14th April 2020

ValuInsight - 2020-2021, or the Survival of the Fittest

- **No valuation model is able to frame stocks accurately in the current environment, in our view.** We have thrown the superfluous overboard to focus on the essential: resilience, recovery potential and “cash burn”. Resilience is defined as the loss of revenues in Q2 2020, which we estimate will be the trough of the crisis. The range goes from +7% (Becton Dickinson) to -75% (Straumann). Recovery potential is measured over a 12-month period, from Q2 2020 to Q1 2021 and expressed as a percentage of revenues retained. The range goes from 113% (again, Becton Dickinson) to 78% (Starbucks).

- **Cash burn is the difference between last year’s cash generation and a standardised estimate of the free cash flow for 2020.** This amount is often deeply negative even for these well-managed and dominant companies, in itself an indication of the severity of the crisis. This measure is important for two reasons. First, it gives an idea of the competitive position between debt and equity holders. Higher debt levels will increase the Enterprise Value and belittle the equity value. The claim on cash will be at the advantage of the former if too much debt is accumulated. Second, we attempt to gauge the pessimism, or otherwise, of the market by comparing the loss in market value to the cash burn.

- **We focus the analysis on a sample of our “Top 100” list**, made of leaders in their sectors and of companies with a particularly resilient economic rent (the ratio of Free Cash Flow to economic assets) and a superior competitive advantage. This, in the belief that the strong will get stronger during and after this crisis, and second liners, even with attractive attributes, will suffer from a higher risk premium for longer. Needless to say, we consider all of our Top 100 stocks highly investable, but not always at the right entry point level.

- **We regress the cash burn with the drop in Equity value since February 17th**. A number of outliers are prominent, including Texas Instruments, Visa, Alphabet who have all fallen like the market but whose cash burn only represents between 5% and 7% of their equity loss, against 21% for the average stock. Qorvo, IQVIA, Sonova or NXP also feature well.

- **We finally attempt to compare the cash burn with undrawn credit lines.** The latter data point is tentative, as patchy and uncertain, but Visa, Texas Instruments, Qorvo confirm their prominence, with Cisco, Oracle, Markit and Comcast also featuring prominently.

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Resilience

By definition, our preferred *normalised* Free Cash Flow valuation approach is not able to measure the damage inflicted by a "flash" economic crash such as the one triggered by the 2020 pandemic. This is about survival. Consequently, we have designed a crisis-specific model, throwing the superfluous overboard and focusing on the essential: the estimated cash burn. This framework is not a forecasting tool. Rather, we have designed it to be able to react quickly to the key datapoint of 2020: Q2 top-line resilience, which will start to be released by companies during the upcoming April earnings season.

Scoring Resilience – From Antifragile to Impaired

Focus on Calendar Q2

We arrange companies on a five-level scale according to their likely revenue profile between April and June 2020. This period, which we assume will represent the trough of the economic flash crash, is crucial in our view for many different reasons, including:

- The initial impact that this shock will have on balance sheets
- The **base effect** that this will create for the path to recovery.

Negative compounding is at work here and creates a trap for forecasters: an 80% drop in output requires a subsequent 400% increase to reach the *status quo ante*.

(i) "**Antifragile**" companies. Readers of Nassim Taleb's books may recognise his terminology here. This defines the ability not only to resist adversity but also to *benefit* from it.

Beyond the suppliers of protective masks, ventilators and related consumables, supermarket chains such as Walmart or hygiene specialists like Ecolab or Clorox are seeing a steep increase in revenues. Obviously, the stocking of basic grocery is a transient phenomenon, but arguably the heightened focus on hygiene may not be about to fade quickly.

Elsewhere, video game editors such as Activision Blizzard are benefiting from widespread lockdowns, supported, unexpectedly, by a recommendation from the WHO to mitigate confinement stress and boredom.

Moreover, a number of "antifragile" companies will benefit from well identified existing trends already in place: digitalization, shift to the cloud, remote working, collaboration software, video-conferencing, e-commerce etc… Companies such as Microsoft, Amazon, Cisco systems will come out stronger, even if some of their activities might come under pressure in the short term. The same applies to semiconductor companies supplying datacentres, communication gear or gaming; NVDIA is perhaps the best example.

