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CASH BURN, COVID AND VALUE VS GROWTH - AUSTRALIAN EQUITIES INSIGHTS

PERPETUAL INVESTMENTS
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Volatile markets

Equity markets continued to be volatile in the last week as they reacted to competing news and events. The US market is only closed two days a week – Saturday and Sunday – but the weekend has magnified opening day woes as news of exponential growth in COVID-19 cases snowballs into pent up negativity by the start of trade. Shutdowns turning into lockdowns. The streets of NYC empty. Troops on the ground in Europe. Ice rinks in Spain converted to makeshift morgues. Every day brings new shocks. Last Monday not only saw equities plunge -37% below the levels of a month ago but also sent the AUD spiralling to $0.55. This came on top of the wobbles in bond markets the week before.

Monday's carnage was worsened by the announcement of the nationwide shutdown of non-essential services in Australia from midday. The massive new stimulus delivered by state and Federal governments was welcome and necessary, but came alongside grave forecasts of the largest reductions in GDP in since at least World War II, huge unemployment queues and large additional drops in equity markets (Goldman Sachs and Bank of America have respectively predicted -41% and -47% declines in the US S&P500 from top to bottom). The consolidation in the markets in the last few days begs the question: have we reached bottom already or is this week just a bear market rally?

The uncertainty around the scale and duration of the virus lingers and makes it difficult for the investors to envisage a baseline for markets. Infection growth rates may prove more accurate proxies for the market than traditional economic data. But there may be some glimmers of hope emerging. The worst hit country – Italy – may finally seeing cases peak, much like China and South Korea before it. This suggests that even the most badly affected countries seem able to stem the delta of infections after several weeks rather than many months.

Finally, a massive US fiscal stimulus of $2.2 trillion finally passed the Senate over the weekend after much partisan bickering. Jerome Powell also had his “whatever it takes” moment, backstopping markets for now. Combined with all of this, Trump is pushing an aggressive timetable for reopening the economy. Time will tell whether this all works. In the meantime we continue to keep your money invested in a range of the best quality and value opportunities we can find.

Below we address some of the things we are grappling with this week:

Cash burn rate

Cash burn rates became a popular concept after the tech wreck in 2000 as many dotcom businesses had their access to capital closed off. Each faced a fast countdown to extinction as they burned through the last cash they would ever receive from investors. Some concept businesses like them today may face the very same fate. But with non-essential services shut down this metric is also being applied to nearly every business in Australia. The majority of companies listed for a reasonable length of time on the ASX have real business models and merely face a countdown to re-opening rather than extinction.

However, it has focused attention on which businesses have the enough existing capital to finance a shutdown for several months if needed. Balance sheet quality varies wildly. Some companies may never need to come to market at all, or only do so at a time of their choosing. But others have been forced to come to market just a few weeks into the crisis. The big risk for many investors is that low quality businesses may not be able to raise money at any price and go broke or - nearly as bad - have to raise fresh equity at such deep discounts to the prevailing share price that existing investors have their ownership diluted to the point where it is effectively impaired – this happened to many REIT investors during the GFC in 2008/9. We have been analysing balance sheets, income statements and talking to companies to assess their cash burn from casinos the building and construction through to retail. Unsurprisingly prudent management teams we have long favoured have overwhelmingly good balance sheets. Companies that have had a cavalier attitude to financial management are at much greater risk.

Portfolios: We have modelled the cash burn rate of stocks in our portfolios and are confident that our investments have the existing capital resources for the months required until a six month shutdown is complete.

How can retailers cope with the COVID shutdown? A case study:

The case for Coles and Woolworths coping in a shutdown seems fairly straightforward, with their essential services in high demand. For other discretionary retailers it's more complex. Their share prices have taken a big hit, even if their business models are all different. Premier Investments is a clear case in point. We have invested in the business chaired by Solomon Lew for many years and we know management, their strategy and their finances very well. The Chairman and CEO are arguably the best and most experienced retailers in the country.

Our first consideration: their balance sheet. They have no debt. In fact, they are net cash, a rare and valuable position in this crisis. Management is also very cost focused and know where savings can be made. On Thursday they announced a complete shutdown for four weeks, with no revenue coming in but also no costs going out; staff keep their jobs but are to be laid off until 22 April and can access entitlements. Online sales of Peter Alexander brand are not affected. But 70% of Premier's stores are already in holdover or with leases expiring in 2020 providing the company with maximum flexibility. These extraordinary circumstances mean Premier intends not to pay any rent globally for the duration of the shutdown. Premier will also get rebates for February and March rents and potentially other tax and lending incentives connected to the stimulus.

But we think the big opportunities for Premier are:

- This crisis catalyses Premier's ambition, as a blue-chip retailer, to renegotiate rents lower in key shopping malls.

