Investec Europe Research Bulletin June 2020

Ideas | Advice | Solutions

Out of the Ordinary®

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Executive Summary

In our research note for June, we examine the impact of the pandemic on Ireland's labour market. From a labour force of 2.5 million people, more than 1 million people have been made unemployed or are being supported by wage subsidies from the State. As severe as the disruption has been, the worst should now be over and 65,000 have returned to work in the two weeks following the initial easing of restrictions, led by the construction sector. We also round-up recent economic events internationally as most countries restart economic activity following lockdown periods of varying forms.

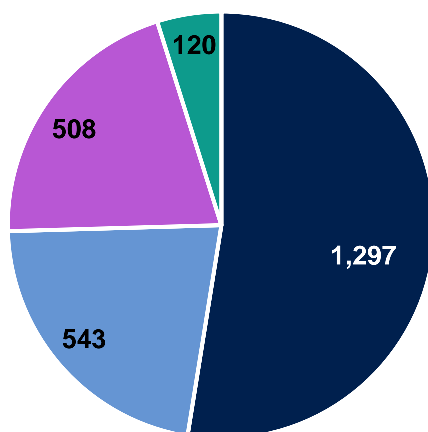
Investec Corporate Finance examines the recently instituted €2bn Pandemic Stabilisation and Recovery Fund and concludes that it will be an important source of flexible capital for Irish corporates. Investec Treasury analyses the quick rebound in oil markets and takes a look back at the last three months of activity by European policymakers which has culminated in a large increase to the ECB's QE programme.

Stay safe and healthy and don't hesitate to contact us if we can be of assistance.

Economic Update: Ireland

Labour market clearly captures the impact of the pandemic, but the worst may be over

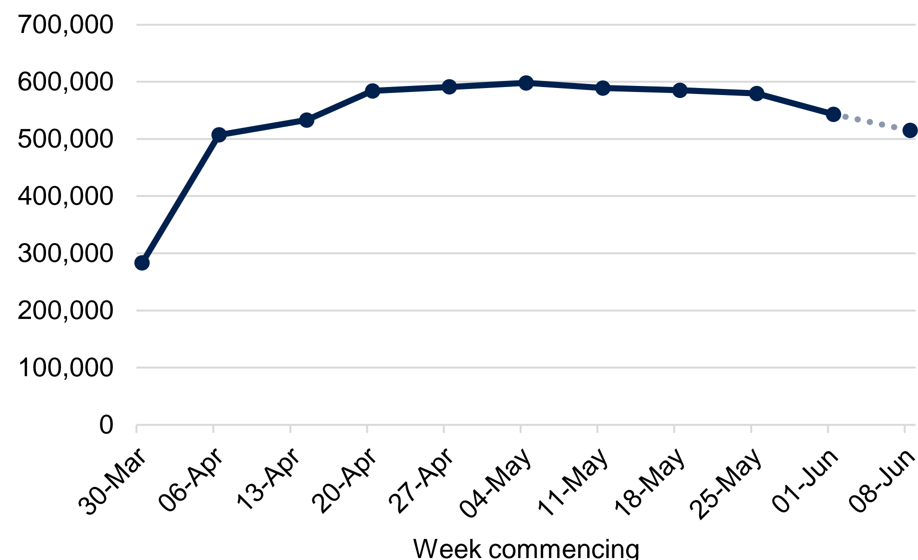
Labour Force ('000): latest picture



▪ **Employed (unsupported by State)** ▪ **Pandemic Unemployment Payment**
▪ **Wage Subsidy Scheme*** ▪ **Pre-crisis unemployed**

**Recipients of at least one payment under the scheme.*
Source: DEASP, CSO, Revenue, Investec

PUP recipient numbers beginning to decline



NB: Number for 8 June is a projection based on latest data.
Source: DEASP, Investec

- Much of the impact of the pandemic and the resulting economic and social restrictions has been reflected in the labour market.
- From a position in Q4 2019 when 2.4m were employed and the unemployment rate was below 5%, as of 3 June, there are 543,000 people in receipt of the Pandemic Unemployment Payment (PUP) and 508,000 people have received the Temporary Wage Subsidy Scheme (TWSS). 'Regular' employment that is not supported by the TWSS has dropped by around 45% to 1.3m.
- However, the country has now passed the peak in terms of labour market disruption. 36,500 people, representing 6.3% of PUP claimants, returned to work in the week following the initial easing of restrictions on 18 May, and a further 28,400 returned to work in the second week.
- The unemployment numbers will continue to reduce in the coming weeks and months provided that the government proceeds with its phased restarting of economic activity, but the pace of this reduction and the long-term damage to the labour force remains particularly unclear at this stage.

