MIRABAUD
Asset Management

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RISK IN THE TIME OF THE CORONAVIRUS

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Our central premise is that SARS-CoV-2, and the extensive mitigation efforts, are a temporary phenomenon. Unlike a "normal" recession, this is going to be a period of very hard stop, followed relatively shortly afterwards by a scramble to get going again. The unknown is the duration of the "stop", and to an extent, severity of the stop. Both are as much a function of policy decisions and public response as the virus. A sensible base case seems to be 8-12 weeks of significant disruption. During this period, businesses could see dramatic falls in revenue (in some cases to zero), yet will need to meet all ongoing costs: salaries, rent, interest payment, etc. There will be some forbearance on taxes and interest payments, and possibly on rent; but salaries (usually the biggest component of cost) are very difficult to mitigate, albeit there is some government support in the UK. These impacts will not be conventionally "cyclical", but more or less universal. For instance, beer supply to the pub is probably going to have its biggest shock since the 1940s.

Vulnerable businesses are those with large fixed costs and large workforces: the particularly vulnerable are those that believe themselves to be non-cyclical so also carry debt. A relatively small, but totally unexpected, volume shock causes a massive cash flow shock putting the balance sheet under significant stress.

Conversely, robust businesses have three characteristics:

1. Most important: resilient revenue streams. A steady source of contracted cash coming into the business regardless of quarantines and shut downs.
2. Second most important: a flexible cost base. Is the workforce able to function remotely? Do the majority of your costs flex down with lower activity levels?
3. Third most important: plentiful liquidity buffers. Normally, a nice cash balance is at the top of my lists of preferred characteristics. This time is a bit different. Most businesses will blaze through even a significant cash pile if forced to endure 0% of revenues whilst incurring 100% of costs for any length of time.

This leads to some surprising conclusions.

In the last crisis ('08/'09), the last thing you wanted to own was a debt focused asset manager. This time, we think that Intermediate Capital will see virtually no disruption to revenues (their funds will keep paying management fees regardless of what happens in the world; the vast majority of which are levied on invested capital and not mark-to-market AUM). Their workforce will happily grab their laptops and work from home, with virtually no impact on business activity. Investors are rushing to sell Intermediate Capital as they are busy fighting the last war, not thinking about the challenges facing them today.

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In the prior crisis ('00/'01), the last thing you wanted to own was a loss making technology company. This time, we think that Blue Prism will see virtually no disruption to revenues (their software robots are on multi-year contracts delivering business critical automated functions): these revenues will be coming through regardless. Meanwhile, the losses incurred have been entirely a function of accelerating growth. If the growth is not there, then the sales force (the vast majority of the cost base) will not be required… swinging the business to profitability very quickly. Meanwhile, the business sits on more than £70m of cash, giving them plenty of time to adapt.

In this crisis, the last thing anyone wants to own is a travel agent. However, OnTheBeach has a hugely variable cost base which responds very rapidly to changing demand levels. Moreover, it is the process of booking holidays which puts cash strain on the business. If booking levels fall, cash is released. Stress testing the business with a 70% fall in bookings for the rest of this year, we model that the company ends the year with ~£50m cash on the balance sheet. If no-one ever goes on holiday again, then OnTheBeach has a problem. If no-one goes on holiday this year, OnTheBeach hunkers down and waits until next year. My stress scenario lowers this year's profits dramatically, but has only limited impact on the value of future cash flows from the business.

We suspect that in their panic, investors are fleeing from the very businesses that will be the most resilient to the challenge we are currently facing. Investors are taking massive risk with net present value (i.e. the risk that short term strains mean they don't collect the future cash flows from supposedly low risk businesses) for the avoidance of risk to short term earnings, which in the long run, are minimal in net present value term.

For investors who value resilient, high quality business franchises on their lifetime of future cash flows and not on a multiple of disrupted short-term profits, this may be a recipe for extraordinary returns from very low risk investments.

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