TAM INTERNATIONAL INVESTMENT NOTE

Liquidity to Insolvency in a Zombie Apocalypse

What is your favourite COVID television series? As many around the world hunker down, online streaming has come into its own. Be it new shows or recycled classics, everyone has their preferred "go to" genre to escape the reality of our self-imposed incarceration.

Watching the stock market over the past week I was taken with the idea of "The walking dead" which is essentially a group of characters banding together to survive a zombie ridden dystopia. It drew my focus onto the realities of corporate survival in today's world and what we might be faced with on the other side of this pandemic driven shut down.

Before we entered into 2020 and the record level of volatility that accompanied it, much was made about the state of our business community. Many feared that, the global economy has fostered a cohort of corporate entities who's business models have been steadily deteriorating along with their revenues, yet managing to remain solvent and trading. Why? With refinancing rates being on the floor and government pressure on banks to keep lending to corporations these businesses have been afforded the ability to refinance their debt and obtain bank loans at record low rates in something akin to robbing Peter to pay Paul. In past market cycles these companies would have naturally gone to the wall as refinancing options were too costly and revenue dried up. This would organically open the way for more innovative competitors to take up market share, consolidate the industry and improve productivity in a wonderfully succinct example of corporate Darwinism.

Indeed, much has been made of the negative effects these companies are having on the lack lustre productivity levels in the economy. Reason being that their survival as low productivity companies serves to create a drag on the economy by employing people who could be better utilised in more efficient corporations and consuming loans and investment which could be injected into more innovative competitors.

So we know this time around that this market has helped foster more of these companies than previous cycles and the fear is that the bumper rescue package in both fiscal and monetary terms will obviously rescue many high quality companies but will also keep companies with real structural risks to their survival in the market and open to being invested in.

How? The furlough scheme will keep staff employed, the business lending programme will allow deeper access to credit lending for these companies. And for some of the larger zombie companies central banks have dropped rates to near 0% or lower making refinancing their non performing debt that much easier to roll over.

Finally the COVID pandemic affords companies the perfect script to attach their historic business failings to something like COVID. So much so that a new financial metric is emerging "EBITDAC" (Earnings before interest, tax, depreciation, amortisation and COVID). Yes that's right, businesses are starting to factor in what their earnings would have been if COVID hadn't happened. First time in my career I have seen a company take a real world scenario which affects almost all businesses and pretend it didn't happen on their balance sheet. Crazy.

The share of companies unable to repay debt and living on day to day revenues (which predominantly constitutes what it means to be a "Zombie" company) pre COVID was at or around the 16% of the US corporate sector. KPMG put this figure in the UK, over a year ago, at 14%. These numbers increasing rapidly as companies begin to slip into insolvency as the debt before the crisis coupled with the government debt taken on to survive COVID starts to overwhelm the meagre revenues being generated from the cratering of the demand side in the economy.

What this spells out is a shift from COVID being a liquidity issue to a solvency issue. The solvency issue was believed to be simply solved by governments greasing the wheels of industry with trillions in liquidity to keep the lights on in businesses until growth comes roaring back. This at the same time as central banks come in on the other side buying up huge swaths of corporate debt in the market enabling corporations to issue more debt.

As we have seen, investors clearly don't see a COVID liquidity issue as too serious given the parabolic stock market recovery. The issue for the stock markets occurs when liquidity issues turn into solvency issues and investors begin to realise pumping trillions into business doesn't increase earnings. Mainly because no matter how much money you pump into businesses and stock markets you can't force people to go and consume. Unsurprising then that Warren Buffett liquidated almost all of his banking stocks a few days ago ahead of a perceived massive wave of corporate defaults.

The real great white hope to fix the solvency issue is the release of a viable vaccine. Whilst we are hoping for this vaccine to come to the rescue of consumption and thus corporate balance sheets, we are planning for it not to arrive in any meaningful size in time to offset a wave of corporate bankruptcies.

As such, the TAM portfolios remain in high levels of cash, high levels of US or UK government debt and precious metals. Moreover TAM's existing equity investments have all been tilted away from more speculative ends of the market, Instead we are focusing on companies with long term business models, low levels of debt, robust margins and high barriers to entry. Essentially the companies with the very highest chance of emerging from this crisis, whenever that may be, in good shape.

We might be wrong and we hope we are for the sake of numerous corporate entities, but should we begin to see jitters in the stock market around corporate survival, TAM's portfolios are firmly positioned to weather this volatility and the work continues every day. Quality is king!

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