Investec Europe Research Bulletin

October 2020

Out of the Ordinary®

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Contents

Executive Summary

This Research Bulletin takes a closer look at what the imposition of Level 3 restrictions in Ireland might mean for the unemployment rate, particularly as downward momentum has waned in recent weeks. We also assess how the recoveries in major global economies are progressing.

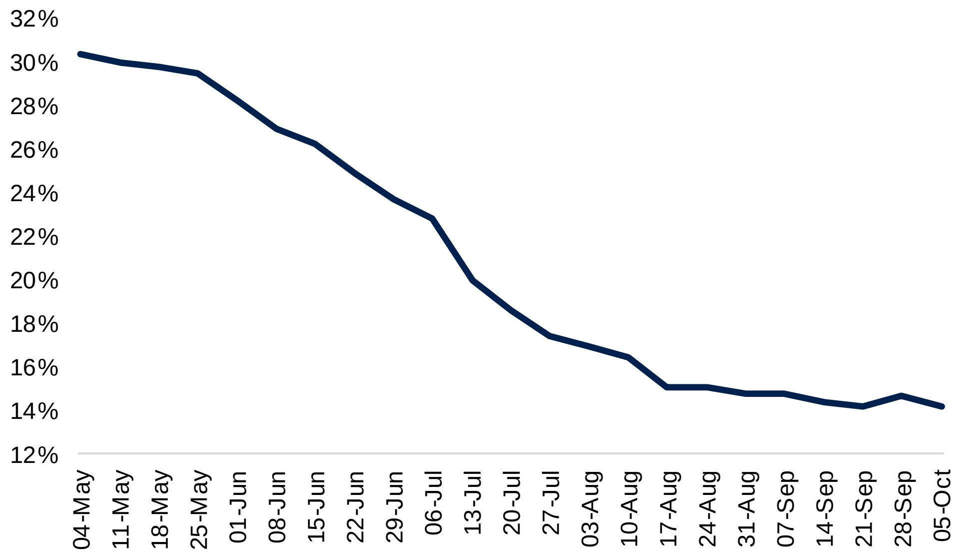
Investec Corporate Finance examines the relative boom in demand for cold storage assets such as warehouses and chilled transport fleets as consumers' appetite for frozen food grows. Investec Treasury urges corporates to take a fresh look at FX hedging strategies and considers the current state of play in the oil market, while our colleagues on Investec's lending desk discuss their appetite for commercial real estate financing.

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

Economic Update: Ireland

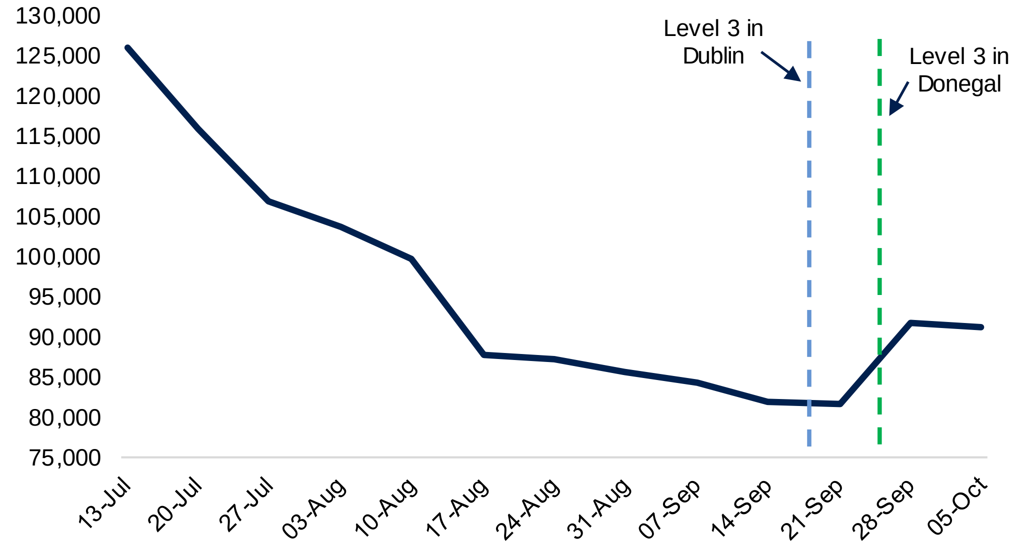
Unemployment to rise again as Level 3 bites