It is possible that these trends may accelerate as a result of the crisis; a large number of companies may attempt to make current travel cost savings more permanent, or even assess if office costs cannot be reduced by promoting home working. We note that such trends are symbiotic with the secular effort to diminish CO_2 footprint, which are likely to support and strengthen them.

Apart from these unusual companies, which do not really require any vulnerability modelling, we score the rest according to the estimated depth of their revenue shortfall during **calendar Q2**.

(ii) “**Resilient”**. This category covers sectors whose sales are relatively immune to lockdowns and the ensuing GDP loss, it includes pharmaceutical companies and consumer staple sectors. The provision of drugs and consumer items covering basic needs are relatively immune to unfolding events.

(iii) “At risk” are companies which might see a noticeable dent in revenues, without endangering their financial structure. They are often solid businesses with a weaker activity. Examples are Comcast, where the solid broadband core business is made more fragile by Universal. RELX, the UK publisher, sees its very defensive franchise weakened by its (small) exhibition business. Waste collectors will see their industrial collection hit by lower volumes, too.

(iv) Next category down is **“Vulnerable”**. In this category are companies that either suffer from the large GDP loss, for example in the Industrial or Automotive sectors, or that suffer directly from lockdowns. The latter comprise health care companies active in non-critical segments such as clinical trials or devices, as hospitals delay non-critical procedures to focus fully on the outbreak.

(v) Finally, we rate some companies **“Impaired”**. This means that their sales profile is in danger of halving, or more. Airport operators or owners (Vinci), travel arrangers (Booking) and airlines are obviously populating this category. But other, better quality businesses are similarly impacted. For example, Sonova, the Swiss hearing aid manufacturer/distributor is facing a steep decline in sales as outlets are closed and senior citizens are confined. EssilorLuxottica is in a similar situation. Some industrial businesses are positioned in the wrong verticals; TE Connectivity, an otherwise well run and competitive business, competes mostly in Automotive, Oil and Gas and Aerospace.

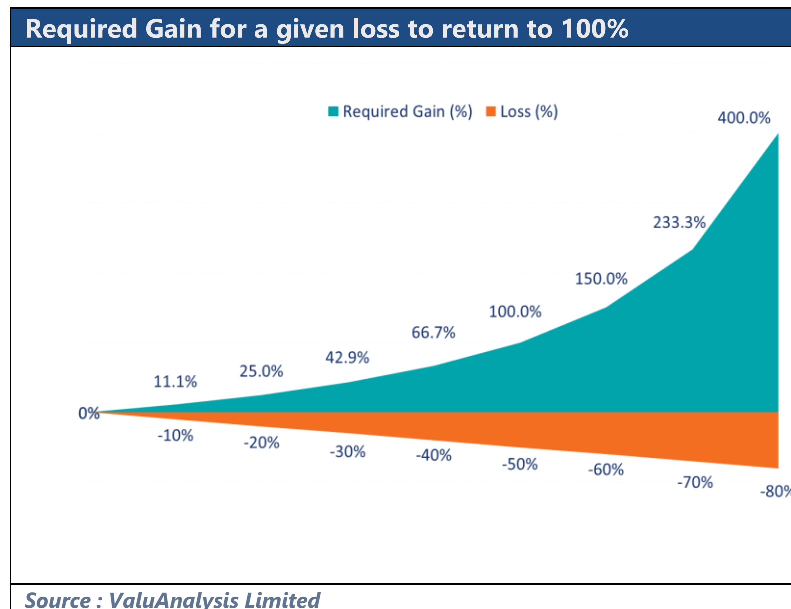
The Path to Recovery - Scoring Deferability

Resilience in calendar Q2 is only part of the story. The recovery in Q3, Q4 2020 and Q1 2021, to stick to a 12-month framework, is dependent on both demand and offer.

The offer side won't be fluid

- The offer side (or "production" side) is difficult to assess but assuredly, this is not just about punching a percentage in a spreadsheet "to get back to normal". As we mentioned, the maths of negative compounding is unintuitive but very real, as illustrated on the chart below.

