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ICGN Viewpoint

COVID-19 and capital allocation

April 2020

In July 2019 ICGN published a Viewpoint report on capital allocation, focusing on this issue from a corporate governance and investor stewardship perspective[1]. The report provided a framework to guide investors on what to look for and engage upon to promote responsible capital allocation practices supporting a company's sustainable value creation. Clearly this 2019 Viewpoint did not anticipate the COVID-19 crisis or its subsequent impact on societies, economies and individual businesses. However, COVID-19 has since heightened the visibility of capital allocation as a critical governance issue, particularly as it is creating severe pressures on companies and forcing important and difficult capital-related decisions.

Some of these pressures were identified in a March 2020 ICGN Viewpoint looking at the COVID-19 as a systemic risk for investors.[2] The report spoke to the need for companies to strike an acceptable balance between the needs and sustainability of the company itself, its providers of capital (both shareholders and creditors) and other key stakeholders. This raises important questions of capital allocation.

Capital allocation is where corporate governance meets corporate finance. It is the process of distributing a company's financial resources with a purpose of enhancing the firm's long-term financial stability and value creation—while providing fair returns to providers of risk capital and showing proper regard to the needs of employees, customers, suppliers and other stakeholders. From an investor perspective, the challenge for companies is to develop—and communicate-- a sustainable capital allocation framework to support long-term company success.

A robust approach to capital allocation can help to guide companies through challenging periods or periods of uncertainty-- as we currently have with COVID-19. Key elements of this strategy, as highlighted in ICGN's June 2019 Viewpoint, should include a policy framework underlying the firm's long-term approach to capital allocation. This framework should address key business priorities, the company's financial health and the linkage of capital allocation to the company's overall mission, strategy and business model. Such a framework should guide the determination as to what is judged to be the right balance of stakeholder interests-- as well as establish the process through which this balance is achieved and communicated among different relevant stakeholder interests.

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[1] See ICGN Viewpoint on Capital Allocation, July 2019: www.icgn.org/sites/default/files/ICGN%20View-point%20on%20Capital%20Allocation_1.pdf
[2] See ICGN Viewpoint on the COVID-19 as a systemic risk,, March 2020: https://www.icgn.org/COVID-19-new-systemic-risk-implications-corporate-governance-and-investor-stewardship

Against this general background, the COVID-19 has given rise to attention to specific capital allocation issues that companies, boards and investors must consider. In a shrinking economy it can be particularly challenging to "divide the pie" of corporate assets and cash flows between competing claimants, to manage a balance sheet and to ensure financial solvency and stability in times of severe stress. Longer term, companies must direct capital to construct a more robust and resilient business model. From an investor perspective these considerations are relevant for both shareholders and creditors.

Capital structure and share repurchases

The crisis has affected the global economy broadly, but its impact will vary in intensity by sector. For many companies and sectors there are serious questions of solvency and survival. As an example, the airline sector has come under particular stress globally and many airlines in a range of jurisdictions will be seeking state support or bailouts.
At the same time, the sector has also become a case study on the effects of dubious capital allocation practices; a recent Bloomberg report reveals that major US airlines, including those seeking government bailouts, spent a substantial portion of their free cash flow over the past ten years on share repurchases.[3]

It is unfair to expect airline companies – or their investors—to have anticipated the magnitude of the shock brought by the current crisis. However, with fleets of costly aircraft the airline industry is a capital intense sector, and even in the best of times it is vulnerable to economic volatility. A less aggressive approach to share repurchases may have made the airlines less financially vulnerable, and also would likely reduce the magnitude of any government bailout or financial support required.

The highly visible, and potentially costly, case of the airline sector gives ammunition to those critics of share buybacks who think they should be severely restricted or eliminated as a general practice. While this situation does demonstrate how buybacks may be misjudged, or even abused, share buybacks, when used prudently, can be a legitimate and useful capital management tool.[4] The legitimate needs of individual companies and sectors will differ and it would be inappropriate to encourage a blanket ban on this practice just because it has the potential to be done poorly in individual cases.