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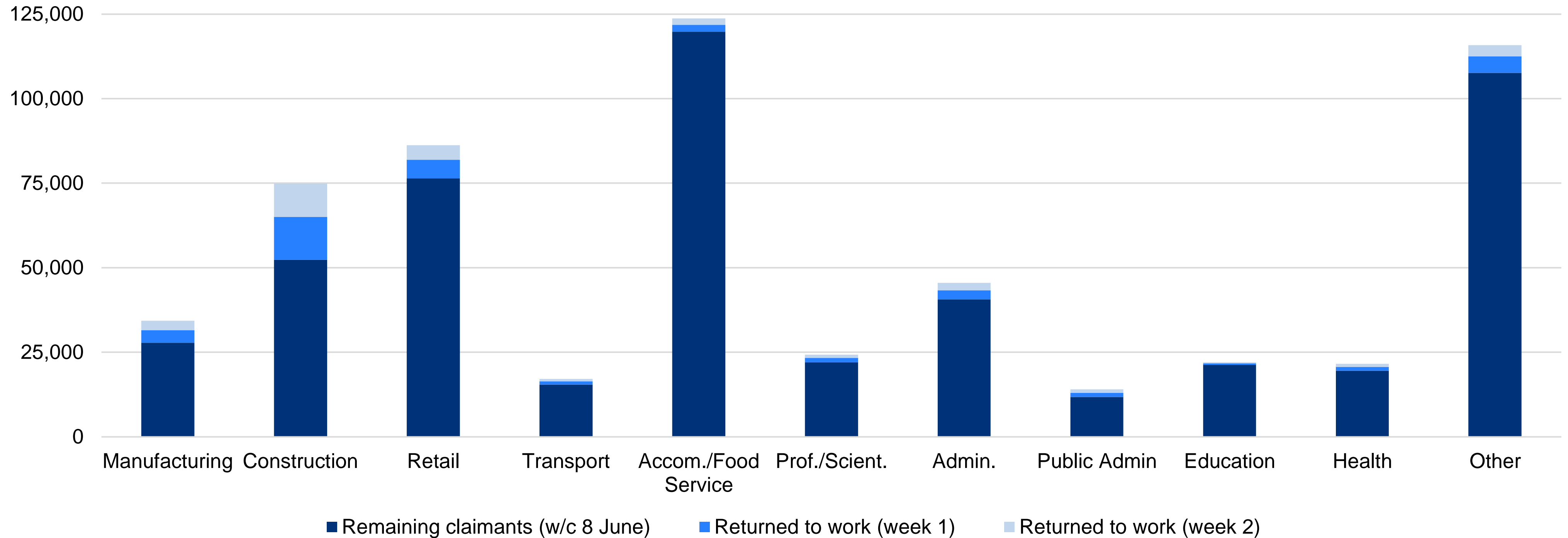
Economic Update: Ireland

Construction sector has seen the highest numbers return to work so far



Source: DEASP

- 30% of construction sector workers that had been receiving the Pandemic Unemployment Payment (PUP) returned to work in the two weeks following the initial easing of restrictions.
- The retail sector had the next highest rate of those returning to work – 9,800 people representing 11% of claimants in that sector – but more than 75,000 retail workers remain unemployed due to the pandemic, second only to the Accommodation/Food Service sector.
- Different sectors will see different 'return to work' rates as the country moves through the various stages of lockdown easing.