Required Gain for a given loss to return to 100%



Source : ValuAnalysis Limited

- With social distancing affecting the organisation of the workplace, logistics, with impaired supplier chains, it is to be feared that productivity will plummet in the early weeks, or months, of the Restart. Quite how this might be compensated by an increased implementation of the digital tools is unforeseeable, but a full compensation seems unlikely. The recovery will be anything but fluid.

Demand will be about deferability of revenues

- On the demand side, we identify *deferability* as a major discriminating factor. To take the Sonova example again, a given hearing condition will most likely not have improved in 6-month time, so it is reasonable to expect sales to recover relatively quickly. The same cannot be said for luxury goods, for instance. A BCG survey[1] finds that Luxury Goods are the third most affected discretionary item in China after Eating Out and Travel.
- We rank companies according to our assessment of the deferability of their revenues, from "fully deferable within 12 months" to "least deferable within 12 months", with two intermediary stages.

[1] "How do you expect your spend to change in the next 6 months across the following areas?" March 12-16, 2020 1831 respondents in China

A Recovery Matrix

In the table below, we show the matrix combining Q2 resilience and 12-month deferability. NB "resilient" and "antifragile" companies are ignored as they carry on their business as usual.

Q2 Resilience / 12-month Deferability Matrix			
	Q2 Impaired	**Q2 Vulnerable**	**Q2 At Risk**
Fully deferable	Sonova	Medtronic	IQVIA
Largely deferable	Stryker	LafargeHolcim	Oracle
Partly deferable	TE Connectivity	NXP	Schneider
Least deferable	Starbucks	LVMH	Visa

Source : ValuAnalysis Limited

Sonova, which we have used as an example throughout, shows up in "impaired + fully deferable". This means that we expect Sonova's Q2 revenues to be marked down in the region of at least 60% (Straumann, the Swiss dental implant company, is reporting -75% for March in Switzerland. Dental equipment & supply is in exactly the same category as hearing aids), but that none of this missed revenue is actually lost; it is simply deferred.

Even based on one example per category, it is possible to draw some general trends from this table:

- Unsurprisingly, the bottom of the table, where revenues are least deferrable, is made of consumer discretionary stocks (Starbucks, LVMH, Visa) and industrial stocks, generally with a bend towards consumer (both TE Connectivity and NXP have a large exposure to the Auto industry).
- Conversely, the top of the table is well furnished with non-pharmaceutical Health Care stocks, who are collateral victims of the pandemic, either because they cannot access the hospitals (IQVIA), or the clients (Sonova), or because their gear is non-essential (Stryker, and parts of Medtronic).

On the next table, we show the typical revenue shortfall or surplus for the 12 months spanning from Q2 2020 to Q1 2021, relative to the previous corresponding period.

These figures are derived from quarterly estimates of the recovery path for each of the 12 sub-categories. At this stage, they are guesses informed by some companies' disclosures of their March business conditions, with both demand and production assumed to be impaired during this period. This approach is not designed to provide financial projections, but, rather, a consistent framework in which we can position many companies.

Q2 2020 – Q1 2021 Revenue growth path			
	Q2 Impaired	**Q2 Vulnerable**	**Q2 At Risk**
Fully deferable	-11%	-5%	+1%
Largely deferable	-20%	-9%	-1%
Partly deferable	-28%	-13%	-4%
Least deferable	-32%	-15%	-5%

Source : ValuAnalysis Limited

For example, -13% means that a company with a "Vulnerable" Q2 top line and partly deferable revenues (typically, NXP) will end the 12-month period (Q2 2020-Q1 2021) with 87% of its previous revenues.

Assessing the "Cash burn"

Once the April 2020 – March 2021 revenue base is established, the rest of the P&L is fairly easy to model. We focus on Cost of Goods Sold and Other Operating Costs (SG&A, R&D and non-cash charges, mainly), to which we add operating and non-operating cash outflows. Our base line, some sort of net cash outflow, will not win the prize for accuracy but provides an idea of the "cash burn", or "cash risk" attached to each company that we monitor.

