

Credit and equity markets and the COVID-19 threat

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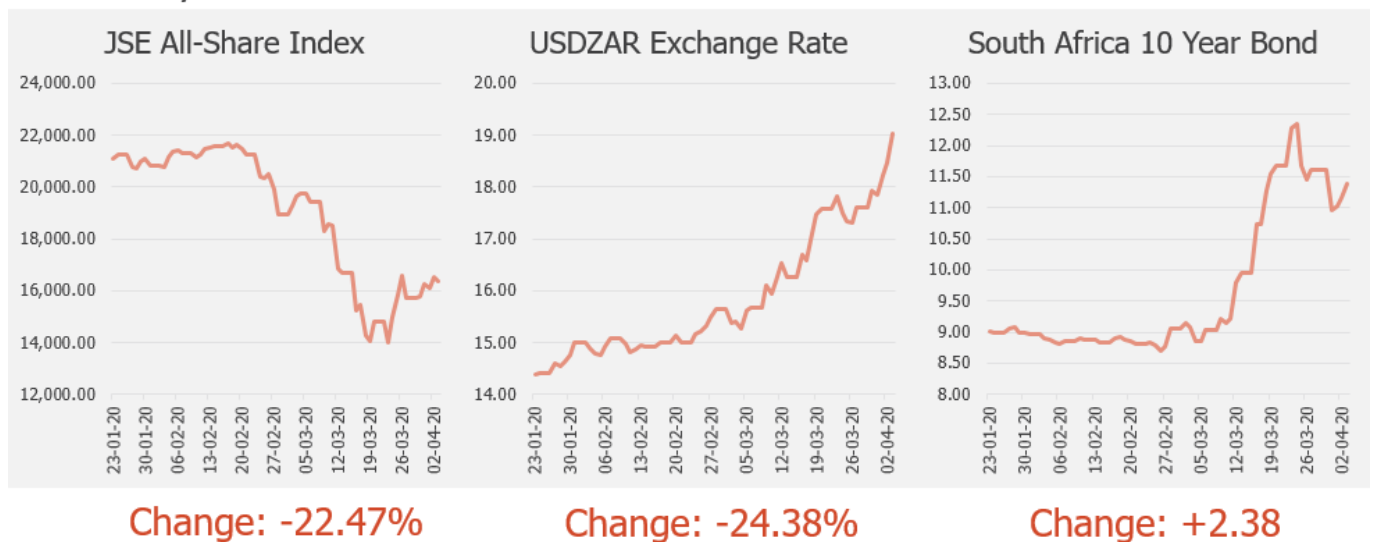
These are extraordinary times

The unprecedented speed and scale of the spread the novel coronavirus (COVID-19) pandemic has resulted in a unique stock and bond market crisis, with significant and ongoing volatility in asset values and a rush to safe-haven assets. Increasingly, countries are being forced into self-imposed recessions in a bid to contain the virus spread and to prevent public health systems from collapsing. This causes a significant loss to the world economy. Likewise, it is clear that COVID-19 will have a significant impact on the South African economy, and on the investments in our client portfolios. This note sets out our thoughts on the impact of COVID-19 on the listed and unlisted credit and equity markets, and the actions taken by the Futuregrowth credit and equity team in managing these uncertain times.

The graphs below indicate the significant changes in key market metrics since the Wuhan lockdown.

Tracking COVID-19: Since Wuhan Lockdown

23 January 2020



Impact on credit markets

Listed Credit: Illiquid local market means expected credit spread widening has not happened (yet)

Several local listed credit auctions have been cancelled in recent weeks. The freeze-up of primary issuance (i.e. new bonds) in South Africa echoes the experience in global credit markets. Lacking access to the credit market (which is likely to continue for some weeks), issuers are relying on relationships with their banks - as well as the use of private placements - to meet their funding and liquidity requirements.

Likewise, secondary market trade (i.e. existing bonds) has ground to a halt as investors struggle to manage (and appropriately price for) credit risk and liquidity in an environment of uncertainty and volatility. The lack of liquidity in the listed credit market means that, even with this crisis, most credit asset spreads have not widened as we would expect. Thus, it is likely that the current credit spreads at which listed bonds are valued do not accurately reflect the increased volatility and risk. Arguably, going into the second quarter of 2020 (pre-COVID-19) credit spreads were already relatively narrow. So, we expect that credit spreads should widen-out, even as normalcy begins to return. In the meantime, it is possible that in a thin market some investors' need for liquidity (e.g. selling credits) could drive spreads sharply. We are already seeing some widening of spreads in listed bank debt.

