TRENDING TOPICS

Corporate Finance Advisory | Week of November 26, 2018

Every two weeks, we write on four themes or trends to serve as a source of thought-leadership for management teams. Areas we cover traditionally include corporate strategy and M&A, capital markets, capital structure/allocation, market intelligence, or other accounting and regulatory subject matter.

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1. The relaxation of Chinese regulatory rules streamlines the process for obtaining share buyback approval

Key takeaways:

- In a step to further modernize its corporations law, Chinese regulators have loosened and simplified share buyback rules and procedures.
    - The overhaul is partially in response to the recent equity market selloff that has sent Chinese exchanges down nearly 30% from their January peak.
- The updated regulations will introduce the treasury stock concept into Chinese accounting practices.
- Prior to the rule change, Chinese firms have not repurchased a significant amount of shares (due to complexity and narrow set of circumstances) vs. other developed countries and this change has the potential to reverse that trend.

On October 26, 2018, the Chinese government and the China Securities Regulatory Commission passed new regulations that expand the permissible scope for corporate share repurchases and simplify the procedures for buybacks. The new rules allow companies to:

1. Repurchase shares for employee stock ownership plans or as a share incentive;

2. Utilize shares for issuance of convertible bonds; and

3. Act as necessary to maintain company value and/or shareholder interest.

The new rules bring a major change for company's accounting practices by introducing a treasury stock system for the first time in China, through which public companies can hold their own repurchased shares. These new accounting concepts will be critical for Chinese corporate finance managers to understand. Key implications for global investors to monitor are how Chinese companies: 1) manage their capital allocation policy, 2) spend an estimated US$1.2tn[1] of cash-on-hand on share repurchases, or 3) pursue debt funded buybacks with the potential for capital to follow this path versus being used for M&A.

[1] Estimated cash-on-hand of Chinese stocks trading on Shanghai and Shenzhen stock exchanges (excluding financial firms).

2. Increased investor interest in tax receivable agreements (TRAs)

Key takeaways:

- TRA monetization, which took a hiatus in 2017, has recently seen renewed investor interest as U.S. tax reform and tax rate changes have been implemented.
- Specialized investment funds, family offices, insurance companies, and certain banks are forming a viable buyer universe for TRAs due to their willingness to undertake illiquidity and duration risk.
- In the future, bid-ask spreads on TRA pricing due to differences in valuation sought by buyers and sellers could be bridged with back-end financing by investment banks and/or retention of upfront cash flows.

In late 2015, J.P. Morgan brokered a transfer of a TRA held by a financial sponsor to an investment fund buyer, breaking new ground for sales of TRAs. Tax reform has since further heightened investor interest in acquiring TRA payment rights. TRA payment obligations have decreased as a direct consequence of lower corporate tax rates, thus lowering the present-value of remaining TRA payments and removing some uncertainty related to future tax rates. These factors combined have created a viable buyer universe for these assets at a 13 – 17% discount rate. Holders are frequently protected from event risk by clauses that accelerate payments in the event of an early termination. Recently, more investors have been willing to absorb risks associated with company operating performance and the creation of any new future tax attributes senior to those covered by the TRA.

Sellers, on the other hand, can transfer these risks for immediate cash monetization, thereby offloading

portfolio company earnings risk and tax rate change risk. As the universe of buyers expands, sellers may be able to achieve more competitive pricing and increased returns. Companies with public trading history and audited financials achieve a more attractive pricing; however, modest management participation is required. Ultimately, the entire process can be strictly confidential, with no public or SEC disclosures required, making it a sophisticated, yet seamless, transfer of assets.

3. U.S. pension buyout market activity is gaining momentum

Key takeaways:

- Funded status has improved significantly for many pension plans in 2018, driven by voluntary contributions ahead of tax reform and recent rising rate environment.
- Firms are increasingly focused on de-risking their pension plans, leading to significant activity in the U.S. pension buyout market in 2018.
- Firms with well-funded plans are now well positioned to defease a portion of their pension liabilities at minimal cost through a pension buyout.

Many firms have accelerated their pension contributions in order to lock-in deductions at 35% corporate tax rate[1]. Record levels of pension contributions, coupled with the recent rise in interest rates, has led to an improvement in funded status, with the top 100 largest plans reaching 93% funding as of October 2018, up from 88% as of December 2017[2]. As funded status improves, pension plans will continue to be exposed to downside in the equity or debt markets, while likely not being able to monetize any overfunding from an upside in the markets. This asymmetric risk reward profile has led many firms to pro-actively focus on de-risking their pension plans and pursue pension buyouts.

U.S. pension buyout market activity has increased significantly over the last few years, with estimated volume of ~$25bn for 2018 and significant pipeline expected for 2019[3]. Notable recent large transactions include FedEx's $6bn risk transfer in May 2018 and International Paper's $1.6bn in October 2018. International Paper's buyout represents the company's second large risk transfer transaction, following the $1.3bn executed in 2017. Firms with well-funded plans are now positioned to take advantage of the attractiveness of the pension buyout market and defease a portion of their pension liabilities at minimal cost. Proactive de-risking can help plan sponsors improve performance during a downturn and enhance competitive positioning.

[1] Firms with December 2017 fiscal year end could make contributions up to September 15, 2018 and receive 35% tax deduction.
[2] Based on Milliman's 100 Pension Funding Index.
[3] Based on Mercer estimates.

4. Recession watch: Divergence in consumer and business sentiment

Key takeaways:

- As of November 26, 2018, the J.P. Morgan composite consumer sentiment index remains near expansion highs at 76.1, after falling as low as 40 in 2011[1].
- Business activity and confidence, however, is showing signs of weakening with notable declines in key October survey readings.
- Combined with ongoing softness in housing markets, auto sales and tight labor markets, the J.P. Morgan preferred economic forecast model now sees a 32% chance of recession beginning within one year, hovering near two-year highs[2].

In recent weeks, consumer sentiment indicators continue to be strong while business sentiment has shown signs of deterioration. The Bloomberg consumer comfort index and preliminary Michigan consumer sentiment index both posted solid results in November. While the absolute level of business sentiment remains elevated, the New York, Richmond and Dallas Fed services surveys as well as manufacturing ISM saw downward movements in their October readings. Accordingly, J.P. Morgan composites for manufacturing and nonmanufacturing drifted lower to 63.6 and 61.7 respectively, compared to peaks since 2011 of above 65 for both.

J.P. Morgan economic models, which combine these data points with a variety of near-term and medium-term indicators, predicted a 25% probability of recession beginning within one year for much of 2018. The recent survey readings along with background risk predictors saw the predicted probability of recession push above 30%. This is largely consistent with the 38% equity market implied 12-month recession probability, which is based on S&P 500 drawdown from the peak. It is worth noting that both 1990 and 2001 saw mutually reinforcing declines in consumer and business sentiment, so it will be interesting to monitor the momentum of these indicators going forward.

[1] J.P. Morgan Asset Management Guide to the Markets, October 31, 2018. All calculations are total cumulative return, including dividends reinvested for the stated period.
[2] Ibid.

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