Companies with Resistance to COVID-19

By Editorial Staff *Thu, Apr 30, 2020*

The equity crash in March was a living experiment that allowed investigators to see precisely which of a company's characteristics help or hurt its share price during a big sell-off.

Just as healthier people seem to resist the COVID-19 virus better, the share prices of financially healthier companies fell relatively less during the market crash last month, according to an **analysis** by academics at the Haas School of Business at the University of California at Berkeley and in Hong Kong.

In their paper, "Corporate Immunity to the COVID-19 Pandemic," Ross Levine of Berkeley, Wenzhi Ding and Chen Lin of Hong Kong University, and Wensi Xie of the Chinese University of Hong Kong pointed out that, even as the S&P 500 Index fell by 34% in the first quarter of 2020, the damage varied significantly from firm to firm, even among those in the same industry.

Examining data from more than 6,000 companies in 56 economies, the analysts found certain characteristics common to the hardier companies:

- Stronger pre-2020 finances (more cash, less debt, and larger profits)
- Less exposure to COVID-19 through global supply chains and customer locations
- More CSR (Corporate Social Responsibility) activities
- Less entrenched executives (indicated by absence of takeover defenses)
- Less large block ownership (>5% of shares) by hedge funds
- More large block ownership by non-financial firms (a sign of long-term investments from strategic partners)

Ross Levine

“The traits of firms were common knowledge,” Levine told *RIJ*. “How the market would price them once a pandemic hit was not known. Fundamentally, there are debates about the sign and importance of CSR, executive entrenchment, board structure, executive compensation, and ownership on a corporation’s resilience to adverse shocks. The response to the pandemic helps determine which theories about corporate resilience actually hold in practice.”

Cash and leverage levels, not surprisingly, mattered a lot. “Comparing two otherwise similar firms, the low-cash firm—the firm with one standard deviation lower pre-2020 ratio of cash-to-assets—would experience an almost 6% (of the sample mean weekly stock return) extra drop in its stock returns in response to the same COVID-19 shock,” the paper said.

“Using a similar comparison, a high-leverage firm (one standard deviation greater pre-2020 leverage than an otherwise similar firm) would experience an extra 10% (of the sample mean value of weekly stock returns) drop in stock returns according to our estimates,” the authors added.

Companies where hedge funds owned big stakes were also more vulnerable. “Hedge funds sell their shares rapidly in response to negative information about COVID-19 cases, intensifying downward pressure on prices, while owners with long-run, strategic commitments to firms (including large corporations), tend to dampen the adverse impact of the pandemic on stock prices,” the paper said.

“Hedge funds might be more focused on pursuing short-run stock performance and engaging in high-frequency trading than other blockholders,” it continued. “As a result, they might be more likely to sell shares quickly in response to news about COVID-19, generating downward pressure on the prices of companies in which they are large shareholders.”

Good corporate citizens and companies with a home-market focus also fared relatively well in the crash. “CSR investments strengthen the informal ties between a firm and its workers, suppliers, customers, and other stakeholders, enabling the firm to more effectively and efficiently work with those stakeholders, and enhance the firm’s likelihood of survival and future success,” the academics wrote.

They added that “the stock price of the more internationally exposed firm would fall by 3.25 percentage points more than the less exposed firm over two months” and that “stock prices in economies with a larger proportion of the population aged over 65 have experienced much sharper declines."

Investors also appeared to recognize that a country's "legal traditions" can be correlated with stock prices.

"Firms in economies with French, German, and socialist legal traditions experienced milder stock price declines than those with a common law tradition," the paper said. "To the extent that legal origin captures state vs. individual/court power, these results suggest that markets viewed states with more power as better able to address the public health crisis, mitigating stock price declines."

RIJ asked Levine how inclusion in index funds, and the **systematic risk** that they confer on stocks in the index, might have affected the price volatility of individual stocks. He replied that causality tends to run in the opposite direction. "In general, when index funds simply buy and hold a particular weighted portfolio of stocks, and those weights do not change frequently, stock prices are determined by those who do trade," he said.

Information spreads like a virus

In their research **paper**, "Feverish Stock Price Reactions" to COVID-19, Stefano Ramelli and Alexander F. Wagner compare the spread of the investment panic to the spread of the virus, dividing the panic into three stages: *Incubation* (January 2-17, 2020); *Outbreak* (January 20-February 21); and *Fever* (February 24-March 20).

The authors use data from corporate earnings calls, Google keyword searches, and stock price movements, to reconstruct the spread of investor anxiety about specific corporate characteristics—a company's degree of globalization, leverage, sensitivity to quarantines and social distancing—as the virus progressed.

During the "outbreak" phase, investors and analysts were mainly worried about a firm's degree of exposure to international supply chains. As the crisis progressed to the fever stage, they became more concerned about a firm's degree of leverage and lack of liquidity.

Like Levine, et al., the authors of this paper observe that highly leveraged companies with low cash reserves were the most vulnerable—and therefore benefited most from the Federal Reserve's actions.

"The Fed announcement to purchase newly issued bonds and loans on the primary market can be expected to support firms running low on cash because it means that they can effectively raise funds immediately from the Fed. The announcement to purchase outstanding corporate bonds and exchange-traded funds (ETFs) on the secondary market can be expected to support firms with high leverage," they wrote.