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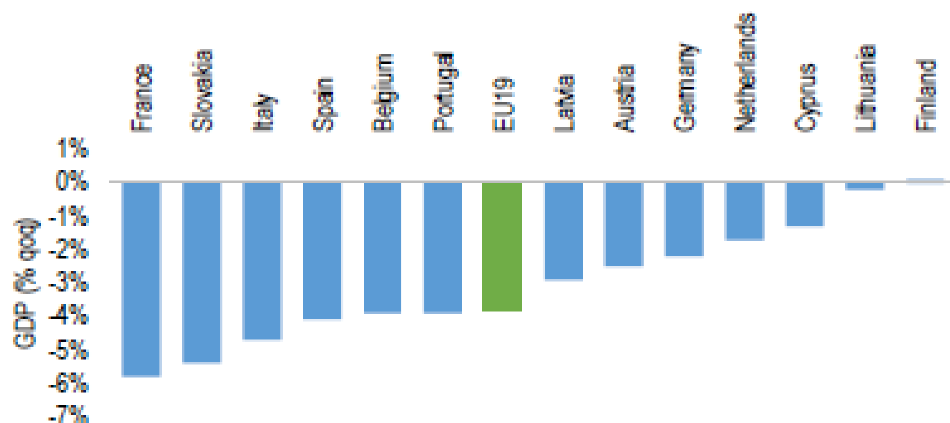
Economic Update: International

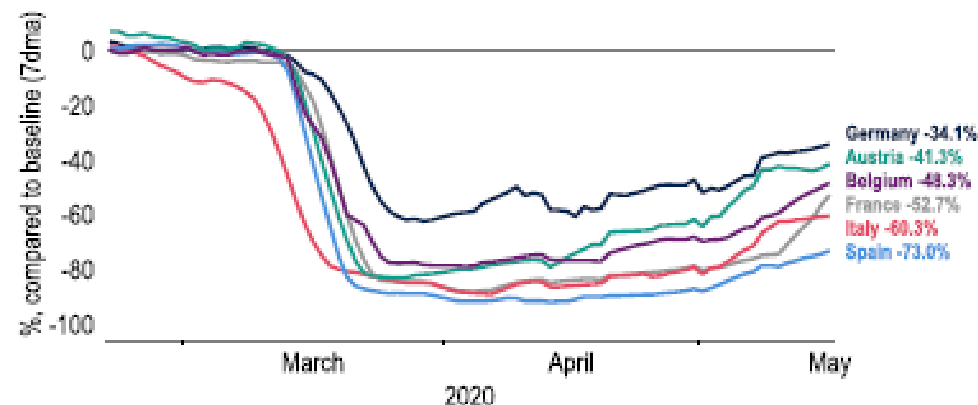
Most countries have eased lockdowns and economic activity is beginning to rise

Q1 GDP in Europe



**NB: Data not available for all countries yet*
Source: Eurostat

Google Mobility Monitor shows societies beginning to restart



Source: Google

- **Eurozone**: GDP fell by 3.8% (qoq) in Q1 but Q2 will see a much sharper drop as shutdowns only took hold in March. There are however some modest signs of hope that the worst of the economic hit has passed. For example, May's Composite PMI witnessed a rebound to 30.5 from April's record low of 13.6 and other indicators such as business climate surveys have echoed the signs of improvement in May too.
- Political leaders have finally made progress on instituting a €750bn EU recovery fund. In a historic agreement, the plan will essentially see the European Commission issue debt and the funds then being transferred to member states, with a majority by way of grants rather than loans. A group of countries dubbed the 'frugal four' still need convincing however. ECB policy will remain accommodative for some time and it has extended the scale of its programme of bond purchases (PEPP, essentially QE) to an unprecedented €1.35trn – see pages 8-9 for a more detailed analysis.
- **UK**: 2020 could see the largest contraction in the UK in 301 years with a double-digit decline in GDP. Surveys point to an improving situation through late Q2, though a sizeable contraction over the quarter as a whole is inevitable. The relevant coronavirus metrics are coming down, prompting the government to begin easing restrictions. Public debt levels are set to soar however following various policy decisions. Talk of negative rates is growing louder in the UK, and is showing up in various yield curves, including negative short gilt yields
- **US**: Social unrest is currently top of the list of issues in the US at the moment and has even prompted concerns that protests could spur an increase in coronavirus cases. May's unemployment rate confounded all expectations and reduced to 13.3% as many States began reopening. US saving rates soared through lockdown, which could spur a mild spending boom through Q3. Still, economic risks remain with chatter of negative rates persisting.