COVID-adjusted unemployment rate



Source: DEASP, Investec

PUP: combined Dublin/Donegal recipients



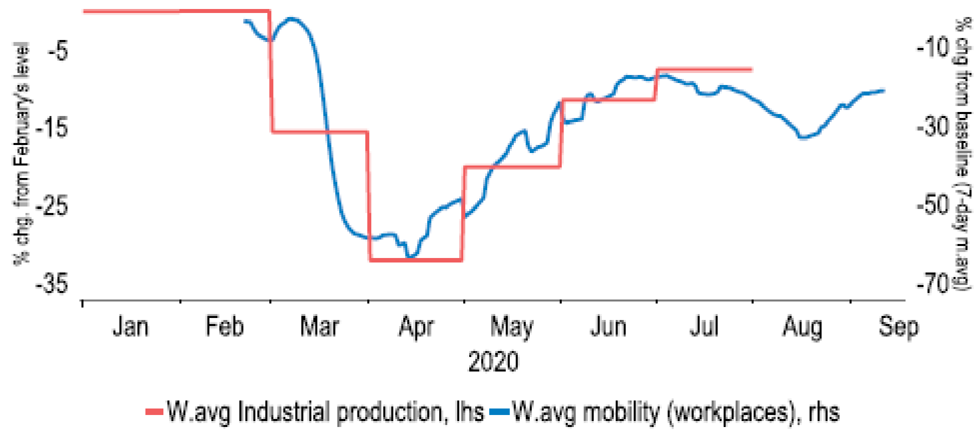
Source: DEASP, Investec

- A number of indicators in recent weeks have shown how the trajectory of the economic recovery is tied to public health developments and the associated restrictions on economic and social activities. The labour market perhaps provides the clearest evidence.
- Since Dublin entered Level 3 restrictions on 18 September, there has been a 10% increase in the number of Pandemic Unemployment Payment (PUP) claimants in the county (75,978 on 14 September to 83,356 on 5 October). The same has occurred in Donegal since it entered Level 3 on 25 September (a 36% increase between 21 September and 5 October), although the overall numbers are smaller.
- Following a strong and consistent decrease in unemployment through the summer as more affected workers were able to resume work, the unemployment rate has been stuck in a narrow range for the past two months. Indeed, since the "second wave" of restrictions began to be introduced by government on 18 August, the (COVID-adjusted) unemployment rate has fallen by less than one percentage point.
- With the entire country now subject to Level 3 restrictions, we suspect that upward pressure on the unemployment rate will re-emerge in the coming weeks. Should Level 3 (or above) apply until the end of the year, the unemployment rate may finish the year materially higher than its current 14.2% and significantly above consensus forecasts. If this is the case, the added fiscal flexibility afforded by a smaller budget deficit than expected earlier in the year (€21bn vs. €30bn) will be very welcome.

