Perpetual Equity Investment Company Limited

Cautious optimism

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At a time when markets are increasingly volatile and the news cycle seems to bring nothing but bad tidings, we're keeping a close eye on markets and companies to assess the impact of the changing economic landscape.

This impact will be more acute for some industries. There will be liquidity pressures and problems with supply chains, exacerbated by the integrated nature of international trade. When China shuts down, it negatively impacts everything from car parts to hospital supplies, which culminates in declining consumer confidence. When this happens suddenly on a global basis, it's challenging for corporates big and small.

Where are we looking and where are we cautious?

Financials – CAUTION REQUIRED

- Investment platforms generate significant earnings from the interest rate spread between that paid to clients and that received from the bank; this will collapse in a zero-interest rate environment.
- Platforms, fund managers and financial planning groups are leveraged to equity markets; recent falls will create earnings headwinds.
- Balance sheet transparency is important; with massive volatility in FX, commodities and bond/equity markets, it's difficult to understand what investment banks globally are exposed to and whether they are on the right side of this volatility or not.

Watch the Balance Sheet, Cashflow and Operating Leverage

During bull markets, investors don't always focus on balance sheets; however, we know an intense focus on each company's cashflow and balance sheet is essential.

Understanding the level and terms of debt and relevant covenants is essential, as is a solid understanding of the asset side of the balance sheet. Is the company asset rich or does it lease all of its properties and only have goodwill on the asset side of the balance sheet?

Harvey Norman, Bingo Industries and AP Eagers are examples of companies with a lot of property on their balance sheets; this puts them in good stead in any downturn. It's no coincidence that these companies still have founding majority shareholders. We view these principal owned and operated businesses favourably because they tend to think long term and are asset rich.

Understanding operating leverage is also important. Companies with high fixed costs and low margins are more prone to generating negative cashflow in a demand shock. TABCORP, for example, has mostly variable costs (tax and racing industry fees) which is preferable than retailers with high fixed cost leverage.

These are key points of analysis for Perpetual, whatever the market cycle.

Observations about balance sheets across the companies we look at

- Understanding the strength of a company's balance sheet going into a demand shock-driven liquidity crunch will provide insight to the company's prospect of survival in this environment.
- A strong balance sheet puts a company in a great position to acquire other companies at depressed prices.
- In a market environment where asset sales and equity raisings are more difficult, caution is required for contractors with problem projects. Interim results showed construction contractors Lend Lease, Cimic and Downer all had extremely poor cashflows.
- Airlines and travel agencies are negative working capital businesses. Customers provide cash before they travel, and this cash is used to operate the business – in a demand shock, this could create a liquidity crunch.
- A lot of recent highflyers have been concept stocks, typically loss making all the way up the profit and loss statement without ever generating much revenue. However, they have sold a dream of being the next Amazon or disrupting a market with a trillion-dollar TAM. Such companies may not survive in the current environment.

Its not all bad news!

- **Shock should be transitory:** While news reports might suggest differently, this too will end. Some aspects of life may take a longer than others to return to normality but the situation will improve. Already, the infection rate in China has significantly declined.
- **Shares are 30% cheaper:** As a value investor, I am seeing more opportunities now than when markets were reaching new all-time highs every day. Importantly, just because a share price has fallen a long way doesn't mean it's cheap – if a stock is 200% too expensive and it falls 20%, it's still overvalued. However, exceptional opportunities continue to emerge every day.
- **Low interest rates:** The probability of low interest rates for longer will likely mean the yield investors are prepared to accept would be lower – or for equities, the P/E they're willing to pay will be higher, all other things being equal. Asset prices should increase when growth normalises.
- **Fiscal stimulus:** The Australian government has a strong balance sheet and after a year of austerity, has the mandate to spend big. This should provide an offset to the demand shock.
- **Embrace the volatility:** Volatility creates opportunity. While more than half of ASX-listed companies are likely to downgrade their earnings forecast, don't wait for the downgrade to buy quality stocks.

If you can buy a good business with a strong balance sheet, good management team and the potential to grow in 'normal' times at a cheap price, take advantage of the opportunity. One word of warning; investors tend to underestimate operating leverage. Given the speed of demand shock, a lot of the revenue shortfall will hit the bottom line.