J O Hambro Capital Management Group

News

New Debt Paradigm

The rising cost of capital is exposing companies over-dependent on ultra-low-cost capital. Careful stock selection might be a better response than running for any available cover


Ben Leyland


Robert Lancastle

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Everyone knows interest rates have risen substantially over the last 12m but markets are still working through all the implications of a higher cost of capital. The three major risks to equity investors are derating, downgrades and debt refinancing, and as we go through this transition period they will take turns in being uppermost on people's worry lists.
The crisis in mid-sized US banks over the last month serves as a reminder that investors need to be very wary of assets purchased or built with, or business models reliant on, an unsustainably low cost of capital. Ultimately, First Republic's problem was that their cost of funding, which had already been rising as deposits repriced upwards, skyrocketed when they needed to replace lost deposits at 2% with wholesale funding at 5%.

One obvious response is to run back to the safety of tech stocks with net cash on their balance sheets. The recent rotation in that direction is understandable, although we would caution that derating risk is not dead, just sleeping. It is equally easy to argue that in this environment you should just sell any company where financial gearing is an inherent part of the business model, for example financials or infrastructure. We disagree, but emphasise the importance of being selective. Not all infrastructure is funded in the same way. For example compare these two infrastructure-based companies, CMS Energy, a US regulated utility which we own, with Cellnex, a European telecom tower company, which we don't.

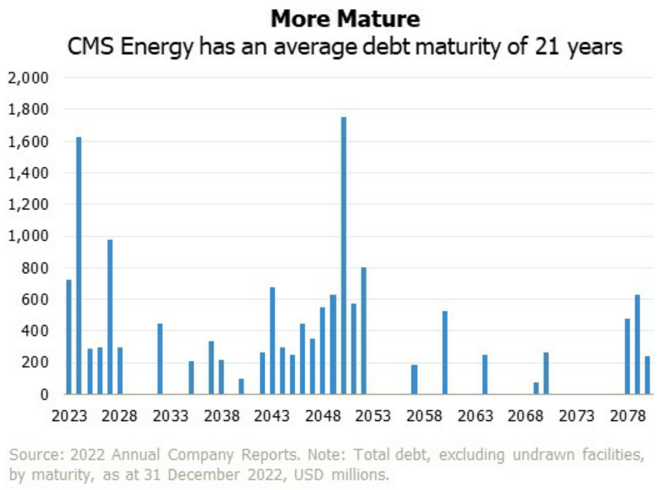
- CMS has long-dated debt with a weighted-average maturity of more than 20 years, with an average coupon (3.9%) which is not that far off their marginal cost of funding (4.6%). For what it is worth (not much, judging by recent events in US financials), the S&P credit rating remains investment grade at BBB+.

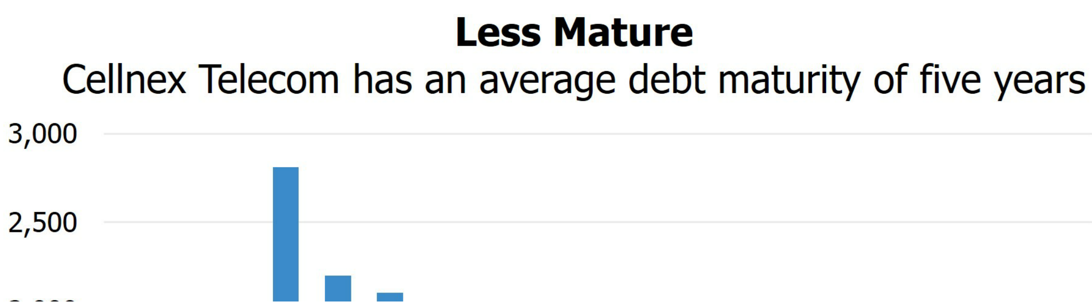
- Cellnex has an S&P sub-investment grade rating of BB+, with short-dated debt with a weighted-average maturity of less than five years and a cost of 1.6% which is likely well below their marginal cost of funding.

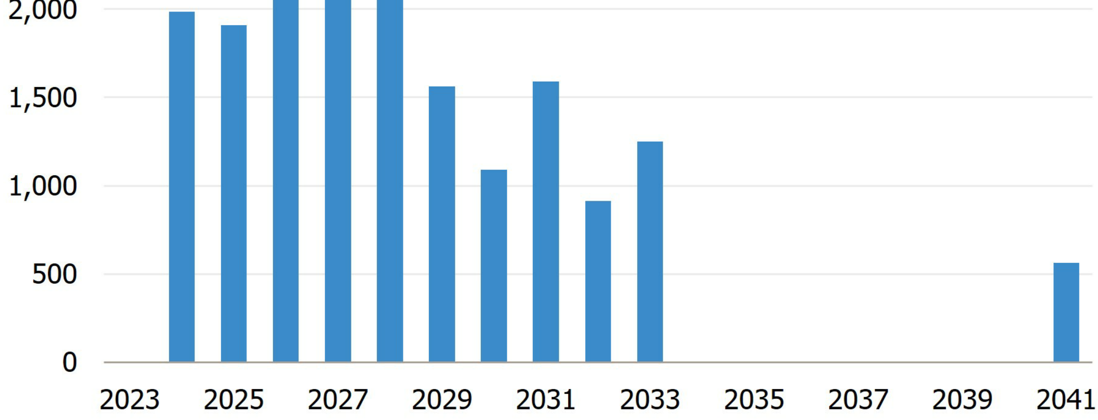
Both of these companies are expected to face rising interest costs in the coming years but for CMS it is likely to be a much more manageable trajectory than for Cellnex.

We would also make two broader points:

- Utilities in the US are regulated on the basis of an 'allowed return on equity' which is nominal and post-interest. Any rise in interest costs can in theory be passed on to the consumer. The allowed ROE tends to move in the same direction as funding costs, meaning that in the medium term we expect to see higher interest rates lead to higher allowed ROEs. Overall we think that US utilities can be regarded as a port in the storm in this kind of environment, and recent share price weakness is an opportunity to increase exposure.
- Where we prefer US utilities to those in Europe, the opposite is true for banks, though for much the same reasons. Companies and consumers in the US tend to have longer-dated fixed rate liabilities than their counterparts in Europe. That means that US banks have a bigger problem than EU banks because they can't reprice their assets up to match the rising costs of their liabilities. Equally, EU consumers and companies potentially have a bigger problem than in the US, suggesting that the thing to watch in EU banks is credit quality rather than interest spreads.
    - Debt Distribution
    - It's not just what you owe – when you owe it determines the cost of replacement







Source: 2022 Integrated Annual Report. Note: Total debt, excluding undrawn facilities, by maturity, as at 31 December 2022, EUR millions.

All data Bloomberg or J O Hambro unless otherwise stated.

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