

Sionna Insight

Debtors' Prison

Up until the mid-19th century, debtors' prisons served as a malicious means for creditors to punish delinquent borrowers. Marshalsea, one of London's more notorious prisons, subjected occupants to a grim plight that guaranteed a debtors' financial position would surely worsen. Constrained by the prison's walls, earning a wage became an impossibility. In addition, Marshalsea's practice of garnish (charging for food, water, and even "lodgings" in the prison) ensured that deleveraging was next to impossible. Debtors' prison presented a series of structural constraints that magnified the risks of an individual's already tenuous financial position.

Today's credit environment parallels the confines of Marshalsea. The process of deleveraging the global economy is underway. As a result, corporations are reassessing the new "appropriate" capital structure in an environment of weakening economic prospects and restrictive access to capital. As capital structures are realigned, as corporate cash flows deteriorate, equity investors face a higher risk of dividend cuts or equity dilution. In the end, corporations that have maintained conservative capital structures or those that act quickly to reposition themselves to the changing landscape will be best placed to take advantage of this crisis. Sionna believes that equity investors should continue to remain vigilant in this environment of heightened risk.

Since 2002, companies have benefited from an incredibly strong economic tailwind. As a result, corporate profitability, as measured by net income margins or return on equity, is at the highest levels experienced in the last twenty years. As outlined by the table below, between 1996 and 2007, companies in the S&P / TSX Composite generated an annual average cash flow of \$876. Over the last four years, S&P/TSX cash flow rose to a peak of \$1,365, 57% above the average annual cash flow for the last twelve years.

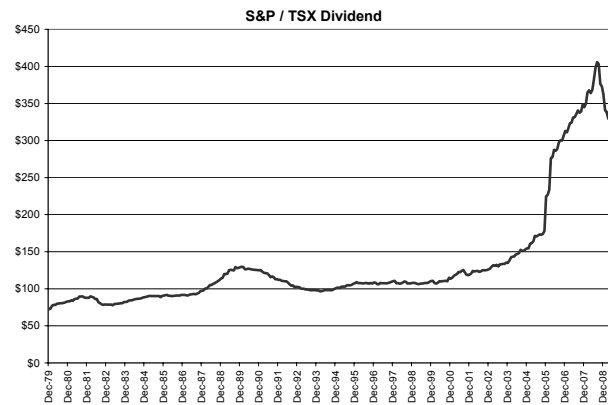
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008F
S&P/TSX Operating Earnings	290	294	247	299	464	308	330	448	540	644	767	818	853
Cash Flow	615	651	645	665	790	732	740	923	1005	1120	1267	1365	1447

Source: BMO Capital Markets

Following five years of prosperity, and being lulled into a false sense of security, businesses and investors are facing a severe wake-up call. Investors will struggle to grapple with the depth and duration of this downturn. Clearly, businesses will experience a decline in corporate profitability and cash flows. In response, management teams have moved to realign cost structures. In some situations, this cost curtailment may not offset declines in revenue. As a result, the cash flow shortfall caused by weaker operating results must be filled by one of three sources: borrow more, pay out less in dividends, or raise additional equity capital. From an equity investor's perspective, with credit markets remaining fairly constrained, we see more and more companies forced to cut dividends and/or raise equity capital to strengthen balance sheet liquidity.

As Sionna has articulated in the past, dividends account for a disproportionate share of equity returns in a sideways market. Of high importance when considering future equity returns is the sustainability of existing dividends. As outlined in the chart below, S&P/TSX constituent dividends have risen substantially over the last thirty years. Most significantly, between December 2004 and August 2008 dividends rose 163%. While this rise is partially explained by the 2005/2006 inclusion of income trusts

into the S&P/TSX, it also captures a period when activist investors implored management teams to deploy excess capital via share buybacks and higher dividends. Management teams must be quick to react to the changing realities of today's environment. Since the beginning of the credit crisis, companies have moved to quickly reduce dividend payouts in response to an anticipated deterioration in operating results. S&P / TSX dividends have declined 19% since peak levels in 2008. According to Standard & Poor's, 2009 is expected to be the worst year for US dividend cuts since 1938. On-going economic uncertainty will likely force more Boards to reassess the appropriate amount of capital to be retained or returned to shareholders.



In addition to dividend cuts, declines in operating cash flow may create the need to access capital markets. Sionna has seen many situations in which innocuous debt levels turn toxic seemingly overnight. The credit market's response to businesses that need financing while facing a swift decline in operating profits and cash flows has been a resounding "no thank you". As a result, companies in this situation (squarely between a rock and a hard place) are forced into completing highly dilutive equity financings. Perhaps the best example of the risk of dilution that exists in the market today is the Canadian banks (for more information see Sionna's previous published articles at www.sionna.ca). Driven by a robust economy, bank profitability soared, providing the industry with ample excess capital and rising stock prices. Despite strong stock performance, bank boards continued to allocate more and more excess capital to share buybacks and higher dividends. During 2005 to 2007, the banking industry bought back 140.5M shares, costing \$8.0B. In 2008, banks required additional balance sheet strength and capital and returned to the equity market by selling 196.5M shares, raising \$8.2B. Despite experiencing one of the most lucrative banking cycles ever, banks sold 12% more shares than they acquired for approximately the same amount of money. Investors' claim to future earnings has declined because of dilution.

It is likely that any bear market rally will eventually be met with a round of secondary offerings. The CEO's focus has temporarily shifted from the income statement to the balance sheet and the need for businesses to raise capital has never been higher. At a price, management teams will move to ensure they have the balance sheet to withstand the worst case scenarios predicted for this downturn. These challenging markets require continued vigilance. The most attractive businesses are those with highly predictable / recurring revenue and cash flow streams. In addition, Sionna remains wary of leverage and the need for eventual access to capital. While all that remains of Marshalsea today is a single wall and two gated arches, its legacy lives on. No doubt exists that today's credit environment will linger in financial history for some time. For many Marshalsea occupants, freedom could only be achieved as a result of gifts from family and friends. Ironically, for some companies, a similar salvation relies on government bailouts. Others may escape by punishing existing shareholders with dividend cuts and/or dilution.

*Creditors have better memories than debtors.
Benjamin Franklin*

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