Economic Update: International

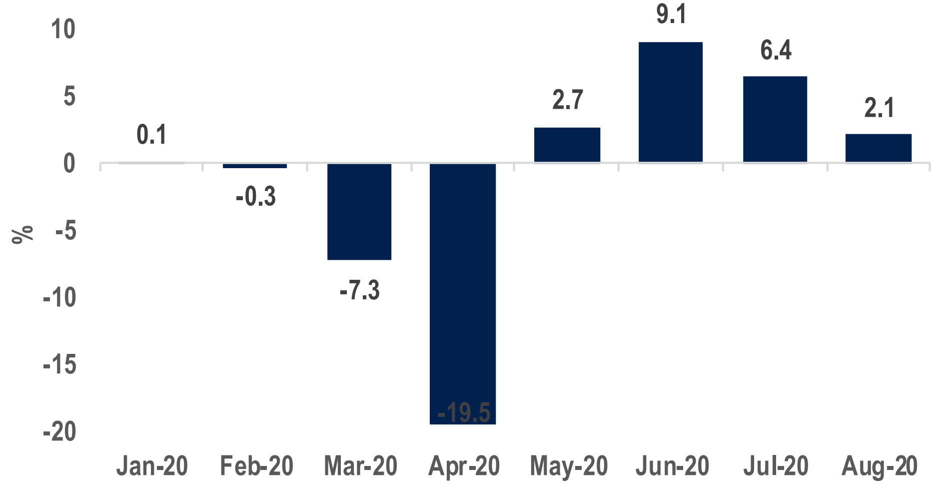
Recoveries fade as virus spreads

Google mobility versus Eurozone industrial production



Source: Macrobond

UK GDP: m/m change



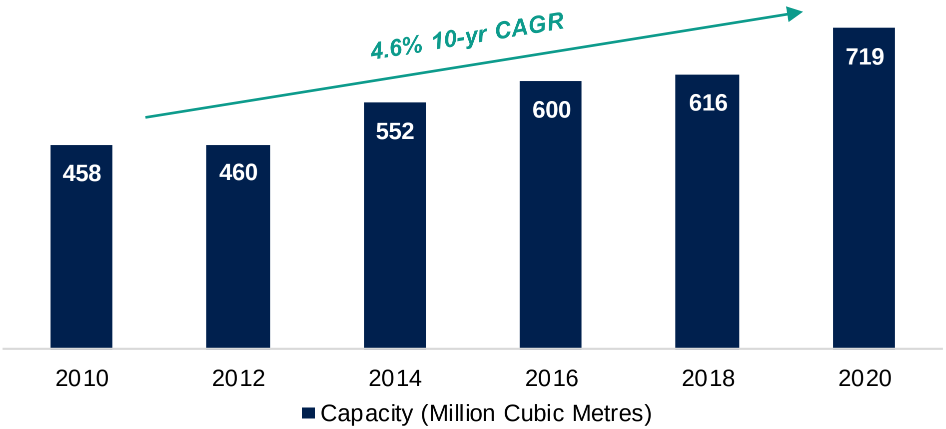
Source: Bloomberg

- **Eurozone**: Since April's lockdown-induced nadir in economic activity there has been a clear rebound as restrictions have eased. In the industrial sector EU19 output fell 26% between December and April, but it has since recovered to leave July output just 5.6% lower. Most notable has been the recovery in Italy which had suffered the biggest fall of the 'core 4', but the EU19's powerhouse Germany has lagged behind. One question is whether this pace of recovery hit a bump in August. High frequency mobility data from Google points to workplace activity diminishing as some tightening in restrictions took place, which looks set to dampen industrial output.
- **UK**: Figures show that the UK economy grew by 2.1% on a sequential basis in August, having expanded by 6.4% in July. This was considerably more subdued than consensus expectations for a 4.6% increase, although it was accompanied by a number of favourable revisions to prior readings. Overall the economy is thought to have been 9.2% below pre-pandemic levels at the end of August. It is evident that the transitory boost from the easing of restrictions has now largely faded and the recovery appears increasingly fragile as rising virus cases lead to a tightening of social distancing measures. As such, the economic recovery is no longer firmly "V-shaped", and a further clampdown risks sending GDP into reverse, creating a wave or ripple more characteristic of a Viennetta than a letter.
- **US**: Daily reported coronavirus cases, though still elevated, have come down following tighter restrictions in many states. But these have squeezed growth momentum, particularly in the absence of a further fiscal package. While there is still hope of a "skinny" pre-election stimulus package, attention is turning to the Presidential Election on 3 November and the prospects of a Democratic "clean sweep" (controlling the Presidency, the House and the Senate) which would greatly increase the prospects for a wide-ranging fiscal package in the new year.

