September 2018

CORPORATE EXCELLENCE INSIGHTS

We are a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: GROWTH CONTINUES IN US MARKET

The majority of markets declined in August 2018, with the notable exception of the US stock market, where extraordinarily strong macro data, and an absence of any inflation concerns helped continue to push the market higher.

£5bn

FIRST BRITISH CARMAKER TO LIST IN LONDON IN YEARS

Luxury carmaker Aston Martin plans to float on the London Stock Exchange, completing a turnaround for the once perennially loss-making company that could now be valued at up to 5 billion pounds ($6.4 billion).

61%

ALIBABA QUARTERLY SALES JUMPED 61%

Alibaba's core e-commerce business is still growing strongly at a time when the broader Chinese economy is slowing amid a trade tariff war with the United States.

$5.1bn

4,000 STORES ACROSS 32 COUNTRIES

Coca-Cola has agreed to buy coffee chain Costa Coffee from UK drinks and hotels group Whitbread for $5.1 billion.

MONTHLY TOPIC LEASING ACCOUNTING REGULATION

As of January 1st 2019, new accounting regulation IFRS 16 will come into force, and the very nature of this principle will change the look of reported balance sheets globally. Operating leases, previously absent from major statements, will be included in the reporting, thus significantly inflating key leverage ratios in those industries, whose business model relies heavily on these types of commitments. Off-balance sheet lease obligations around the world were estimated to reach $3tn in 2016, representing a substantial amount of undisclosed debt.

IFRS 16 will provide investors with an important tool of comparability that will enable fair assessment of both companies that buy or borrow their assets to execute operations. The new standards are also set to increase accountability, as they will require businesses to do much more than just disclose lease assets and liabilities, and might potentially entail changes in policies, processes and systems.

After the new standards are applied, businesses will appear to be more asset rich, but also more heavily indebted. Some companies, especially in the Retail sector, might see major changes to their reported key figures and performance indicators.

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IFRS 16: PUTTING BALANCE SHEETS TO THE TEST

While everyone is busy assessing business implications of the raging trade war between the US and China, the least of one's concern are changes happening with stale accounting regulations. And yet, with the new IFRS 16 standards, IASB is about to deliver a silent blow that will put the balance sheet quality of many companies across the globe to a serious test. The remarkable yet confusing fact is that these new standards were first announced back in early 2016, but market participants do not seem to have given it a reasonable amount of attention.

IFRS 16 – essence and impact

IFRS 16, applicable as of January 1st 2019, will require businesses to report operating leases, previously kept off the balance sheet, as a part of their liabilities. Low value assets and short term leases of 12 months or less would be the only two exemptions from the new rule, with limited early adoption by some companies, who have already applied IFRS 15[1]. Now, while it is true that the new standards address long-awaited need for additional disclosure requirements and will enable fair comparison between companies that borrow to buy or to lease assets, it also bears significant negative implications for key metrics associated with leverage, such as gearing, equity ratio, etc. After new standards are applied, businesses will appear more asset rich; however, this asset inflation will come with more volatility and additional debt. Putting things into perspective, in early 2016 Financial Times estimated that businesses worldwide would be forced to add $3tn of leasing commitments to their balance sheets[2]. Two years out, any metamorphosis could have happened to balance sheets globally, especially given that the low interest rate environment might have tempted companies to borrow more while debt is cheap and increase their reported leverage. In the MSCI World All Cap Index, about 45% or 1259 companies report according to IFRS, of which as many as two thirds have operating lease obligations. Currently operating lease obligations make 2% of the total assets and 9% of the debt outstanding for the largest companies in the stock index. For the retail sector, the most critical in this sense, operating leases constitute 12% and 37%, respectively.

Retail will see its key debt metrics change significantly

IFRS 16 will spare no industry from the effect of an additional debt burden; however, some will take a much harder hit than the others.