But the airline example does provide a reminder of why both investors and boards should demonstrate skepticism and carefully scrutinize buybacks with regard to the company's specific business and financial risks. They should assess capital adequacy and financial solvency to ensure a resilient approach to capital allocation that is robust under different planning scenarios. Beyond financial reserves, companies may wish to consider other forms of 'capital' - intellectual, social and human - as critical to long term sustainable value creation. This will require deep reflection on what levels and forms of capital are required, particularly in times of stress. There is no generic solution to this; companies must be assessed on a

[3] Brandon Kochkodin, "US Airlines Spent 96% of free cash flow on buybacks": https://www.bloomberg.com/news/articles/2020-03-16/u-s-airlines-spent-96-of-free-cash-flow-on-buybacks-chart
[4] The positive applications of share buybacks as a capital management tool are discussed in ICGN's Viewpoint on Capital Allocation, July 2019: www.icgn.org/sites/default/files/ICGN%20Viewpoint%20on%20Capital%20Allocation_1.pdf

case by case by basis. But in more normal times the prudent use of buybacks may still be an appropriate tactic.

However, the COVID-19 crisis is not a normal planning or stress test scenario. In the current environment, when capital is diminishing generally, it will be generally difficult for share buybacks to be a legitimate use of funds for companies or their shareholders. This pertains not only to the airline sector, but across many sectors, and is particularly relevant to the financial sector, which combines confidence sensitivity, high financial leverage and systemic significance. Hence, until a semblance of normality returns to the financial markets the practice of share buybacks is likely to face resistance not only from regulators but also many long-term investors.

Dividends

Shareholders naturally have an interest in receiving dividend payments both to generate cash income and to augment total shareholder returns. In turn, most companies have dividend policies to guide payout decisions and the balance between providing returns to shareholders versus retaining capital in the business or rewarding management. Share prices tend to reflect dividend expectations in individual companies, and companies are often loath to cut dividends given the share price impact and the expectations of shareholders.

As with share buybacks, dividends are a legitimate tool for capital allocation and providing returns to shareholders. And there is also the risk for abuse, to the extent that dividend payments to shareholders may compromise a company's ability to invest for future value generation or eat into needed capital for the future. This is matter for appropriate governance by company boards and ongoing oversight by shareholders.

The severity of the COVID-19 crisis heightens attention to how companies deal with dividend decisions. For severely affected companies, dividend payments may require substantial, if not complete, reductions or suspensions—at least if this is required to ensure the company remains solvent and financially stable. In other sectors, lower dividend payouts may be a legitimate, if not inevitable, corporate response to lower levels of profitability – or indeed losses in many cases.

For companies the appropriate response to dividends will have to be assessed on a case by case basis in line with the company's business risks and financial health. Lower payouts are likely to be a near term reality as the wide economic impact of the crisis will affect company financial performance across a broad range of sectors. Investors should be prepared to show flexibility here to support companies in this difficult period by accepting lower, or delayed, dividend payouts where necessary. Many ICGN Members, will be showing understanding regarding reduced dividends in this period of uncertainty.[5]

At the same time, however, dividends themselves are in many ways a social good insofar as they support the livelihoods of ordinary pensioners and long-term savers— including many retail investors. If companies are in a position to pay dividends without compromising their

[5] Attracta Mooney and Stephen Morris, "Investors step up pressure on companies to slash dividends", Financial Times, 25 March 2020: https://www.ft.com/content/fbb0817c-6ebe-11ea-89df-41bea055720b

long-term financial stability they should continue to do so. It is ultimately up to the board to determine the appropriate level of dividends in light of investor needs and the company's own long-term sustainability.