And

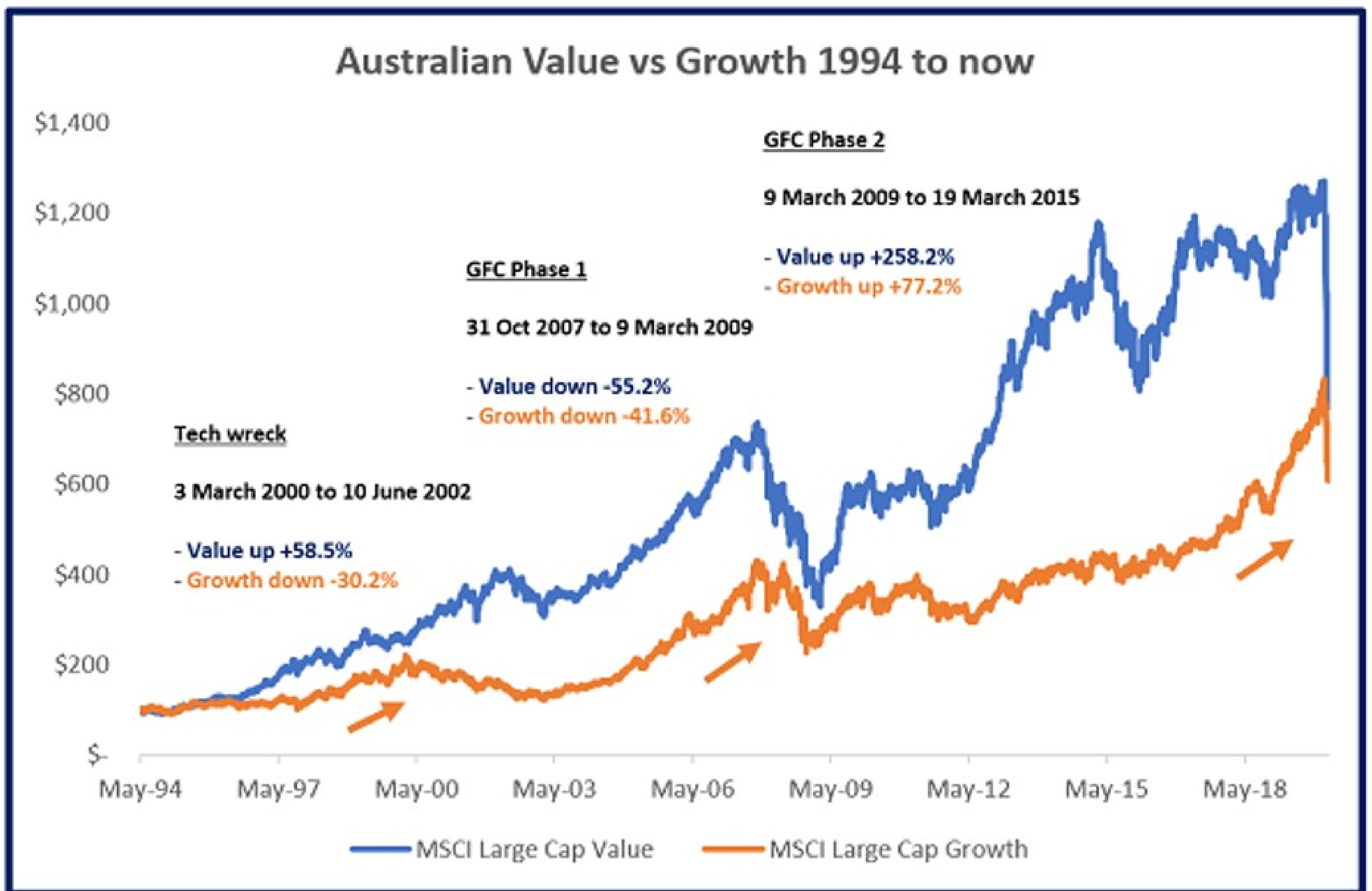
- Premiers pristine balance sheet gives it great strategic ability to buy the assets it wants coming out of this crisis.

Portfolios: We have taken advantage of the market declines to add to our position in Premier, which remains our top pick in the discretionary retail space.

Why has value not done better & why have growth stocks not de-rated?

This is a question that often comes up at times like now. Firstly, as Chart 1 shows, value has easily beaten growth over the long term, back to the inception of the MSCI value and growth indices in 1994. This is despite numerous growth stock booms (indicated by orange arrows), including the largest and most recent which started in around 2015.

Performance of the MSCI Australia Value and Growth Indices since inception 1994



NB: Past performance is not indicative of future performance.

More closely analysing the periods of changing performing make for some interesting observations.

It shows the differences in performance between value and growth in the last two market crashes preceding the present crisis.