Modelling Operating Costs

Broadly, we assume that Cost of Goods Sold are a direct function of revenues, such that Gross Margin is relatively unaffected by the fall in revenues, when it happens. We build-in a lag and a cushion, because the relationship between the two is not entirely 1 to 1.

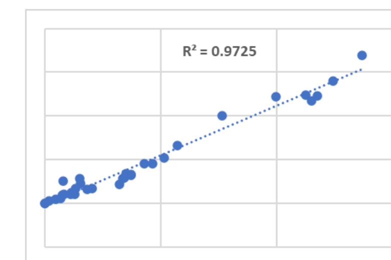
Other operating costs are mostly SG&A, R&D costs and depreciation. We exclude depreciation and other amortisation as they are non-cash[2]. The rest is deemed largely fixed, but we give a 20% credit for the worst affected companies for Q2 and Q3 (i.e. estimating a 20% cut in these fixed costs, most, we think, in Personnel costs).

This creates a home-made "cash operating income" (pre-tax), from which we deduct operating and non-operating flows.

Modelling Cash Outflows

- Operating flows are CAPEX and Intangibles acquired, which we think will be deeply cut during the 12 months ahead, especially at the most exposed companies. Deducted from cash operating income, this creates a proxy for Free Cash-flow. We have tested the accuracy of this estimate by regressing our proxy calculation for 2019 with the CIQ[3]-calculated number. As the chart on the right demonstrates, the proxy calculation is reasonably accurate.

Proxy & real 2019 Free Cash Flow



Source : CIQ and ValuAnalysis

- We estimate non-operating flows to be the sum of the portion of long-term debt due, the portion of lease debt due, other short-term debt and income tax payable (from the previous year).

This gives a worst-case scenario (at least we hope) for 2020, from which we can estimate the "cash burn", defined as the difference between last year's annual proxy operating free cash *inflow* and the total 2020 net cash *outflow* (or considerably smaller inflow in a limited number of cases).

[2] Companies do not report depreciation and amortisation consistently, some put them in Cost of Goods Sold, for which we adjust, too.

[3] S&P Capital IQ

Stryker: largely deferable revenues hampered by a large base effect

Below, we feature Stryker as an example. On the basis of a severe Q2 trough in revenues, this is what our standardised cash-flow calculation would look like.

Stryker	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Total 2020	Q1 2021
Revenues	**2813**	**2190**	**2486**	**2821**	**10310**	**3329**
YoY % change	*-20%*	*-40%*	*-30.7%*	*-31.7%*	*-30.7%*	*+18.4%*
Cost of Goods Sold	**1127**	**877**	**996**	**1130**	**4131**	**1334**
Gross Margin					*60%*	
Other Operating Costs	**1575**	**1439**	**1461**	**1584**	**6059**	**1575**
Cash Operating Income (ex. D&A)	**305**	**68**	**223**	**302**	**898**	**615**
Operating non-P&L cash costs					**-473**	
Non-operating non-P&L cash costs					**-1116**	
Estimated (outflow) inflow					**-691**	
2019/2020 cash burn					**-3537**	
Undrawn credit					**3046**	
Source : ValuAnalysis Limited						

Of note:

- Despite a largely deferable revenue base, a punishing Q2 revenue drop will probably not allow a 100% recovery over Q2 2020 – Q1 2021 (the standardised model gives 91%).
- The 2019/2020 cash burn on that basis would be ca. 3.5bn, slightly over the undrawn credit limit (ca. 3.04bn).
- The equity market value drop since February 17th represents 4.1x the -3.5bn cash burn, which is less than the average multiple of our sample (4.6x). The company is attractive on the basis of its business characteristics, but its shares are not yet at attractive levels on that basis.

Alphabet: a limited base effect and a fully deferable path to recovery

Below, we feature Alphabet as an example. We are still unsure about the hit that Alphabet's advertising revenues might get in Q2, but we suspect it might be in the 10% area at a minimum.