Unlisted Credit: Companies need to ensure access to liquidity and capital to weather the storm

Our borrower counterparties expect economic headwinds during and following the pandemic, although the exact magnitude of the impact on their cashflows and operations remains unknown at this stage. Tough trading conditions are inevitable and operating performance will be adversely impacted. Liquidity, access to capital, balance sheet strength and the ongoing market turmoil are all being monitored closely by our team, for each borrower and sector in which our clients are invested. Borrowers are also faced with the impact that the virus will have on their staff's safety and health, and have all executed strategies to help them navigate this in the coming weeks/months.

Impact on equity markets

Listed Equity: Dramatic sell-off

The listed equity markets were quick to react to the negative COVID-19 news flow, with a dramatic sell-off across the board. From the peak of 17 February to the low on 21 March – the South African equity markets lost 34% in value, mirroring similar declines seen across bourses worldwide.

Some buying activity has come back into the markets following the positive news of success in flattening the curve in China, Korea and Japan, and the announcement of sizeable stimulus packages across the globe.

President Ramaphosa's quick action in announcing the lockdown and other measures was seen as positive by the markets. The big question remains as to how long curtailed measures will remain in place and the inevitable negative impact of this on company earnings, cashflows and operations going forward. The question we are considering is what the impact will be once we return to "normal life".

Our strategy has been to selectively buy good quality, defensive companies offering deep value from the panic sell-off, for those funds whose mandates allow this. We see this as an opportunistic time to pursue such a strategy and our investment and stock selection process has been informed by investing in companies with strong management teams, good governance, a defensive market positioning and resilient balance sheets.

Unlisted Equity: New deals on hold and engagement with existing investee companies

The unlisted equity market has experienced a general "hold" on deal activity as the effect of the COVID-19 pandemic has resulted in a review of pricing and prospects in general. In our existing portfolio, we have engaged with our investee companies to assess their strategies over this uncertain time, monitoring such items as cash flow forecasts, business sustainability and ultimately any risk and opportunity areas that might present. We are mindful that there is a high probability that equity shareholders will be called on to support businesses over these uncertain times, as access to capital becomes increasingly tighter and short-term cash flow requirements might present.

In line with the above – we have identified and revalued the portfolio of unlisted equity assets, considering the rising capital costs, the effects of the immediate lock-down on revenue, cashflow, profit and operational prospects, and have revised our longer-term growth forecasts downwards.

Looking forward: Pre-emptive action on existing and new deals

We have examined, and will continue to examine, the impact of the current uncertainties on both potential and existing borrowers and investee companies in order to remain ahead of any credit and market events - and to ensure that our pricing, rating and valuation methodologies remain robust and relevant.

Across the different assets we manage, our actions to date have included:

