FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

10 July 2020

Volume 1056

Beyond COVID-19

The macroeconomic environment that we are most likely to inherit after the lockdown and the view across sectors

Written by: Bafana Patrick Mathidi, Head of Equities, ALUWANI Capital Partners

Even though questions arise about the duration of the pandemic-induced lockdown and the most likely glide path towards resumption of economic activity to normality, human and economic costs continue to accumulate to unimaginable levels. Concerns remain on whether the relief measures and programmes announced by authorities and civil society are sufficient to carry us through to some normality beyond COVID-19 given the unfolding and projected scourge.

In the midst of this, financial markets have somewhat recovered from the initial sell-off and lows recorded in mid-March 2020. This is in stark contrast to deteriorating economic fundamentals, further raising questions about how far out financial markets are in pricing the ‘new normal’, when it will unfold and what that new normal looks like.

The period between the current lockdown period and when global economies are safely resuming full economic productive activity will remain fluid, in our view, with most economic statistics laying bare the effects of the pandemic on humans and economies. Given the fluidity, it makes for a difficult investment environment especially since the one key variable that goes into company valuation, earnings, has become unpredictable. Even corporate executives who generally occupy front row seats with a clear view of the company’s prospects, have become reluctant in providing both earnings guidance and any forward-looking projections.

Our investment process considers valuation, quality (a combination of ESG factors including our proprietary definition and markers of what makes a good company) and both structural and cyclical themes that can directly either enhance or detract from the perceived value of a company. Given the fluidity of the current lockdown macro environment (as mentioned a few times above) we have rather opted to place greater focus on the quality and thematic considerations of our stock selection process in the current environment. We have therefore focused our client portfolios on companies that we feel (based on our prior and existing knowledge of their respective operating models and calibre of management teams) are most likely to 'survive' but not necessarily 'thrive' under this environment. These would be companies with limited debt on their balance sheets, that are highly cash generative in the normal course of business, that are market leaders in their respective sectors, and are led by management teams with an impeccable track record of shareholder value creation through any market cycle.

What operating environment can we expect after lockdown?

We have no singular view of the world and future, but rather prefer to use scenario-planning techniques in our assessment of the state of the macro environment, and the extent to which such scenarios may be priced into financial markets.

So, what does a post-lockdown, domestic macro-economic environment look like? South Africa's fiscal reality was already constrained, and the much needed and necessary relief measures put in place by the fiscus will unfortunately place further strain on the economy. Not to mention, at the risk of being lulled into a false sense of comfort, we still have underperforming state-owned entities that require fiscal support, with the pandemic making it worse in some instances. Depending on which survey and forecast one chooses to believe, the downward trend in economic growth and the sharp rise in unemployment seem inevitable. A macro backdrop that is not conducive to corporate earnings growth.

Three scenarios to the domestic macro backdrop after lockdown

Scenario 1: L-shaped recovery where economic activity recovers to pre-pandemic levels (consensus was at 1% GDP growth for 2020). We assign a very low probability to this scenario happening within an 18-month to three-year investment horizon. For us to assign a higher probability of this scenario playing out within our investment horizon would need a clear commitment to implementing the much talked-about and much-needed structural reforms on the part of government followed by rapid asset sales to boost the fiscus to redirect those proceeds towards stimulating economic growth.

Scenario 2: We believe that a square root recovery has the higher probability of playing out, where some productive capacity and consumer confidence is restored to boost domestic growth after the lockdown, but that the recovery is not sufficiently meaningful to restore activity levels to those prior to the lockdown. This scenario is hinged on a global macro-economic recovery led largely by the G7 largest economies, where South Africa gets its fair share of the initial recovery, but domestic constraints result in the economy moving sideways from there beyond our investment horizon.

Scenario 3: A V-shaped recovery is predicated on very targeted reforms being implemented immediately in anticipation and aimed at avoiding a worst-case outcome post the lockdown. Political and business analysts alike are beating the drum louder and louder and urging the President not to let this crisis go to waste and rather use the political space to fast-track economic reforms. Impressive the response to the pandemic has been to date from the President, an economic plan aimed at reviving economic activity and growth post the lockdown remains elusive, although there remains some scope for a positive surprise.

