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TRENDING TOPICS

Corporate Finance Advisory | Week of November 12, 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. For multi-class shares, MSCI is in a class of its own

Key takeaways:

- After extensive consultation, MSCI announced that its Global Investable Market Index (GIMI) series will retain companies with multi-class shares at their free float market capitalization weight.
- MSCI’s decision marks a departure from other major indices that have decided to exclude multi-class shares, including S&P Dow Jones and FTSE Russell.
- Given this divergence in index eligibility, will we see a shift in fund flows towards index-tracked products that reflect investor preferences for voting structures?

On October 30, MSCI concluded an 18-month consultation process with the investment community regarding unequal voting structures. MSCI had temporarily excluded companies with multi-class shares from

its investable universe during the consultation period. After the decision to retain multi-class shares, all companies with such structures will be eligible for inclusion as part of MSCI's February 2019 quarterly review and May 2019 semi-annual review.

As we observed in our October 2017 note, "To multi-class, or not to multi-class", institutional investors have campaigned for years against multi-class shares that concentrate founder/management control. Spurred by the March 2017 IPO of Snap, Inc. with non-voting shares, S&P opted to explicitly exclude multi-class shares structures and Russell added the requirement to have a minimum of 5% public voting rights. MSCI defended its decision with the argument that global market benchmarks should reflect the broadest investment opportunity set available, without the constraint of specific investor preferences. Acknowledging the importance of voting rights to many investors, MSCI will also develop a new index series in Q1 2019 with voting rights as part of the eligibility criteria.

2. Economic conditions are driving ratings changes

Key takeaways:

- Due to improved economic conditions, the ratio of potential fallen angels (IG firms on credit watch negative or review for downgrade to HY) to potential rising stars (HY firms on credit watch positive or on review for upgrade to IG) fell from 2.3x a year ago to 1.6x at the end of Q3 2018.
- With five new companies joining the list last quarter, the total debt issued by potential fallen angels increased by 21% to $229 bn.
- However, given the historically high proportion of firms in the triple-B category today, a reversal in economic conditions could quickly flood the "crossover zone" with potential fallen angels.

The latest quarter of 2018 saw ten new companies enter the "crossover zone," which is Moody's term for ratings closest to the line between speculative grade and investment grade. This brings the totals for potential fallen angels and rising stars to 47 and 24, respectively, which represents the highest levels seen since the third quarter of 2013. While the ratio of potential fallen angels to potential rising stars is at its lowest since Q2 2015, the number of actual rising stars remain high. In contrast to the 39 rising stars observed in 2018 till date, only 16 in 2017 and 18 in 2016 got the upgrade to investment grade. Should recent economic conditions deteriorate or cause adverse impact on underlying factors that dictate credit performance, an even higher number of companies will find their ratings in the crossover zone on a path to

non-investment grade status. North America currently houses 43% of the potential fallen angels and 45% of the related debt, which poses a greater risk of default than that seen by other regions of the world.

3. U.S. borrowers to benefit from relaxed tax rules for “deemed dividends”

Key takeaways:

- Under proposed regulations, U.S. multinationals would be relieved from “deemed dividend” rules that have previously limited credit support (e.g., asset pledges, guarantees) from foreign subsidiaries.
- As a result, to support borrowings, U.S. corporate borrowers can more readily pledge the stock or assets of foreign subsidiaries.
- In general, beginning in 2018, credit packages can include upstream guarantees from foreign subsidiaries and the amount of first-tier foreign subsidiaries stock pledged as collateral can exceed the previous cap of 65%.

Historically, under Section 956 of the U.S. tax code, U.S. multinationals were deemed to receive a taxable dividend — "deemed dividend" — when controlled foreign subsidiaries lend to, or support a borrowing by a related U.S. borrower (e.g., through a guarantee, asset pledge or certain stock pledges). The 2017 tax reform legislation resulted in tax relief for cash dividends from 10% owned foreign subsidiaries, but neglected to exempt “deemed dividends” that were not actually paid. The proposed regulations released on October 31st are intended to correct this technical inconsistency by providing the same exemption to “deemed dividends” arising from credit support.

While the regulations are yet to be finalized, U.S. corporates may generally elect (but are not obligated to do so) to rely on them for foreign subsidiaries with tax years that start after December 31, 2017. U.S. borrowers may elect to continue to exclude foreign collateral for other legal or economic reasons. Nonetheless, the new regulations are expected to vastly simplify financing arrangement going forward, because collateral packages should, over time, eliminate this market standard, tax-driven carve-out.

4. Value stocks showing signs of a comeback

Key takeaways:

- Recent market volatility has brought with it signs that value stocks are making a comeback relative to growth stocks, which dominated returns over the past decade.
- In a test of resiliency, large-cap value stock returns only fell 5.2% compared to the 8.9% decrease in large-cap growth stock returns as of October 31 for the quarter beginning September 30.[1]
- Although current large-cap growth and value stock P/E ratios closely align with their 20-year averages, small-cap value stocks are 2x below their 20-year average while small-cap growth stocks are 3x above their 20-year average.

Investors have anticipated value stocks to make a comeback for the better part of the last decade. Although value stocks showed brief signs of a comeback in 2016, the trend quickly transformed into one of the longest bull-market runs that shaped market-highs. Value stocks have had a good run; however, growth stocks have enjoyed a better one. Large-cap value stocks have returned almost 80% since market peak (October 2007) and almost 350% since market low (March 2009), whereas large-cap growth stocks have grown 167% and 445% during the same time frames.[2] It will be worthwhile to monitor whether the recent resiliency of value stocks will continue in the coming months.

[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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