Apart from airlines and other sectors that are severely impacted by the crisis, scrutiny to banking sector dividends will be of particular relevance, given the sector's systemic significance, high leverage and need for capital resilience. Many banks will face asset quality challenges related to both corporate and retail debt on their balance sheets that have been affected by the crisis. Dividend suspensions for many banks may be a legitimate, if not prudent, capital allocation decision to preserve both cash and capital until the full impact of the crisis on the banking sector is better understood. This may be particularly relevant in Europe since the European Central Bank is allowing banks to operate with lower levels of capital to continue to fund the economy during the crisis. The European Banking Federation, a bank industry association, has publicly called for the suspension of both dividends and share buybacks in the banking sector to preserve capital at this critical point in time.[6]

While many banks are taking the initiative themselves to reduce or delay dividend payments, banks are also likely to come under pressures from regulatory authorities in many jurisdictions. From an investor perspective, it is clear that bank creditors and holders of bank debt benefit from greater capital prudence to preserve the financial flexibility and credit standing of the banks. Thus, fixed income investors should also be supportive of bank dividend cuts. The impact on shareholders is more direct, particularly for retail shareholders who may rely on dividends for basic income.[7] However, shareholders with a long-term perspective in both individual banks and in the financial system as a whole should also be prepared to accept a either a dividend holiday or significant dividend reductions in recognition of broader financial sector risks.

Remuneration

There is also a capital allocation dimension to executive remuneration, particularly with regard to variable pay relating either to cash awards or to share-based incentive plans. Both eat into capital. Bonus awards are a standard feature of executive pay, and at least in normal times are an expectation of managers—just as dividends are an expectation of shareholders. The impact on the ability of individual companies to pay executive bonuses at present will differ on a case by case basis depending on specific corporate circumstances. In some ways remuneration decisions relating to variable remuneration payments are simpler for those companies most severely affected by the crisis. However, even for managers that may be performing capably in the current crisis, the overarching need to preserve the company's long-term financial health must take precedence over executive bonuses and incentives. As in the case of dividends there is no generic solution that works for all companies in terms of executive pay. As always, investors should be prepared to support incentive awards when they are justified—and challenge them when they are not.

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[6] David Crow and Stephen Morris, "European banks back suspension of dividends and buybacks", Financial Times, 26 March 2020: https://www.ft.com/content/5fac9d7a-5c5d-4017-9934-c15b97d7230f

[7] In Hong Kong retail investors threatened legal action against the UK domiciled HSBC plc following the suspension of its annual dividend in 2020. " Hong Kong investors warn of action over HSBC dividends", Financial Times, 5 April, 2020: https://www.ft.com/content/3681a998-8164-4fd1-a5e5-ae54f56a3b70

The question of fairness is also important for companies that are forced to lay off staff or ask staff to operate with pay cuts. Maintaining or increasing executive pay in such cases could easily threaten employee trust and motivation as well as the company's social licence to operate. This will require judgement and discretion by both managers and boards. For many investors, engaging on remuneration is not the most immediate priority amidst all the other current dynamics of the crisis. But they will be paying attention, and excessive pay practices will continue to be identified, and challenged, by investors both on an economic basis and from a broader social perspective.[8] Early evidence suggests that low income populations are suffering disproportionately from the pandemic.[9] Covid-19 has the potential to invigorate a debate about excessive levels of executive compensation and its impact on income inequality and society's capacity to respond to global emergencies.[10]

Boards will need to balance remuneration awards against these pressures, and, where relevant, executive pay packages should demonstrate solidarity with, and reflect the experience of, shareholders and stakeholders. Otherwise the company may face reputational challenges that could undermine trust in the business.

Capital raising and shareholder rights

In ways that relate to capital allocation, companies may be required to seek additional capital to provide financing through the crisis. This is another area that will call for investor support, and a possible suspension of traditional shareholder rights may be justified to provide additional flexibility to companies. For example, to facilitate capital issuance when companies are in need of financing the UK's Pre-Emption Group recently issued a notice encouraging investors to consider supporting equity issues that could be 20% dilutive – far higher the UK's traditional annual pre-emption standard.[11] However, the clear preference among UK investors is for any new capital raisings to offer pre-emption rights and minimize dilution to shareholders. Companies that abuse this flexibility will lose trust with their investor base.