The actual outcome will be somewhere between scenarios 2 and 3: some businesses and companies will inevitably cease to operate, at least in the shape and form as we have come to know, however there will be a series of new industries and businesses that will emerge, including rising phoenixes picking up market share where some companies have just struggled to survive this period.

What are we most worried about domestically?

A key question that remains top of mind for our team is the ZAR/USD exchange rate. All traditional valuation tools indicate the rand as being oversold or cheap against its major crosses (US dollar, pound sterling and euro) and historically the rand surely has the propensity to recover sharply solely on sentiment unaccompanied by fundamentals. It is therefore likely that the rand can recover at least to a R15 to R16.50 range after lockdown. Other than our banks' exposure, the overall portfolio is not well-suited to a stronger rand beyond the R16.50 range.

Banks: On our banks' exposure, surely, they are at the centre of the domestic economy and there is a strong correlation between GDP growth and banks' earnings. Are banks pricing in a high probability of capital raise, given their deep discount to book values share prices currently? Within the main JSE sectors, banks have been hardest hit, just behind the property sector names. In our view, we think banks are in a much better shape compared to the global financial crisis in 2018 in that they are more than adequately capitalised, and relief measures announced by the regulator are highly supportive. However, the lingering question is the impairment and bad debt experience post lockdown, especially if some of the relief measures announced prove insufficient especially for highly indebted individuals followed by some (or more) corporate failures.

Property: Focusing on the property sector, our view remains bearish. Are we being overly pessimistic of the sector, given the consistent underperformance? In other words, does the market valuation for the sector not present a unique entry level with significant margin of safety on the downside? Certainly, the sector is offering a lot of value at current levels, however we have always viewed the sector as a 'late cycle' play, meaning that a lot needs to come right with the economy to provide some basis for a positive outlook and constructive investment thesis on the sector. In our view, this sector is ripe for some structural changes (because of the pandemic and resultant lockdown) in tenant behaviours both in terms of shopping and demand for space.

As a result of the lockdown and need for social distancing, e-commerce is set to take off as a viable alternative to safe shopping, with most retailers investing (currently and increasingly more going forward) in supply chains. While we note that it won't completely replace on-the-floor consumer shopping experience, in an environment where there is already a lot of space capacity with probably more to come post lockdown as some businesses simply fail, excess supply on its own will continue to supress some of the key fundamentals necessary to unlocking shareholder value. On the office rental side, we think some of the structural changes will be driven by business uncertainty and low confidence resulting in the lack of commitment to long duration leases and less demand for office space, in preference for more flexible work arrangement with employees and therefore demanding more flexibility in office space. These are all trends that were starting to emerge pre-lockdown, and in our view, these get accelerated, all working against property landlords.

Retail sector: Our view is that the profitability of the retail sector in aggregate is most likely to come under pressure due to an increase in costs from a current and sustained weakening of ZAR due to the imported component of some retail items, especially apparel fabric. We are likely to see lower margins from increased promotional activity aimed at stimulating sales, as retailers compete for likely lower consumer spend (this should impact apparel and clothing retailers more than food retailers). Dislocation in global supply chains will put pressure on SA clothing retailers to find newer or closer markets for procurement, which could result in higher input costs and further margin compression as pricing power to the end consumer remains limited. Balance sheets are likely to be stretched, even worse for apparel retailers who are unable to sell all their items due to lockdown regulations and have high debt levels already, coupled with the likelihood of tightening in credit and lower liquidity, this will put pressure on dividends. Worsening macro and poorer consumer are likely to lead to deterioration in the debtor's book of the credit retailers leading to impairments debt write offs and poor earnings as a result.

A 'new normal' operating environment for retailers will be characterised by a changed consumer behaviour, in our view: more online vs face to face shopping and thus less bricks and mortar store expansion, in addition we are likely to see more bargain hunting and the need for value for money shopping, and on the food retail side more in-home ready to eat private label brands will find increasing favour with consumers. We favour retailers with innovative management teams, strong balance sheets, compelling value offering to customers and those that have invested in e-commerce channels.

