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The Unholy Trinity

Published on: 11 May, 2020 **|** Author: Investment Team

A fire requires three ingredients to be self-sustaining: fuel, a source of oxidation (oxygen in the air) and a source of ignition. This is known as the fire triangle. A fire can be prevented by removing any of these ingredients. This principle of elimination or avoidance of harm is used by fire fighters when fighting and controlling fires. The key here is that all three ingredients are required in the right amount for a fire to start and to be self-sustaining. If only two of the three ingredients are present, even in generous servings, a fire will not start.

A similar analogy can be made with companies during distressed periods. What sort of company is almost certainly guaranteed to fail during periods of distress such as now? This unholy trinity of traits is as follows:

1.Companies at risk of revenue falling to zero

This doesn't have to be a literal, 100% drop in revenues, but any company where a clear majority of its revenues rapidly disappears because of the pandemic and the second order effects of the lockdown, is at serious risk of collapse. This is the most important part of the unholy trinity because it pays no respect to the intelligence of a company's management, a healthy balance sheet or a good product/service.

This will apply to any company that requires close proximity of humans in a confined space. Think of airlines, cruise lines, cinemas, theme parks, bars/restaurants and shopping centres. These are the businesses most affected by the pandemic. If revenues stay at near zero for long enough, any cash outflows will inevitably lead to the business collapsing.

2.Companies with excess leverage

Leverage comes in two flavours – operational and financial. Companies with high fixed costs whereby a small drop in revenue can cause a disproportionate drop in earnings have high operating leverage. Financial leverage is simply debt, whether from the bank or bond holders. Frequent interest payments act as a strain on a business which is more strongly felt during difficult periods.

Leverage, served in either operational or financial flavours, improves returns on the way up but works in reverse during bad times. The key thing to note is that low financial leverage i.e. debt, gives a company optionality to take on more debt if required, in order to survive.

Who would the bond market lend money to more favourably? A company with no debt or a company whose debts are 10 times its earnings? The former of course. Low debt improves the odds of survival. It also improves the price paid for survival. If a company has to issue shares (now at depressed prices) and debt at unfavourable terms, the company may survive but shareholders could be wiped-out. A historical example? Some UK Banks during the global financial crisis issued shares at already depressed prices. Some investors who thought this was a bargain were essentially throwing good money after bad money and ended up losing more than their initial investment.

3.Companies that do not generate free cash flow

There can often be a big difference between what a company reports in profits for the year and what it reports in free cash flow. Companies that overstate accounting profits but understate free cash flow are, in essence, exaggerating how well they are performing. This doesn't mean the company is fraudulent. More often than not, it is simply a victim of an accounting quirk. This quirk is particularly unfavourable during a crisis if the free cash flow is significantly lower than its reported profits.

As the fallout from the Covid-19 pandemic plays out, it is important to note that stock prices will do what they always do in times of distress – they will fluctuate wildly. This is independent of how much the pandemic directly impacts the performance of the underlying companies in our strategies. Now obviously no one predicted the timing and scale of a global pandemic. Many experts thought it was inevitable, but no one could peg a date to such an event so in a sense, one has limited control over the first trait of the unholy trinity – companies at risk of revenue falling to zero.

However, avoiding companies with excess leverage and poor cash conversion is firmly within the realms of control of every investor and this has always been our approach at Tacit.