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Outside the Box

Opinion: Beware of ‘zombie’ companies running rampant in the stock market

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A total of 19%, or 571 companies, in the Russell 3000 Index are considered unviable

Aggressive intervention by the U.S. central bank added to the ranks of the corporate walking dead. ***GETTY IMAGES***

Few would dispute that the Federal Reserve’s enormous doses of monetary medicine this year were necessary to alleviate the worst economic impacts of the coronavirus pandemic.

But every treatment comes with risks and side effects, and the aggressive intervention by the U.S. central bank added significantly to the ranks of the corporate walking dead, as I call it.

These so-called zombie companies continue to muddle along in a financial twilight zone because near-zero interest rates are driving investor appetite for risk while allowing faltering businesses to keep tapping capital markets for the cheap cash they need to make up the shortfall between lackluster earnings and the money needed to pay interest on their debt.

A widely accepted definition of a zombie is a business with an interest coverage ratio of less than 1 for three years. On that measure, 11% of Russell 3000 Index companies are unviable, a figure that jumps to 19%, or 571 companies, on a 12-month basis. Altogether, those 571 businesses employ more than 800,000 people. (The index encompasses 98% of the total stock market.)

No profits

Partly due to companies in pre-product, pre-revenue development phases in sectors such as tech and biotech, about a fifth of Russell 3000 companies have had no or negative earnings per share on average over the past 25 years. Currently, that number is 10 percentage points higher, at 30%. To put that in context, the proportion was 29% in the dot-com bust era at the turn of the century and last exceeded 25% during the Great Financial Crisis (GFC).

Rather than being limited to small, little-known enterprises, zombies include names such as security services player ADT Inc., ride-share company Uber Technologies Inc. oil-drilling expert Transocean and movie-theater operator AMC Entertainment Holdings Inc. While some of these companies are in sectors that have been hit hard by the pandemic, Tesla Inc., Wayfair Inc. and Roku Inc. are also among the household names whose earnings before interest, tax, depreciation and amortization (EBITDA) don’t cover debt payments.

That doesn’t inevitably mean that these businesses lack long-term viability for profitable growth. Many earlier-stage businesses — along with more established ones such as Salesforce.com Inc. and Amazon.com Inc. — reinvest significant portions of revenue in future growth, delaying profit generation until they establish dominance.

Investors are willing to fund biotechs such as Moderna Inc. that are in the earlier, less profitable phases of their life cycle in the expectation that innovative products will prove to be sustainably cash generative over the long term. Moderna had a loss of 59 cents per share on higher research costs even as revenue surged more than nine times to $157.91 million in the three months through Sept. 30. Despite the inherent risks, the prospect of an efficacious vaccine validating MNRA’s platform technology has fueled the company’s market capitalization to $39 billion.

Low returns on bonds

With yields on asset classes including Treasuries, investment-grade and high-yield debt at near record lows, investors’ willingness to take additional risk is extending to lower-quality companies, allowing them to continue to raise debt financing. U.S. corporate bond issuance almost doubled to $1.45 trillion in the first nine months of 2020 from the same period a year earlier, with high-yield accounting for a record $346 billion through the first week of October.

That helped to compress the interest coverage ratio for the Russell 3000 as a whole to 4.6 times at the end of the third quarter, from a peak of 7.17 times in early 2015 and bringing the data point close to the 4.53 level seen during the GFC, suggesting well-run companies are also feeling duress from the pandemic.

This pressure is likely being exacerbated by the behavior of more stressed businesses. Short-term management thinking likely contributed to the predicament many zombies find themselves in, and such companies, with median net debt running at 4.8 times EBITDA, are unlikely to take a long-term view now that the imperative is to survive at all cost.

Many among the walking dead already have tighter margins than their peers, and should they opt to discount prices even more steeply in a bid to win an order and keep the doors open, the risk increases of a race to the bottom on pricing.

While zombies in regulated industries, such as for-profit hospitals operator Community Health System, are more limited in how far they can cut prices, those in less regulated industries such as toy maker Mattel Inc. can be more aggressive, potentially impacting rivals such as Hasbro Inc. during the critical holiday season.

Investors should therefore give a wide berth to irrational industries where this type of tactic can cause contagion for well-managed competitors. Such sectors include consumer discretionary, in particular hotels, leisure, restaurants and travel; oil, gas and energy equipment suppliers; media and entertainment companies; and struggling players in road, rail, electrical equipment, machinery and commercial services in the industrials arena.

Prudent investing

Prudent investors shun destroyers of value and focus instead on allocating to well-run companies with low leverage that generate a high return on invested capital because of their scale or because they hold a sustainable competitive advantage derived from a unique technology or intellectual property (IP).

Adobe Inc. and ServiceNow Inc. are examples of software providers with strong management and IP that operate in spaces that are benefiting from the digitization of the global economy.

Costco Wholesale Corp. is an outlier among retailers that has proven to be especially resilient during the pandemic, in large part because of a value proposition that few, if any, can match.

Health care is a sector that seems likely to benefit from increased spending, which may boost companies such as diagnostics and pharmaceutical supplier Thermo Fisher Scientific Inc., while animal medicines maker Zoetis Inc. is also proving to be resilient as pet owners prioritize the welfare of their furry friends regardless of financial stress.

Another large-cap that can lean on its scale, especially as concern about the virus leads to more electronic and contactless payments, is Visa Inc.

While about two-thirds of zombie firms eventually recover, according to research by the Bank of Finland, about half take three years to break the spell, while 15% take more than five years. Investors who allocate to them are therefore not only predicting which will survive but are tying up capital potentially for several years that could be earning a return elsewhere.

The more prudent approach is to avoid the walking dead altogether and back resilient, high-quality businesses with low leverage that can meet their obligations.

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