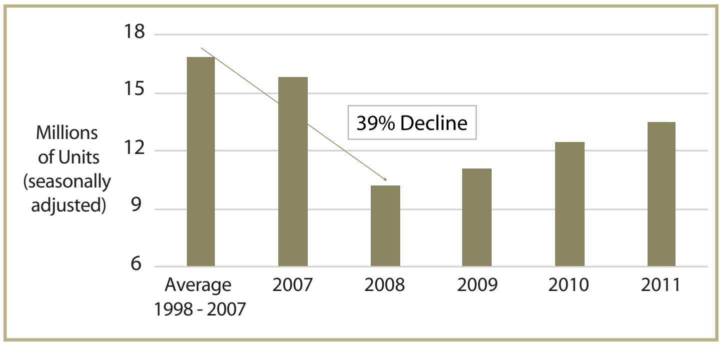
Cash Is King in All Regimes

Heavily indebted companies got into serious trouble during the financial crisis of ten years ago.

We have been thinking a lot about cash lately. Not the kind we carry in our wallets, but the cash that a corporation keeps on hand to run its business. We have also been thinking about debt, in particular, the levels of debt a corporation may take on in order to expand, make acquisitions or, in some cases, repurchase shares. Ten years ago, global financial structures were under extreme duress as many financial institutions were caught holding low-quality assets without enough capital to act as a buffer. Lending dried up and many companies could not roll over their debt; those that could did so on punitive terms; others went bankrupt. It was a time of panic for many companies and investors. A minority of companies were in a strong position because they had avoided debt and, in some cases, built up cash reserves that proved to be of massive advantage.

Figure 1 - North American Auto Sales



Source: Bloomberg, Antares Calculations

Canadian company Magna International weathered the storm thanks to its big cash buffer.

Consider the historic example of Canadian company Magna International, which sells parts and components to the automobile sector. In 2008 as the panic was unfolding, it became evident that vehicle sales were going to plunge (Figure 1), and that Magna's customers like the Detroit Three (GM, Ford, Chrysler) were going to be in big trouble – we all remember the government bailouts. Magna, on September 31, 2008, held $700 million of debt, but this was more than offset by $2.4 billion of cash, meaning the net cash position (cash less all debt) stood at $1.7 billion. One year later, that net cash was cut in half to $865 million, a level that would prove to be Magna's lowest during the "Great Recession."

Lest we be tempted to say, "gee, that's a great story (can I go home now?)", we should remember that nobody knew at the time what the low point would be and there was concern that many of Magna's customers and suppliers were in bankruptcy. In that atmosphere of elevated uncertainty, the shares, despite the company's financial strength, declined from $25.24 on July 16, 2007 to $6.50 on March 6, 2009, a 74% walloping. But the market got it wrong. Just as recessions are pretty much certain, so are recoveries, and with the improved outlook for the auto industry, Magna's shares recovered to the $25 range by December of 2010 and have gone on to higher levels since then.

The strong get stronger; the weak get squeezed.

We believe there is an important lesson to take from this. Companies with robust balance sheets have an opportunity to emerge from a downturn in a stronger position than would have been the case had the downturn not happened. This was true of Magna. Big customers are reliant on stability from their suppliers and Magna proved itself to be reliable, in spades. Thus, Magna gained market share from its weaker competitors *thanks to the downturn*. The company's revenues in 2007, before the downturn, were $26 billion. They plummeted to $17 billion in 2009, but then rose to $29 billion by 2011 even though aggregate automobile sales were much lower in 2011 than in 2007, as shown in Figure 1.

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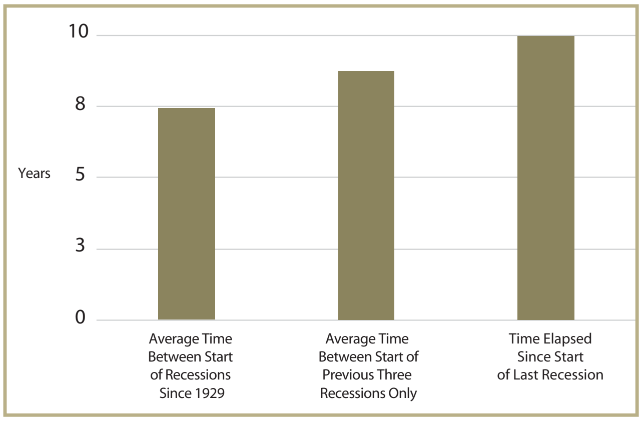
The current economic expansion continues but is getting long in the tooth.

We mention this not because we have a dire view about the economic outlook – we don't – but because we are realists: neither the United States nor Canada has experienced an economic recession for nine years, and they have tended to occur roughly every seven years since 1929 (Figure 2). If our countries were milk, they would be past due, but still fresh.

Figure 2 - Historic Recessions in Canada



Source: C.D. Howe Institute Business Cycle Council, thecanadianencyclopedia.ca, Antares calculations

The consensus view often misses inflection points.

We are mindful that the consensus view of many financial pundits and economists seems to be that the economy will be fine for a couple of years yet: we read that there will be growth without too much inflation. This is a plausible scenario, and the consensus is often right. However, we are equally mindful that the consensus is often wrong and, critically, tends to miss important inflection points. For example, we often infer that a recession is coming *after* the stock market is already down because investors have "sniffed out" a negative turn in corporate profits. The pundits figure this out too late, which is unavoidable, perhaps, because their followers tend to ask for a sunny forecast.

In light of this, we continue to ask ourselves "how, given that the future is always uncertain and the experts are often wrong, can we best deploy our clients' capital so as to both protect it from permanent loss and give it good odds of growing at an attractive long-term rate?" That's where cash and debt come into the picture. In recessions, corporate profits decline – in some cases they disappear for a while. Companies that are more likely to survive and thrive are those whose existence is not threatened by debt. Conversely, over-levered companies frequently get into trouble: they are forced to raise debt on expensive terms, or they are forced to raise equity capital on terms that dilute current shareholders, or they go bankrupt. None of these options is positive for the company's owners. This is why, in our research, we are screening global markets for companies that hold more cash than debt on their balance sheets: they can pay it off in a pinch, or, if necessary, borrow some money on fair terms if needed for a short period of time. As anyone who has played Monopoly quickly learns, it never hurts to have a bit of cash in pocket when your opponent owns hotels on Boardwalk and Park Place.

We want well-financed companies in your portfolio.

Thank you for your continued trust,

Your Portfolio Management Team