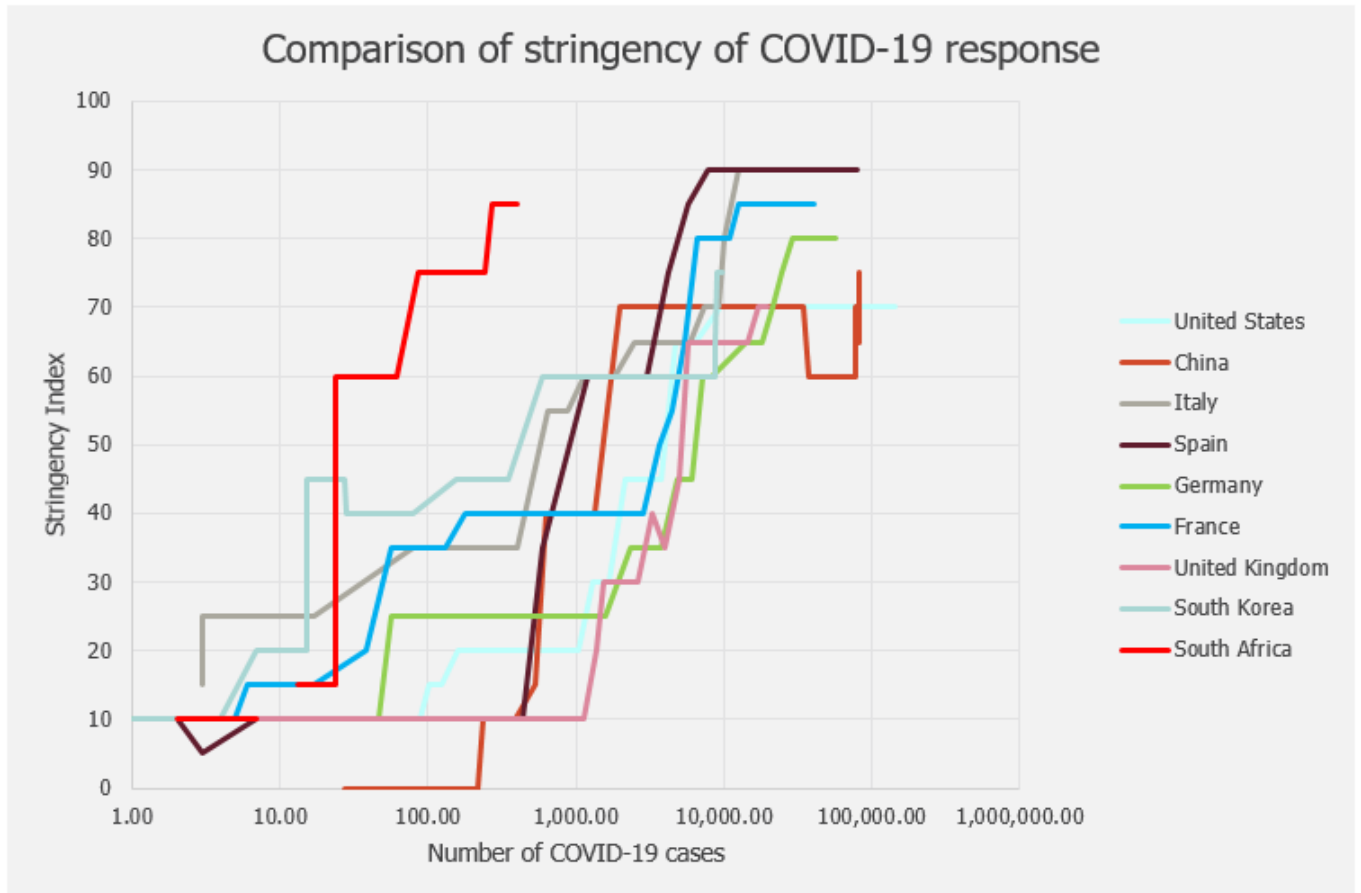
1. Reviewing our existing portfolios to understand which sectors, investments and borrowers are most at risk;
2. Reviewing our entire portfolio of assets to re-rate and revalue investments (where appropriate) to ensure that changes resulting from this pandemic have been appropriately captured for each counterparty for the month ended 31 March 2020;
3. Reviewing upcoming maturities/roll-overs and how these will be funded by borrowers, and ensuring they are aware of the increased cost of funding in the market;
4. Engaging with borrowers on what support, if any, they will be seeking from both funders and shareholders;
5. Engaging with our investee companies to assess the support from shareholders that will be needed (if any);
6. Remaining defensive in the way we price credit (i.e. spreads), while acknowledging that this market may well present opportunities to invest in quality credit counterparties at appropriate valuations and position sizes;
7. Managing spread duration by holding true to our conservative approach, and applying caution and appropriate risk-based pricing when considering extending credit to borrowers, or rolling existing exposures;
8. Considering whether the valuation of existing instruments adequately captures the current market volatility and liquidity;
9. Reviewing our forecast models and cashflows for investee companies to ensure the effects of this pandemic on their business and economic growth assumptions have been appropriately considered;
10. Revisiting the discount rates applicable in valuing our underlying unlisted equity investments; and
11. Reviewing deals that are in negotiation and legal phase, to ensure that the proposed pricing remains appropriate and that we have (and assert) "market flex" clauses which give us the right to reprice the cost of funding in the event that the current market volatility extends or worsens.

Our ongoing commitment

Futuregrowth remains committed to the nation's efforts to flatten the curve of this pandemic in South Africa. A huge area of concern is our fragile healthcare system, the relatively large proportion of our population that is classified as immuno-compromised (e.g. high TB and HIV infection rates) and the crowded living conditions faced by large parts of our population.

We have built a Government Stringency Tracker to compare the responses of various governments to COVID-19. The figure below [update for latest – see attached email from today Monday with the updated graphs] shows that the South African government has quickly implemented measures to mitigate the spread of COVID-19, in some cases responding faster than some well-developed countries.

Government Response Tracker Index



Source: University of Oxford

Futuregrowth has taken several measures to mitigate the impact of COVID-19 on our business, including working from home and the provision of comprehensive IT support, so that we can continue to seamlessly manage and protect our clients’ investments – and protect the health of our staff and others.

Our team remains available to address any questions or concerns you may have.

Published on www.futuregrowth.co.za/newsroom.

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