Investec Corporate Finance

€2bn PSRF Fund – Significant support for Irish Corporates

Introduction

- It has been well documented that there has been a broad range of Government supports announced for businesses in recent months. These have included working capital and other loan schemes, trade credit guarantees, tax supports and wage subsidy schemes, amongst others. These have either been administered directly through Revenue, State Bodies including Enterprise Ireland and SBCI, or through the Irish banks.
- In May, the Government launched the €2bn Pandemic Stabilisation and Recovery Fund ("PSRF"), which will be managed by the NTMA through ISIF. ISIF is already a significant investor in Irish corporates, both directly through provision of growth capital and indirectly through private equity funds and lenders that are active in the Irish market which it has supported.

PSRF Overview

- In our view, the PSRF will be of significant importance to the recovery of the Irish economy, supporting medium and larger enterprises that are significant employers. This will be an important source of flexible capital to address the challenges that Irish corporates will face in the weeks and months ahead.
- We have set out the key criteria and features of the PSRF below:

Criteria

- > 250 employees or turnover in excess of €50m, or of substantial scale and significant importance at national or regional level. Negatively and materially impacted by the pandemic
- Businesses with proven business models which were commercially viable prior to the C-19 pandemic, that can demonstrate a return to viability
- Investments will need to yield both a commercial and economic impact return in line with ISIF's requirements

Sectors

- All sectors considered (subject to existing ISIF restrictions) but it is expected that support will focus on those sectors that are most significantly impacted by C-19, including retail, hospitality & leisure and aviation
- Alignment with existing ISIF priority themes (Regional Development, Housing, Indigenous Businesses, Climate Change or Brexit) is not required

Approach

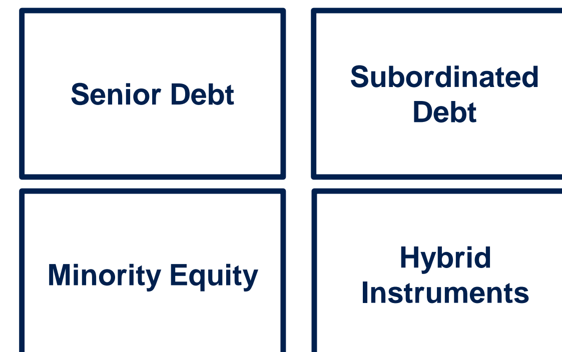
- **Flexible:** Willing to participate across the capital structure through various instruments, no controlling / majority positions
- **Co-investment:** Expected from existing shareholders with available capital; welcomed from new co-investors in line with current approach
- **Double bottom line:** Commercial return and economic impact, with a focus on near term economic activity and employment
- **Long term:** Patient capital, which can take a long term view to support stabilisation and recovery of the Irish economy

Investec Corporate Finance

€2bn PSRF Fund – Significant support for Irish Corporates

Flexible Capital Solution

- The flexible nature of the PSRF mandate will be an important element in its successful deployment. The PSRF will have the ability to invest across the capital structure, providing an appropriate capital solution that supports the company in question. This form of investment is expected to range from debt instruments (super-senior, senior and junior/mezzanine), hybrid instruments such as redeemable preference shares or convertible loans, through to minority equity investments.
- A co-investment approach, which is how ISIF has typically tended to invest in the past, will leverage the economic impact of the invested PSRF capital.



Engagement with Capital Providers

- Early engagement with all forms of current capital providers has been critical to address the initial fallout from the C-19 pandemic. As we progress to recovery phase, holistic capital solutions may be required as part of the next stage of these engagements, to take into account medium and longer term requirements. Many corporates are commencing the planning process for this, and understanding the position of all capital providers is important before seeking to engage with the PSRF or other potential capital solutions
- We believe equity investment can play a key part of the funding solution for some Irish corporates, as it addresses both current liquidity requirements and can support longer term growth. Our perspectives on considerations of minority equity are set out in a previous note (Link).
- For our part, Investec has significant experience in advising Irish companies in sourcing capital from ISIF, recent examples of which include Green Isle Foods and ATA. In addition, we have a strong track record in refinancing and sourcing alternative forms of capital for companies, including co-investment partners.

