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Long-term buyers should focus on strong company balance sheets

Summary

The response to the COVID-19 pandemic is already causing a widespread cash flow crisis for many European companies. Next, there will be significant downgrades to earnings forecasts. Some of the downgrades and equity price falls will be overdone and will create trading opportunities. At this stage, we cannot have high conviction in the sustainability of the upcoming trading rallies. For us to do so, we need to see a peak in the growth rate of fresh COVID-19 infections and deaths. We also need more clarity into the full scale and duration of governments' support measures. The government-mandated lockdowns are starting to have a dramatic negative impact on European economies – figure 1. If these are sustained, the economic downturns could be deeper but shorter. Our upcoming EMEA Strategy Monthly will address these issues in more depth

Looking longer-term

This bulletin takes a longer-term view. We focus on which types of companies are best placed to survive even the worst-case scenario of a protracted European recession. Such a scenario would involve a prolonged COVID-19 impact into the second half of 2020, alongside insufficient government support measures. In such a scenario, the equities of some companies with strong balance sheets would also get caught up in indiscriminate selling, creating opportunities for investors. So these types of stocks should ideally be bought into weakness, in tranches, for the long-term.

Corporate revenue collapse demands extensive government support

The current crisis is having immediate negative consequences for the corporate sector across Europe. With government-mandated lockdown measures likely to last at least a few weeks, consumer demand has collapsed. This is devastating for the revenues of companies in many sectors. Various government support measures are rightly focused on supporting stressed companies and their workers. They aim to maintain European economies' productive capacity and workers' spending power. In that way, governments hope to increase the chances of economic recovery once the rate of new infections and deaths eventually slows. The specific government support measures differ by country and are likely to be increased in both size and breadth over time.

Immediate corporate cash flow pressures

In the short-term – and especially in the second quarter – corporate cash flow is critical. The revenue shortfalls will lead directly to cashflow shortages for many companies. A rapidly rising number of UK and European companies across multiple sectors are thus seeking to bolster their cashflows. Their treasurers' view is that their survival depends on it, hence their taking action even before the government support measures are fully implemented. In most cases, the equity prices of companies taking aggressive actions have risen in response to the announcement of action. This tells us that the market thinks these survival strategies are appropriate.

In the leisure sector, Intercontinental Hotels have cancelled its dividend, as has Travis Perkins in the building materials sector. Marks & Spencer – a UK retail bellwether with a 136-year history – has cancelled its dividend and as well as £100 million of clothing orders. The clothing retailer Primark has cancelled orders yet to reach its distribution centres, invoking 'force majeure' clauses in contracts. This is hurting suppliers, which face non-payment for orders they have already shipped. Department store Debenhams has told its landlords to accept lower rental payments or face shutdowns through company voluntary arrangements, a form of insolvency procedure.

Huge earnings declines expected

Consensus earnings estimates from top-down strategists in Europe remain too high. They still point towards 4% earnings growth in 2020, down from 10% earlier in the year. Consensus earnings growth estimates for the UK are now almost flat at 0.3% for 2020. The coming weeks are expected to see sharp declines in earnings expectations for 2020.

The brunt of the earnings impact will be felt in the second quarter, as business and factory closures, combined with spending and activity declines, feed through into profitability. The start of recent downward revisions has been dramatic – **figure 2.** We expect sharper downward revisions in earnings than during the Global Financial Crisis of 2008-09. While the services sectors will be particularly hard hit, we expect manufacturers also to suffer, albeit less severely. A full-year earnings decline of 15% or worse is not inconceivable. At this stage, it is still too early to forecast 2021 earnings with any conviction.

One implication of this lack of earnings visibility is that buying for the long-term based upon earnings forecasts is very challenging. Earnings before interest, tax, depreciation, and amortisation (ebitda) might prove more useful in the months ahead. Even more reliable are likely to be companies' book values. However, even these will likely need some adjustment. For example, banks' capital is currently being eroded by their customers drawing down credit lines.

Long-term winners will have strong balance sheets

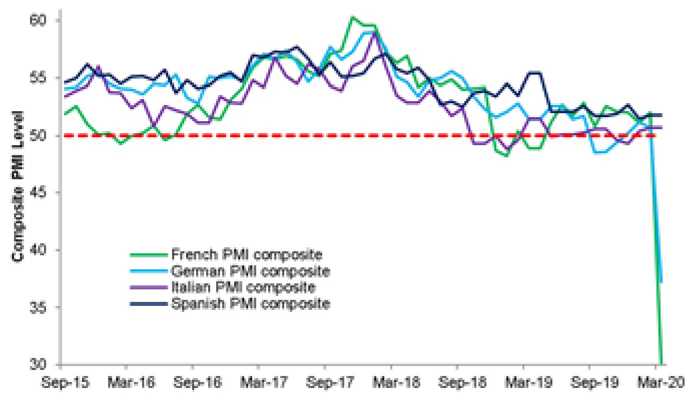
In the event of a weak European economic upturn, long-term investors should focus on companies that have strong balance sheets. There reasons for this are twofold:

1. Many strong balance sheet companies also have high dividend yields, as well as strong historic growth rates in their dividend payouts. Their balance sheet strength should raise the likelihood of their maintaining dividend payouts. At worst, they may cut dividends by less than other firms. With interest rates likely to remain very low for some time, equities with decent dividend yields should increasingly command a premium.
2. As well as aiding companies' survival, strong balance sheets may also enable takeovers of weaker firms or their assets at reasonable prices.

We have screened all European companies to find those with the strongest balance sheets. As their equity prices get sold off indiscriminately, we advise accumulating in tranches so as to seek attractive average entry prices. Our preferred basket of European companies ranks particularly highly on the following metrics: (1) Free cash flow-total debt; (2) Cash dividend coverage; (3) Operating cash flow-to-interest expense; (4) Cash & short-term investment; (5) Positive free cash flow positive; (6) Positive trailing three-year dividend growth.

Please reach out to your relationship manager for further details on our preferred companies.

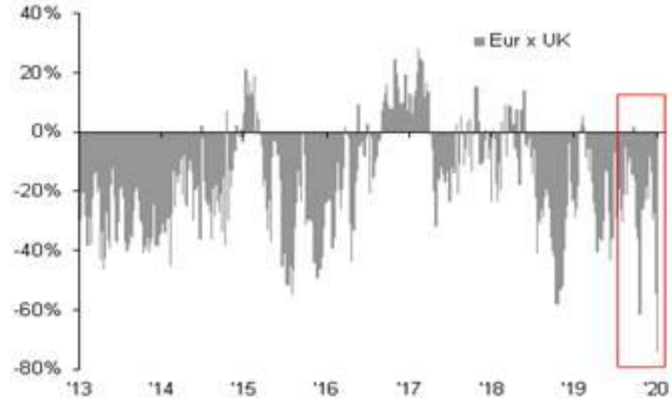
Figure 1: Sharp drop in March PMI numbers



Source: Bloomberg as of 24th March 2020

Indices are unmanaged. An investor cannot invest directly in an index. They are

Figure 2: Weekly European earnings revisions lower



Source: Bloomberg, Citi Research as of 24th March 2020

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NO BANK GUARANTEE · MAY LOSE VALUE