existing bondholders who do not benefit from a change-of-control (CoC) put, entitling them to redeem their bonds at 101% of face value. This is because bondholders with no CoC put will experience a capital loss as the bonds reprice in response to the increase in financial risk brought on by the substantial increase in debt. If shareholders agree to be bought out, they no longer have a long-term interest in the business and can disgorge their stake at a substantial premium. In contrast, bondholders continue to have a long-term interest in what is now a significantly more risky company, and can find themselves at the bottom of its restructured debt stack.

Figure 5. TDC's LBO announcement: When the interests – and performance – of credit and equities diverged

When the buyout of TDC was announced, the company's share price jumped nearly 35% and the spread on its five-year CDS widened by nearly 200 basis points – or some 157%, the equivalent of almost six points on a cash bond. The company is now privately held.
Source: Bloomberg as at August 2018.

Having said that, these potential conflicts of interests need to be put in context: the S&P 500 grew to $22.8tn by December 31 2017, while the volume of all US private-equity activity at the market's peak in 2007 was about $540bn, just over 2% of the S&P 500's market capitalisation.[6]

Getting along, for the good of all

The financial stakes managed by bond and long-term shareholders provide them with the legitimacy – and, arguably, an obligation – to engage companies on ESG, strategic and other material concerns. Both types of investor have a shared interest in the sustainable growth, enterprise value and long-term health of companies, and this alignment enables them to jointly engage corporate management teams and boards on common objectives. In rare situations, the interests of bond and shareholders can diverge, and in these exceptions from the norm we see cause for asset owners to act in order to preserve value for their beneficiaries. However, in the vast majority of circumstances, bond and shareholders have mutual interests – particularly in the management of ESG and other long-term factors that influence long-term performance. This is why we choose not to engage through the lens afforded by financial instruments. Instead, our broader perspective compels us to engage with companies for the benefit of all stakeholders.

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[6] "Detailing the US PE industry in 12 charts," by Stanford, K., published on February 13 2018 in Pitchbook.

This was published in September 2018 before Hermes Investment Management rebranded as the international business of Federated Hermes

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