The tech wreck: why did value perform immediately?

The chart firstly shows the performance of value vs growth around the dotcom period. On this occasion from the very beginning of the tech crash growth stocks began to underperform.

From March 2000 until 10 June 2002 growth stocks fell -30.2% whilst value stocks rose +58.5%. But why did growth underperform and value do so well? Much of it may have to do with the circumstances. Growth stocks were obviously expensive, tech in particular. The US Federal Reserve had been tightening policy consistently in the leadup to the tech bubble (except for 1998 when there was a slight easing). Indeed the Fed tightened throughout 2000 even after the market peaked and the economy did not enter recession until a year later in 2001. A high policy rate thus triggered a substitution away from expensive growth to relative cheap value almost immediately. This contrasts sharply with the experience in the GFC as illustrated in the same chart.

GFC Phase 1: Why did growth continue to outperform in the early phase of the GFC?

There had already been a substantial boom in growth stocks, with growth rising +256.3% from and value stocks up just 138.4% March 2003 to the 31st of October 2007. Yet instead of value outperforming when the GFC hit, value underperformed again. From 31 October 2007 until 9 March 2009 growth stock fell -41% and value fell -55.2%.

Whilst many growth and interest-rate exposed sectors were expensive in 2007 (such as REITs and entrepreneurial stocks) the markets immediate response to the economic shock of the financial crisis was to penalise value stocks. With banks and resource companies typically categorised as value stocks, these companies fell hardest in the immediate aftermath of the GFC as macroeconomic factors of the crisis trumped valuations.

Altogether in the 6 years from 2003 to 2009, encompassing the 4.5 year growth stock boom before the GFC and the first 18 months of the GFC value delivered a return of just +6.8% versus a whopping +108.2% for growth.

GFC Phase 2: Value outperforms after stocks bottomed

However from that point onward value stocks outperformed, as depicted in the chart. They were already very cheap and there was ample room for outperformance as the economy expanded, banks stabilised and the resource boom resumed.

Value stocks rose from 2009 right through to 2015, erasing all of their losses vs growth since the beginning of the GFC. Altogether

value stocks rose +258.2% from 9 March 2009 to 14 March 2015. Growth stocks, having hitherto held up so well, could manage only a +77.2% return.

In 2020 market conditions looked like 2000-2002 but are behaving more like 2007-9:

Part of the reason investors may be perplexed by the underperformance of value relates to the fact that markets looked much like they did in the leadup to March 2000 and there were expectations that value was finally due some outperformance. Growth stocks, in particular tech, were very expensive just as they were 20 years ago. The Fed had been on a tightening cycle over the last few years. It was perfectly reasonable to expect the markets were heading for a similar final act.

However the Fed had backed off rate hikes in the wake of two significant market corrections in 2018, much like 1998, even though the economic conditions appeared to be strengthening again heading into the US election. It will never be known if a tightening labour market would have forced the Fed to return to tighter conditions as 2020 unfolded and thus popped the growth sock bubble, much like in 2000.

However the sudden arrival of the COVID-19 crisis produced another macroeconomic shock, much like the banking crisis in 2007. Instead of focusing on the expensive growth sectors vulnerable to higher policy rates the market immediately focused on a rapidly deteriorating business cycle and began to discount cycle stocks including resources and banks. The energy wars have not helped. One question yet to be resolved is that given the speed of the crash will the recovery be as rapid as the correction? Whilst the coming recession looks deep, there are reasons to think that once the viral concerns recede, economic recovery may be swift. If so, so could the market recovery given that markets always look forward. But we have to wait and see.

Portfolios: Despite the painful underperformance of some favoured value names, especially in the energy, resource and consumer discretionary sectors, we think they are far more likely to outperform as this current cycle progresses, much like value did in the period after the GFC.

Tough decisions:

We also have to be prepared to make some tough decisions for our investors. Unibail Rodamco Westfield is on many measures one of the cheapest companies in the world, trading at an enormous discount to book value and with a double digit dividend yield of over 10%. If it wasn't for COVID-19 management's plan to gradually sell non-core assets and reduce debt made sense. Their debt was not overly excessive relative to their assets in normal times. But with the unprecedented shutdown across Europe saw shopping centres emptied overnight and even relatively modest debt levels suddenly loomed large. Selling a company like this way below its intrinsic value is painful, but balance sheet strength comes first for our investors in times like this. COVID-19 has also led us to think more broadly about the shopping mall space. Whilst Unibail's assets were excellent, the crisis may well speed up a trend that has been emerging for some time; power has been gradually shifting away from landlords to tenants. The current crisis, in which landlords are expected to bend to the needs of their retail clients, may further accelerate this trend.

Portfolios: Unibail Rodamco Westfield exited.

Find out more about Perpetual's range of Australian Share Funds.

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