Healthcare sector: We see a possible change in the business model in this sector. For example, there will be a need for a rethink of the supply chain diversity to mitigate against issues of procuring drugs and medical equipment going forward. Some adjustments to the day-to-day ways in which hospitals operate (e.g. trimming down people per ward). Anecdotal evidence from some international hospitals suggests that capacity utilisation could remain low for a while. Rooms which previously had space for two beds only have one bed to maintain distance. Whether this will be the case in the country will depend on our experience of the virus. Nevertheless, hospital occupancies are likely to be low with non-critical care cases and surgeries being postponed creating capacity for the COVID-19 spill-over especially from the public hospitals. From an ethical perspective, especially post COVID-19, questions are likely to arise as to why the private sector cannot assist with other 'normal' cases, resuscitating the NHI debate once again.

Oil & chemicals: The global uncertainty regarding COVID-19 has resulted in the reduced demand for crude oil. Lower oil prices have negatively impacted the profitability of Sasol and this will necessitate the need for expensive oil hedges in 2021. Furthermore, lower oil prices for WTI in the US will curtail oil production in that country with the result that higher ethane prices (the key input to Sasol's LCCP operation) will negatively affect the profitability of that operation. At the same time of this global uncertainty, Sasol needs to dispose of assets to help reduce the size of a potential rights issue. Realising fair value for these assets at this time could be difficult to achieve, especially with all potential buyers facing the same macro environment. Sasol needs further debt covenant relaxation to ensure adequate liquidity over the next 12 months. Several self-help measures aimed at shoring up liquidity are becoming difficult to achieve as demand for oil and chemical products has declined. Should offshore asset disposals be achieved, Sasol will become more exposed to the very assets (Secunda and Sasolburg) that are producing alarming levels of CO^2 emissions.

PGMs (Platinum Group Materials): Demand for PGMs has reduced due to the decline in global activity and falling demand for new vehicles. Offsetting this has been the increase in PGM loadings in catalyst converters and falling production of PGM metals due to lockdown measures in both South Africa and Zimbabwe. Palladium has been less affected than platinum since the former is also produced in North America and Russia where lockdown measures are not so apparent. A more pronounced decline in demand for PGM metals (secondary viral infections) may result in further metal price erosion and a reduced appetite for PGM counters.

Gold: An end to the COVID-19 crisis, an easing of geopolitical tensions and a reduction in quantitative easing will all contribute to a weakening of the gold price and a likely sell-off of the gold counters. This is not our base case over the immediate future given the uncertain environment.

Tobacco: Compared to other staples companies, we expect BAT's earnings to be less affected by COVID-19, except in countries such as South Africa where legal sales of tobacco products are prohibited. This is despite some slow-down in sales of both tobacco and next generation products.

The slow-down in sales of vaping products (more regulation-related) will have less impact on BAT compared to other peers due to the former being under indexed in this technology. Industry regulation remains the greatest threat to the tobacco industry, but this threat is somewhat reduced by the taxation derived from tobacco. We remain overweight BAT in our clients' portfolios.

Media: MultiChoice continues to have strong balance sheet capacity. However, there is significant risk in a bear case scenario where we would expect significant subscriber decline in SA as both premium and mid-market categories experience severe churn. In SSA, we would expect subscriber growth to slow materially resulting in significant declines in EPS. Prosus/Naspers are preferred picks in this environment given strong balance sheet and Tencent continuing to be a driver as it has a positive medium-term outlook. Prosus/Naspers can be expected to emerge from lockdown and subsequent economic repercussions in a stronger competitive position in its key online classifieds.

Glacier Research would like to thank Bafana Patrick Mathidi for his contribution to this week's Funds on Friday.

Bafana Patrick Mathidi, Head of Equities at ALUWANI Capital Partners

Bafana Patrick Mathidi is a Founding Member and Head of Equity & Multi Asset Strategies at ALUWANI Capital Partners (Pty)Ltd. Bafana trained as an accountant but practicing as an investment professional. He has over 20 years of industry experience and has been managing equity portfolios for more than 12 years. His skill set lies is in understanding the broader macroeconomic dynamics of financial markets, business models and financial asset valuations. Over this period, he created an investment process that placed the ALUWANI Domestic Equity fund as one of the best performing in South Africa, as rated by Morningstar for 2017.