Conclusion

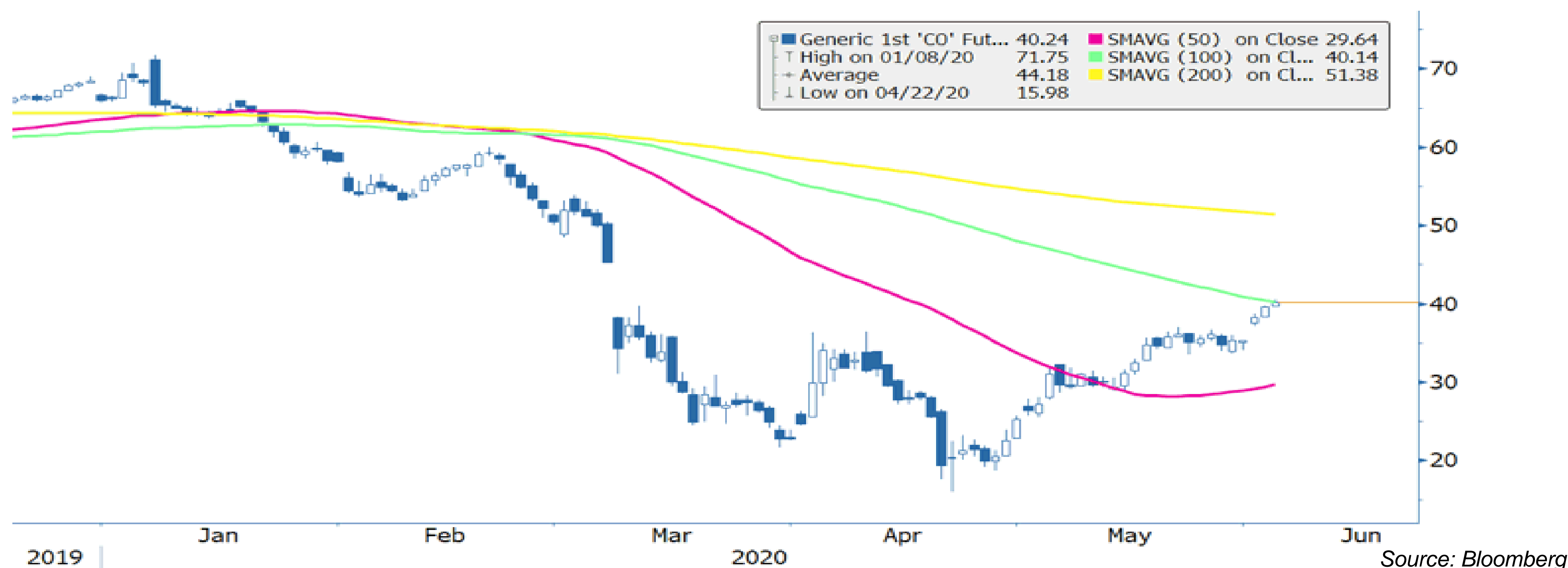
- The PSRF builds on existing Government packages that have primarily been focussed on supporting the SME sector and is a welcome development for medium and large scale Irish enterprises. If you would like to discuss the above, please do not hesitate to contact any member of the Corporate Finance team.

Eoin Kennedy is a Director in the Corporate Finance team at Investec (eoin.kennedy@investec.ie; +353 87 986 3426)