Another potential compromise in shareholder rights relates to annual general meetings (AGMs), where delays may be prompted by financial reporting challenges and where the inability to convene physically will give rise in some cases to virtual AGMs in lieu of physical meetings. A recent ICGN Viewpoint reported on how a range of individual markets globally are dealing with disruptions to the 2020 AGM season.[12]
Many investors prefer physical AGMs (or a hybrid structure) to allow shareholders to raise questions directly and to underscore board and management accountability to shareholders.

[8] SquareWell Partners, "Institutional Investor Provide Clarity on their Stewardship Responsibilities", March 2020: https://squarewell-partners.com/home/#who-we-are
[9] Kristen Jordan Shamus, Kristi Tanner, Niraj Warikoo, "Wayne County, Detroit Account for 47% of State's Coronavirus Cases, *Detroit Free Press*, April, 4, 2020.
[10] Daniel Thomas et. al., "Investors and Politicians Demand Coronavirus Pay Cuts", *Financial Times*, April 2, 2020.
[11] Financial Reporting Council, "Pre-Emption Group expectations for issuances in current circumstances", 1 April 2020: https://www.frc.org.uk/news/april-2020/pre-emption-group-expectations-for-issuances-in-th
[12] ICGN Viewpoint, "How different markets are handling shareholder meetings during the COVID-19 health emergency", March 2020: https://www.icgn.org/how-different-markets-are-handling-shareholder-meetings-during-covid-19-coronavirus-health-emergency

But in the current environment investors need to accept reasonable compromises and support companies as they confront the challenges—at least until the acute pressures of the crisis abate.

Conclusion

The economic shock brought by the COVID-19 crisis is both severe and likely to have long term effects. This will give rise to important capital allocation decisions by companies that will impact investors, stakeholders and a company's own sustainability. These impacts will vary between companies and sectors and it is incumbent on companies and their boards to find an appropriate equilibrium between competing interests for capital. Investors will generally be supportive of companies in this difficult environment, but will also want to have their needs appreciated and rights respected as the crisis evolves. Specific considerations to guide boards – and investor engagement with boards—include:

Sharing the pain. The crisis will affect a broad and interconnected "ecosystem": companies and their executives, investors and stakeholders. While the company must first prioritise its own financial solvency and sustainability, capital allocation decisions that have disproportionately positive or negative impacts on any one component of this ecosystem will be scrutinised by investors and must be weighed carefully by the board.

Most investors are ordinary citizens, not the financial elite. Cuts in dividends will not affect only a few wealthy investors. They will lead to cuts in retirement income for ordinary savers and pensioners who are the ultimate beneficiaries of most asset managers and asset owners. This is a broad base of society, for whom a basic retirement income represents a social good. Particularly as end beneficiaries the needs of the ordinary shareholder must be considered in the capital allocation process.

Do not abuse the relaxation of shareholder rights. Greater investor flexibility about AGMs and capital raising is meant to show support to companies, not establish a future precedent for business as usual. Investors expect companies to respect these additional flexibilities as temporary measures and not to exploit them. Traditional shareholder rights and standards should be reinstated as and when more normal market conditions are established. Company abuse of shareholder rights will be tracked by investors and can damage investor trust.

Long-term focus: avoid extremes and prescriptive responses. The COVID-19 crisis is bringing appropriate scrutiny to capital allocation practices, including share buybacks and dividend payments, which have the potential to weaken a company's financial resiliency. In this immediate environment it may be tempting to consider simplistic, and possibly extreme, reactions, such as a blanket ban on share buybacks or dividends. However, prescriptive capital allocations solutions will not be relevant for all companies in all sectors, nor likely to stand the test of time. It is ultimately a matter for the company and its board to develop a bespoke and balanced response that meets the company's immediate needs during the crisis, but also positions it for long term sustainability and positive outcomes for investors and stakeholders.

About ICGN Viewpoints

While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to inform and generate debate.

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