Alphabet	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Total 2020	Q1 2021
Revenues	**39610**	**35050**	**35751**	**37538**	**147948**	**39790**
YoY % change	*+9%*	*-10%*	*-11.7%*	*-18.5%*	*-8.6%*	*+0.5%*
Cost of Goods Sold	**20233**	**18239**	**18545**	**19327**	**76343**	**20312**
Gross Margin					*48.4%*	
Other Operating Costs	**12022**	**12468**	**13754**	**15235**	**53479**	**12022**
Cash Operating Income (ex. D&A charge)	**10268**	**7256**	**6364**	**5889**	**29777**	**10369**
Operating non-P&L cash costs					**-22822**	
Non-operating non-P&L cash costs					**-1968**	
Estimated (outflow) inflow					**+4987**	
2019/2020 cash burn					**-14045**	
Undrawn credit					**4000**	
Source : ValuAnalysis Limited						

Of note:

- Despite an exposure to advertising, which we believe is only partly deferable, Alphabet would recover 102% of its revenues by Q1 2021, on our standardized model. This is still a shortfall of ca. 10 to 12% relative to its previous growth rate.
- The seemingly massive -14bn cash burn however is dwarfed by the drop in market capitalisation more than 15 times larger. Given that debt is not a problem for Alphabet, this makes this stock a clear outlier, to which we would allocate an active exposure.