Investec Treasury

Oil Prices increase 90% since the start of May

Brent Crude Moving Averages – a reminder of how technical the market can be

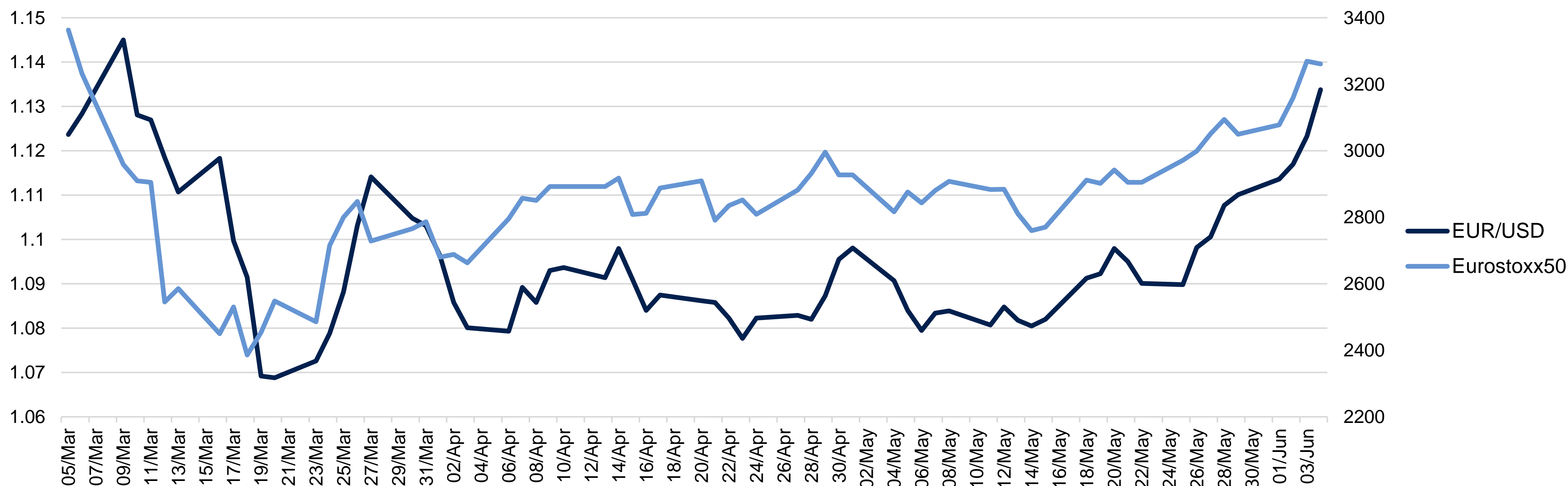


Source: Bloomberg

- The chart shows Brent breaking through the 50-day moving average in the middle of last month when Brent was around 30 $/b. It then pushed through the April highs and is now testing the 100-day average over 40 $/b. It may be fundamental considerations that are stimulating these moves, but the size of moves are constrained by technical levels.
- But what a difference a month makes. The backdrop for oil remains promising as the market rebalances. US producers are in the process of cutting 1.75m barrels per day (bpd) of existing production by early June. That's on top of OPEC+'s agreement to curb almost 10m bpd of output, which is being strictly adhered to after taking effect at the beginning of May. Total global production is now 80-90m bpd from 100m bpd at end-2019.
- OPEC's reductions have been key to rebalancing the market. Supply is no longer outpacing demand at the scale it was a month ago, and some are even forecasting a shortfall in Q3. The rebound from lockdowns has been more swift than many expected and gasoline and jet fuel use is rising.
- This week's US crude inventory figures show a fall of 2m barrels in storage, plus domestic production fell by 200k bpd offering further support. In the weeks ahead, watch for OPEC+ countries deciding whether to keep cuts in place. If they do, and the US increases output, they will lose market share.

Europe, under duress, steps up to the plate

EUR/USD vs. Eurostoxx 50 index, last three months



Source: Bloomberg

- Looking back a few weeks ago to mid-May, the EUR/USD exchange rate was sitting just above the $1.08 level and close to recent crisis lows. The mood music surrounding the European (fiscal and monetary policy) response to the crisis was less than appealing and the aggressive nature of the EUR/USD sell off meant that there was a very real probability that the EUR/USD exchange rate could head towards the $1.00 (parity) level or even lower. Not ideal for the dollar buyers amongst our clients and, knowing full well how cripplingly indecisive the channels of European bureaucracy can be, it was hard to assuage their concerns.

Europe does not take quick decisive actions

- It's maybe understandable that Europe as a whole with its many branches of power / policy enforcement (European Commission, ECB, etc.) and various national interests can be slow to react and implement change during normal 'peace times'. It is however the European response time during periods of crisis that can sometimes boggle the mind. We only have to recall how it took over two long years of Eurocratic wrangling before former ECB President, Mario Draghi, felt comfortable enough to deliver his now laudable 'whatever it takes' battle cry in July 2012 at the very apex of the seismic European sovereign debt crisis of 2010-2015.

Europe, under duress, steps up to the plate

- As the COVID-19 situation escalated into early March and it was looking apparent that the pandemic had the makings of not just a global health crisis but (due to draconian 'lockdown' restrictions) a global financial crisis also. It's no surprise that all eyes therefore turned to international policy makers as to their response to the unfolding pandemic. Given the previous European track record, one could be forgiven for not placing the utmost faith in a swift, comprehensive retort from Brussels and Frankfurt.

