Chapter 16
Other Credit Factors: Ownership and Management

What's in this chapter:

- ownership considerations
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AN ANALYST SHOULD always understand a company's ownership structure and develop a sense of management's goals as well as their past record in achieving their goals. Ownership and management's first obligation is typically to the shareholders. Sometimes what is good for shareholders may not be good for debt holders, and vice versa. While having a fiduciary priority to the shareholders' interest, a management team has to focus on being fair to a multitude of constituents for the longer-term good of the company and its shareholders. These constituents include employees, customers, and debt holders. Therefore, how the company ownership and management have treated debt holders in the past can impact how the debt securities are valued in the market.

Ownership Considerations

Understanding the ownership of a company can give an analyst insight into potential future actions. If the company is public, it can make a difference if there is one dominant shareholder, or if an activist investor takes a stake and advocates for certain changes. It can also be good to understand how much of the company management and employees own. If senior management have a large stake in the company, they have a vested interest in the company performing well, but if performance falters, it may be difficult to change leadership. When a company is private, the motivations of the owners might be different if it is owned by a financial firm, such as a PE firm, or if the ownership is a family trust.

When a company is publicly owned and has no controlling shareholders, it can be a takeover target. If a stock is materially underperforming its peers, management may be under pressure to do something more radical or depart from current strategy. This may be true even if the company is sound from the debt holders' point of view.

In the USA, for companies with public stock, an annual proxy statement must be filed. It shows the major shareholders and management's compensation and stockholdings, as well as the names of the directors and their holdings and affiliations. The compensation section can be particularly interesting because it may outline options and bonuses for the management team if certain goals are met. This helps to understand management's incentives and the targets they are striving for. Large shareholders can influence how a company operates, and if there are large outside shareholders, these documents are where some of the information can be found. It can be especially valuable to note if their ownership stake is new or has recently been increased. The footnotes in these documents can be very valuable because sometimes ownership stakes are held in trusts or other entities and the footnotes may explain the joint ownership of some of these entities.

The most common private ownership structure in the leveraged debt market is ownership of a company by a PE firm. PE firms usually have a series of investment funds from which they use capital to buy companies. Investors in these funds have a time frame in which they want to see a meaningful rate of return. For these reasons, when a PE firm owns a company, the PE firm typically has in mind a time frame and strategy for how it will get a return on its investment—this may be a shorter time frame than the strategic plan of a publicly held company. Therefore, ownership by a PE firm almost ensures that a transaction of some kind is in the plans in the near future. PE firms vary greatly in their investment focus, their style, and what expertise and value-added features they bring to the company's management. Keeping a separate list of PE firm styles and history can be helpful.

While it is not the norm, there are times when controlling stakes in public companies are held in different classes of common stock, where one class has supervoting power. Therefore, a relatively small ownership stake in these shares may have much more control over the board of directors and the overall vote in key shareholder matters. Often the non-super-voting stake is publicly traded, whereas the supervoting shares may not be publicly traded. The economic benefits to the two classes are usually equal. If the company is sold, each share of voting and super-voting shares would be paid the same value.

Management Considerations

Analysis of management has a much higher level of subjectivity than the analysis of financial statements. A view has to be developed of whether to believe the management team can do their jobs and if they are setting achievable or unrealistic goals. An analyst hopes to have access to both managers and owners through conference calls and meetings. The goal is to try to gain insight into what is going on with the business's operations, and what the key drivers of the business are, and to understand goals and strategies as a well as the metrics management looks at to measure success.

Where possible, look at what management has done in the past, either with the current company or with other companies. Examining management and ownership's history with other companies can sometimes help with analyzing a company's strategy.

Sometimes management has a history from which can be gleaned various aspects of how a company might be managed, including growing revenue, cost cutting, and asset acquiring or selling. This background information can impact how the debt securities trade and can help guide the types of scenarios to model. It is helpful to have a standard list of items to address with every management team, and a subset for specific industries.

An outline of a management checklist could resemble the following:

1. Operational History
   a. Has the company met its guidance?
   b. How have margins compared to the industry?
   c. How do revenue and EBITDA trends compare to the industry?
   d. Is there the ability to grow the company?
   e. What are the operational KPIs that management uses?

2. Strategic Approach
   a. Does management have a reasonable strategy for positioning the company?
   b. How do they expect to compete?
   c. How are they managing technological change?
   d. How have they dealt with any crisis in the past?
   e. What are the financial KPIs?
   f. What is their approach to the balance sheet and long-term financial goals (target leverage)?

3. Governance
   a. What are the structures of management and the board?
   b. What are the management and employee ownership stakes?
   c. Are there potential conflicts?
   d. What is the history of employee relationships?
   e. What is the history of legal and compliance?

One of the advantages of looking at multiple companies in the same industry is that it is easier to see if there are outliers among management teams in terms of operational results, expectations, or strategies. Outliers are not necessarily bad, but they should be examined carefully. For example, a manufacturer of auto parts announces that through cost cutting, it will get EBITDA margins up to 15% from 9%, without hurting its revenue. The company would seem to be well on its way to improving the credit. Look at five or six comparable companies, and if none of them have EBITDA margins better than 12%, it is reasonable to be skeptical of the announcement the company just made.

Management incentives are important to understand. Investors tend to favor situations where management has a meaningful stake in the firm. In the case of a PE firm, investors will often examine how much of their initial investment the PE investors have recouped to try to understand their likelihood of pursuing equity sales or dividends and their level of interest in how the company is performing.

The composition of the board of directors is important to look at. Investors want to see some outside independent directors who are not aligned with management or ownership. The idea is that outside independent directors help balance those who may be closer to the company. The independent directors also should represent minority shareholders' views equally with the larger shareholders and management. A more diverse board can be very beneficial to bringing outside views and checks and balances to a company. The board has certain legal responsibilities, including analyzing risks, and should be a good governor of any extreme plans proposed by management. Significant changes to a board of directors should be analyzed as to what the differences are in the interests and background of those who left the board and those who joined.

Closing Comment

Management, ownership, and board composition are a vital part of credit analysis. Understanding how management acts can be an important guide when prioritizing scenario analysis and event analysis. Often views and insights about a management team can be garnered from other operators in the industry, though it is important to understand their motivations for sharing their views. More candid views often come in person-to-person conversations as opposed to electronic forms of communication. If an analyst wants to be ahead of the market and prepared to react quickly, it is critical to develop a thoughtful view of management styles, likely motivations, and the strategies of management teams.