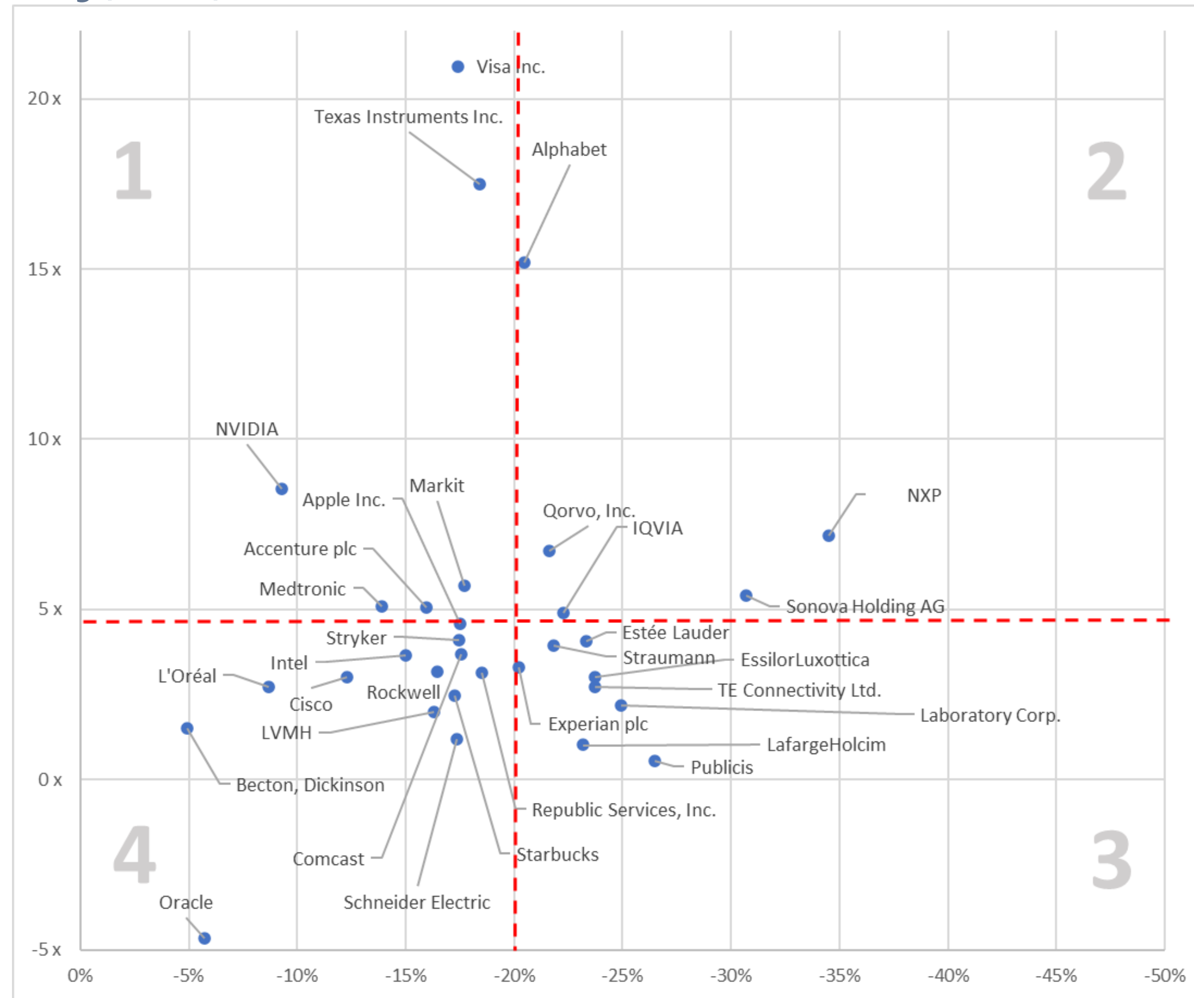
Cash outflow Metrics

Finally, we measure the cash outflow against balance sheet strength and equity valuation

Market Capitalisation drop versus multiple of Cash-earnings Swing 2019/2020.

- This ad-hoc ratio, created for the needs of this crisis, measures, in our view, the level of worry of the market relative to our standard scenario. A stock with a high ratio, say 8 or 9x, means that the market is pricing a higher “cash burn” than what we model. The red lines on the chart (next page) are the market averages, with -20% for the market fall (vertically), representing 4.6x the average cash burn (horizontally).
- There are three clear outliers: Visa, Texas Instruments and Alphabet. The exceptional profitability of these businesses and the fact that they have dropped roughly like the market make them stand out. There is actually a fourth outlier, Schlumberger (not on the chart) with a drop of more than 50% in market value and a “cash burn cover” of 3.1x.
- Quadrant 1 is dominated by stocks that have fallen less than the market and have a modest relative cash burn potential. No surprise here to find Apple, Accenture or Medtronic.
- Quadrant 2 is, potentially, the most interesting area to consider, with stocks having fallen more than the market but harbouring a stronger financial situation relative to this fall than the sample average. Their natural evolution is to move to Quadrant 1. We find Qorvo, IQVIA, Sonova and NXP equally attractive.
- Quadrant 3 stocks have been penalised more than the market for their material estimated deterioration in cash generation. Apart from Schlumberger, whose fall (50% or more) is staggering, Estée Lauder appears potentially investible.
- Quadrant 4, with stocks having fallen less than the market, should harbour the more defensive ones. This is indeed the case for many of them (Becton Dickinson, Cisco or Comcast). Some other names are less clear. Starbucks or LVMH probably need to fall more, unless we have been undeservedly harsh in our cash burn assumptions. What is penalising these stocks in the model is the lack of deferability; sales and growth can start again but from a lower, non-recoverable basis, as we cannot go out and drink that coffee yesterday, for instance.

Drop in Market Value since February 17th (horizontal) vs. Multiple of cash-earnings swing (vertical)