During times of economic crisis, the US is more often than not the first out of the stimulus blocks

- Whatever you may think about the US humanitarian and medical handling of the pandemic, one can't argue that the speed and scope of the US monetary policy and fiscal response was nothing short of breath-taking. By the end of March the US Fed and Government between them had unveiled an array of liquidity and fiscal packages that totalled well over $4tn. On the night of the 18 March, as the pandemic raged across the continent and two days after the benchmark Eurostoxx 50 index touched off the crisis low of 2,300, the ECB delivered an 'unscheduled' but very welcome jolt of €750bn QE, the Pandemic Emergency Purchase Programme (PEPP).

As welcome as this massive liquidity injection from the ECB was, market analysts weren't satisfied

- The less robust Italian, Spanish, Greek and Portuguese economies, hardest hit by the lockdown restrictions were screaming for fiscal aid. Italy and Spain in particular were adamant that given that the pandemic qualified as a natural disaster, they didn't want bailouts (loans) or the stigma that comes attached to them. Markets looked on aghast as the all too reticent surplus, northern economies such as Germany, the Netherlands and Sweden remained less than empathetic to their neighbours' plight. Debt mutualisation it seemed was still an alien concept even in the most dire of situations. Talk of the breakup/dissolution of the EU was worryingly topical again.

In the background however, Macron was hard at work urging Merkel to agree to a hugely symbolic pan-European fiscal aid programme

- On 19 May it was announced that Merkel and Macron had both agreed to support a 500 billion-euro aid package. This was followed shortly thereafter (27 May) with the announcement that the European Commission was to increase the size of the proposed Franco–German 'recovery fund' to €750bn (€500bn grants & €250bn loans). The draft plan still needs to be agreed by all 27 EU member states, with a number of northern countries (Austria, Sweden, the Netherlands and Denmark), dubbed the 'frugal four', continuing to have concerns. The bonds issued by the European Commission would be repaid from the EU budget and the proposal marks a very significant and symbolic step in efforts to shore up the European project and a major win for Macron.

What a difference two months makes

- If all that wasn't enough, the ECB, at its scheduled monetary policy meeting yesterday, announced that it is to boost the level of its QE purchases by another €600bn, taking the intended size of the PEPP to a massive €1.35trn. Ordinarily, an ultra-loose monetary stimulus package of this size would weigh heavily on the value of the euro. It does now seem that the concerted actions of the European Commission and the ECB have created such a 'feel good' factor that the benchmark EUR/USD rate has jumped to levels ($1.1350) not seen in three months when the Fed slashed US interest rates. Europe take a well deserved bow.

Contact Details

Corporate Finance

Liam Booth
liam.booth@investec.ie
T: +353 1 421 0345
M: +353 86 2841805

Shane Lawlor
shane.lawlor@investec.ie
T: +353 1 421 0347
M: +353 86 8073904

Tommy Conway
tommy.conway@investec.ie
T: +353 1 421 0358
M: +353 87 6187842

Jonathan Simmons
jonathan.simmons@investec.ie
T: +353 1 421 0351
M: +353 87 6370984

Eoin Kennedy
eoin.kennedy@investec.ie
T: +353 1 421 0386
M: +353 87 986 3426

Treasury

Aisling Dodgson
aisling.dodgson@investec.ie
T: +353 1 421 0084

Philip Ahearne
philip.ahearne@investec.ie
T: +353 1 421 0128

Peter Ellis
peter.ellis@investec.ie
T: +353 1 421 0223

Gearoid Keegan
gearoid.keegan@investec.ie
T: +353 1 421 0098

Alan Harrison
alan.harrison@investec.ie
T: +353 1 421 0086

Mark O'Brien
mark.obrien@investec.ie
T: +353 1 421 0091

Private Client Lending

John McWeeney
john.mcweeney@investec.ie
T: +353 1 421 0005

David Gilligan
david.gilligan@investec.ie
T: +353 1 421 0433

Helen Fitzgerald
helen.fitzgerald@investec.ie
T: +353 1 421 0050

Economics

Ronan Dunphy
ronan.dunphy@investec.ie
T: +353 1 421 0468

Chief Executive Officer

Michael Cullen
michael.cullen@investec.ie
T: +353 1 421 0074

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