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FROM THE INSIDE OUT

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Beyond the Stock Price: Capital Market Signals Worth Heeding

Capital markets span a wide variety of vehicles including stocks, bonds and derivatives, each of which can potentially emit different signals. All too frequently, management teams only focus on their stock's price action to the exclusion of everything else. To the keen observer, esoteric corners of the capital markets can signal when a company is in trouble and in need of transformation services. Ultimately, the goal of business transformations is to create value in the form of improving a company's posture in the equity and debt markets.

Among the most valuable indicators followed by Jim O'Donnell, Senior Director with Alvarez & Marsal in San Francisco are these top five:

1. **Short interest**

Short interest is a statistic which gives insight into how many shares of a company's stock are sold short. While virtually every stock that trades has a certain amount of their shares sold short, when the amount of short interest exceeds a certain level, "that starts to indicate more than just hedging – the market is suggesting that either the company's fundamental strategy is wrong or its execution is flawed," says Mr. O'Donnell. Companies should monitor the level of short-selling occurring in their stock and seek to gain an understanding around which investors are shorting it as well as their short thesis.

Paradoxically, the amount of short interest can be a lever of shareholder value creation because it represents future buyers of a company's stock. The best solution to erasing the interest of short-sellers is to give the market a positive surprise and thereby trigger a scramble by these short sellers to buy back the shares they have sold short.

2. **Debt trading**

Irrespective of the stock market, the bond market expresses its own opinion on a company's fortunes. That opinion can be viewed by looking at the price action in the company's bonds. When the price of a company's bond falls, it may mean investors are less confident of being repaid. A falling bond price can be the forerunner to a plunging stock price. So, what spooks bond markets? Debt investors typically focus on companies' free cash flow, how much debt they have on their books and how close they are to covenant violations (breaching the terms of the debt and triggering a default).

"Frequently, companies are able to roll over their debt for another five to seven years, but if the debt markets are not too fond of you, they will charge you more interest to do that, or in the worst case, they won't lend to you at all," says Mr. O'Donnell.

Another important debt market cue for a company to monitor is the difference between the yield on its bonds and the yield on risk-free government debt of the same maturity. When this difference (known as the spread) widens, it can be a signal that bond market investors are growing more nervous about being repaid.

"Spreads are a very emotional type of barometer," says Mr. O'Donnell. "The availability of capital that lenders are willing to provide ebbs and flows based on sentiment. When the capital markets window closes, if your company is seen as a poor-quality borrower, you have a problem."

3. Credit default swaps

Credit default swaps (CDS) are an esoteric derivative designed to hedge credit risk (the risk of not being repaid). When the CDS price goes up, that's not a good thing - investors are effectively betting that the borrower has a higher likelihood of default.

"As a derivative, CDS are certainly more obscure than stock or bond prices, but still offer 'rich information' because they can provide a real-time estimate of how debt market investors view the company's risk of default," says Mr. O'Donnell. Companies can also learn a lot about their major rivals and customers by looking at their respective bond price and CDS trading action. There are strategic and tactical benefits to paying attention to these signals - is the market betting a that competitor is about to go bust? Is there a risk a customer may go bankrupt and won't be able to pay?

If a company seeks to influence the price action of its CDS and bonds, it is important to understand that the debt market takes a "show me" approach, according to Mr. O'Donnell. "The best way to influence sentiment is to improve free cash flow and reduce leverage – the bond market wants to see action," he adds.

4. Option volatility around earnings

In the days leading up to an earnings announcement, options trading on a company's stock exhibit price behavior that can provide valuable information on how the markets perceive the probability of a company missing consensus earnings estimates. A large implied volatility embedded in option prices ahead of an earnings announcement indicates a high degree of uncertainty or anxiety around the results and predicts what will happen to the stock price as a result of an unexpected event. Option traders call this predictor the "implied move." The implied move estimates what percent a stock will move up or down based on good news or bad news.

"If the management team has done a good job and established credibility with the market, you will likely only see small predicted moves ahead of earnings announcements," says Mr. O'Donnell. "If you're a serial disappointer with three quarters of misses behind you, the volatility expectations embedded in stocks' options will be far greater."

Option implied volatility around earnings is a factor that senior leadership and boards should be aware of. "This should be an internal measure on management's report card. It is an indicator of when companies need to do a better job of communicating with the capital markets, managing expectations and executing on their stated business model" says Mr. O'Donnell.

5. Makeup of the shareholder base

One of the biggest changes in their shareholder base for most companies over the last decade has been the increasing presence of index funds. Today, they can comprise from a fifth to a third of a company's shareholder base. Unfortunately, investment from passively managed index funds doesn't reveal anything about the market's view of a company's prospects. It is the investment strategies of the actively-managed investment funds apart from the index funds which can offer useful information for leaders. Whether they are growth investors, value investors, hedge funds or quant funds (which pick stocks based on computer models), it is important to understand what will make these fundamental investors turn negative on the stock and sell.

An analysis of selling shareholders is important as well. Are stalwart long-term shareholders throwing in the towel and walking away after five to ten years? "Management teams who are trying to create value need to understand what motivates their shareholders," says Mr. O'Donnell. "If a big enough holder decides to sell, it will likely hurt the stock price, and companies should have an understanding of what will trigger that sell discipline."

In short, well-run companies should keep track of the signals the capital markets are sending because they are the final determinant of value creation versus value destruction. There is no good reason to remain oblivious: "All of the information is out there in the public domain and companies can create dashboards to monitor these signals without difficulty," adds Mr. O'Donnell.

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