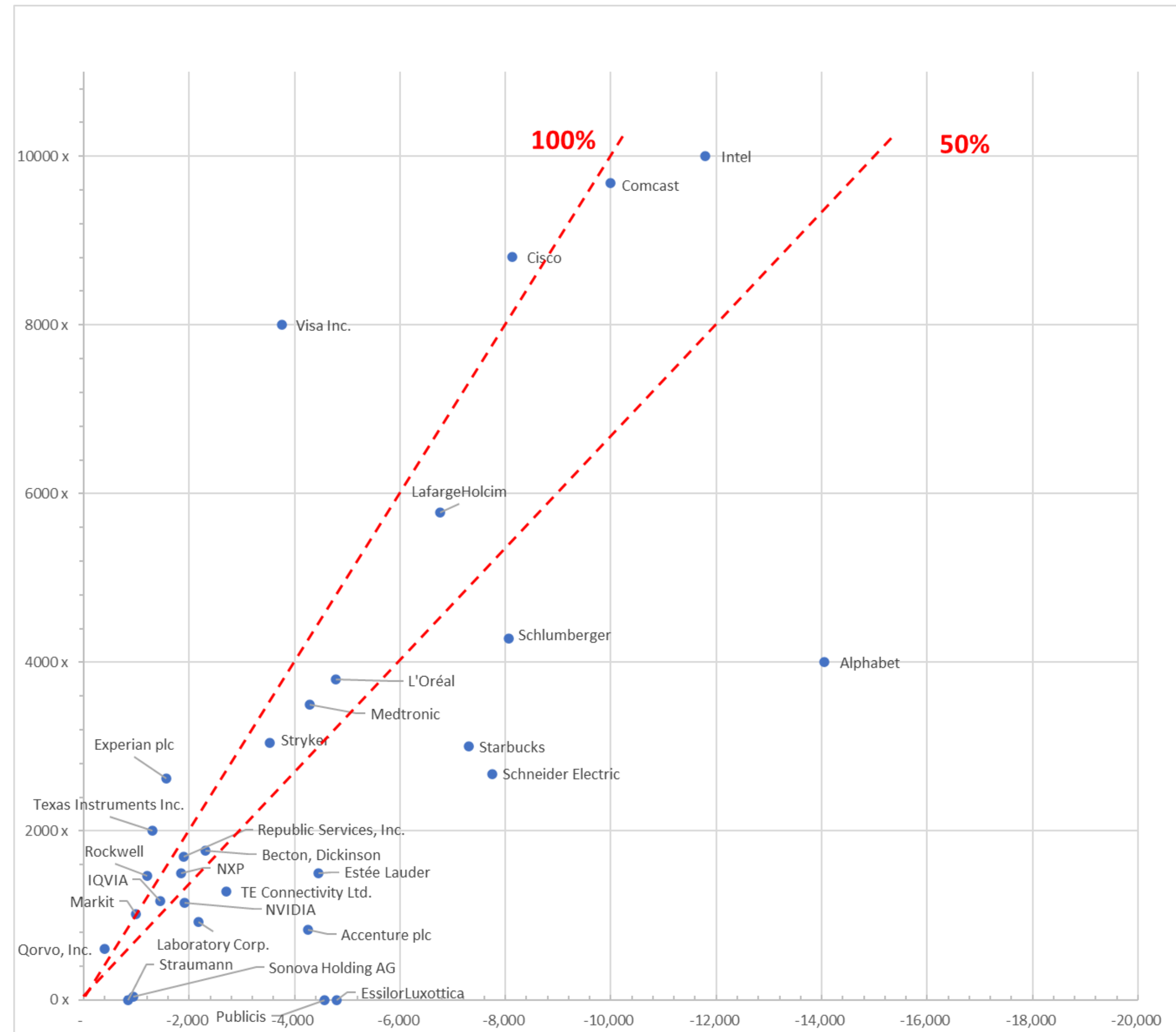


Source : ValuAnalysis Limited

Undrawn Credit vs. 2019/2020 swing cash-loss.

- Undrawn credit is a tentative data point. It tends to be disclosed in 10K reports and is collected by our data provider (S&P Capital IQ) but not systematically so (especially not in Europe). We advise to take this information with extreme prudence (nb: this datapoint is as of last reported year) but believe that we can draw a number of interesting conclusions. On the chart, we show the 100% line (meaning that 100% of the swing is covered by undrawn credit lines) and the 50% line.
- **Visa and Texas instruments confirm their star status.** The combined view of the previous and this chart suggests that the swing is solidly underpinned, and more than anticipated by the market, relative to the rest of the sample. Alphabet does not quite make the cut, but it controls a vast amount of cash, and therefore is less exposed – in fact not at all – to banking facilities.
- **Other well covered companies include Qorvo, Markit, Rockwell, Cisco and Experian.** Oracle, not on the chart, has a positive swing and does not need any further credit.
- **Among the Medtech sector,** Stryker and Medtronic are both covered similarly and adequately, above 80%
- **A number of stocks have 50% or less cover,** including Starbucks (this looks vulnerable, given their extensive lease commitments), Schlumberger, TE Connectivity, Estée Lauder, Schneider, Sonova (we are less confident about the ratio for European companies, though), Laboratory. Corp. and, surprisingly, Accenture.

Undrawn Credit vs. 2019/2020 cash-earnings swing ("cash burn")



Source : ValuAnalysis Limited

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