Fig. 1 MSCI World AC selected leverage ratios by Sector, as reported for FY17 and after application of IFRS 16

	NDE	NDE Adj	ER	ER Adj	DE	DE Adj
Consumer Discretionary	28%	50%	42%	37%	53%	75%
Consumer Staples	37%	63%	43%	37%	49%	73%
Energy	36%	46%	49%	44%	44%	55%
Health Care	9%	10%	56%	47%	27%	33%
Industrials	44%	63%	35%	36%	72%	88%
Information Technology	-11%	-2%	52%	37%	30%	38%
Materials	36%	42%	49%	43%	50%	56%
Telecommunication Servi	76%	88%	36%	40%	87%	113%
Utilities	114%	130%	28%	32%	137%	138%

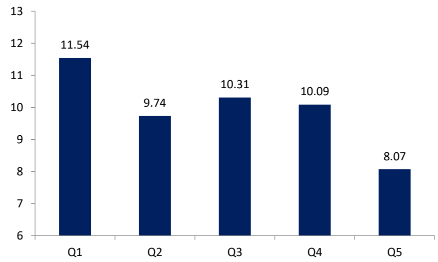
Note: NDE – Net Debt to Equity, ER – Equity Ratio, DE - Debt to Equity, Adj. – Ratios adjusted for IFRS 16.

As our analysis shows, unsurprisingly, Consumer Discretionary and Staples are the two main sectors with a substantial amount of obligations related to operating lease contracts, especially the Retail business. The equity ratio is set to decrease by more than 10 ppt points and debt to equity to increase by more than 20 ppt points for Consumer sectors, putting many companies at risk of dropping out of quantiative filters applied by asset managers and index providers. Within the consumer sectors, particular caution should be applied to Food & Staples Retailing and Specialty Retail, as after IFRS 16 is applied net debt to equity is seen to rocket from 29.8% to 98.6% and from 0.8% to 60.3% respectively. Telecom Services will also experience significant changes to its key leverage ratios, and so will some subsectors of Industrials, like Auto manufacturers.

Implications for Stock Performance

If one should account for the upcoming changes in fundamentals or not, is one's own call to make. However, there are certain things, like the potential impact on performance that should be considered regardless. Muradoglu and Baturevich (2010)[3], investigating the predictive ability of debt ratios with regards to the abnormal returns of S&P 500 companies, identified that, in the long run, the companies with the lowest gearing ratios exhibit the highest outperformance.

Fig. 2. Annualized return for MSCI World AC excl. Financials according to Quintiles based on Debt to Equity ratio, % (31.08.1998-31.08.2018)



Our performance back-testing for constituents of MSCI World AC excluding Financials (Fig.2), based on the Debt to Equity ratio, shows that stocks falling into the last quintile (having the highest leverage) delivered the lowest active annualized return over the last 20 years as opposed to those that were less heavily indebted.

Obviously, higher leverage goes hand in hand with higher volatility and larger downside, and it also often might mean that fast-growth, capital-hungry companies are dropping from investment radars. So, one needs to find the tradeoff between the firm's development pace and the balance sheet quality to reach sustainable above average results. It would be particularly important given expectations of increasing interest rates.

Quality impacted as well, but metrics remain healthy

We also had a look at how the Hérens Quality Universe will be affected and if the magnitude of the impact is more or less pronounced. It appears that Quality companies proportionally have more off balance sheet operating leases than the general market primarily due to Consumer sector bias. Therefore, the difference between current and adjusted for IFRS 16 ratios (Fig. 3) is more substantial. However, key leverage ratios for Quality companies still remain remarkably healthy as compared to the overall universe, even after the adjustments are made.

Fig. 3 Selected leverage ratios for MSCI World AC and HQAM Quality Universe, as reported for FY17 and after application of IFRS 16 (Adj.)

	Market	Quality
Net debt/Equity	36.1%	4.7%
Net debt/Equity Adj.	43.6%	18.6%
Equity ratio	38.8%	55.8%
Equity ratio Adj.	34.4%	44.3%
Debt to equity	56.6%	27.0%
Debt to equity Adj.	68.7%	32.5%

This underpins the very essence of the Quality Strategy that calls for investments with sound financial conditions and strong balance sheet structures, especially with regards to debt levels. Therefore, even after IFRS 16 is applied, quality companies are likely to maintain their robust fundamentals as one of the key factors to a solid performance profile.

1. Effects Analysis, International Financial Reporting Standard "IFRS 16 Leases", January 2016
2. Burgess, K., Agnew, H. and Daneshkhu, Sch. (2016) Reporting rule adds $3tn of leases to balance sheets globally, Financial Times, January 13, 2016.
3. Muradoglu, Y. G. and Baturevich, B., Would You Follow MM or a Profitable Trading Strategy? (2010). Frontiers in Finance and Economics, Vol. 7, No. 2, 69-89, October 2010.