Investec Corporate Finance and Investment

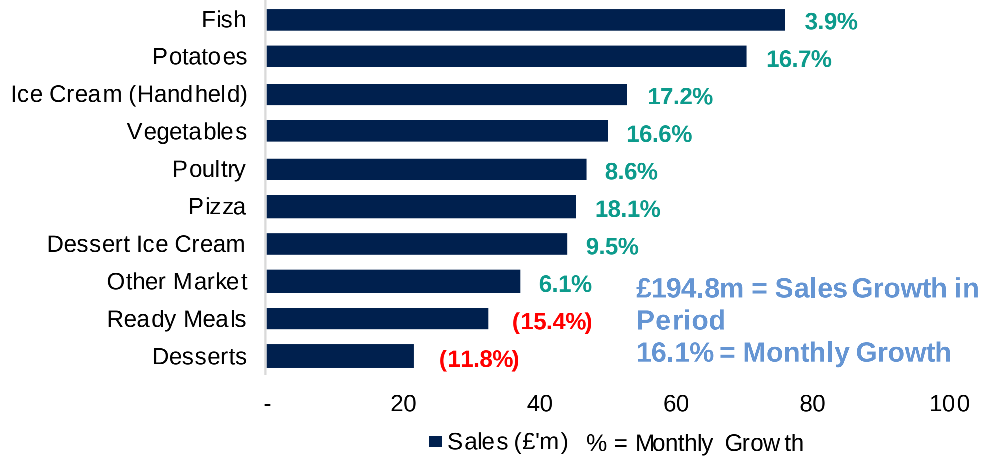
Cold storage assets becoming hot property

Fig. 1: Global Growth in Refrigerated Warehouse Capacity



Source: Global Cold Chain Alliance Capacity Reports

Fig. 2: UK Frozen Food Sales (4 W/E 19/04/20)

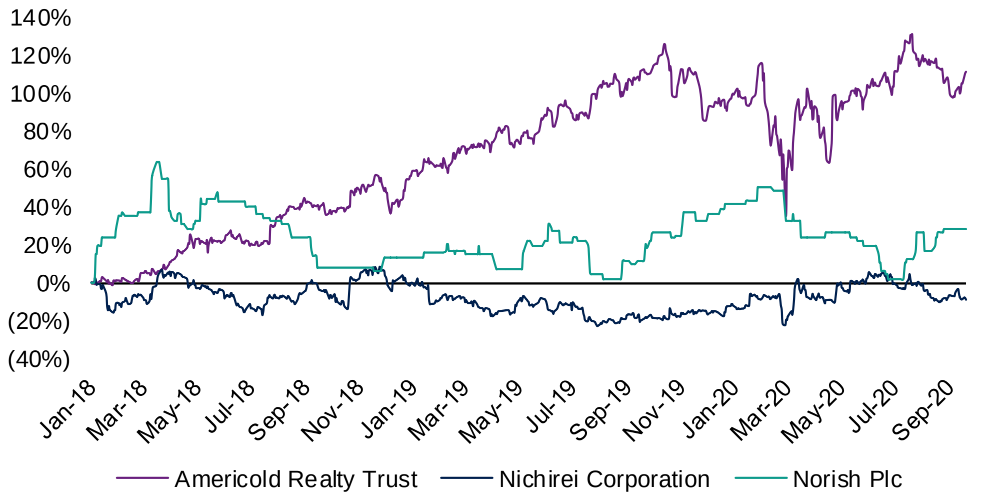


Source: Kantar – 4 week period ending 19/04/20

- **Recent discussions we've had with a wide range of international real estate capital providers (of both equity and debt) keep coming back to the same favourite themes, namely the Private Rental Sector (PRS) and Logistics. Previous research notes have featured PRS, but here we will focus on Logistics, and specifically on cold-chain logistics considering the importance of these for our major exporters in food and pharmaceuticals**
- Cold-chain logistics essentially comprise blast-freezing and / or chilling rooms, cold-storage warehouses, and refrigerated or chilled transport fleets
- Historically, cold-storage warehouses were associated with EU Intervention schemes to support prices of farm produce by storing frozen beef and butter, often for years on end. But those days are long gone and cold-stores today sit in the middle of sophisticated and mission-critical supply chains for the international food and pharmaceutical industries
- This reliance by very large industries on specialist cold chain operators has not been lost on the smart-money Private Equity investors; some of the largest funds globally have poured capital into this sector in recent years, names like Brookfield, Blackstone, Goldman Sachs, and Oaktree
- In recent months there has been a flurry of deal-making in the sector; global market leader **Lineage Logistics** raised $1.6bn in a private placement to pension funds putting a value on the business of $16bn; global #2 **Americold** acquired more stores in the US and New Zealand, and Oaktree hinted that it may sell **AGRO Merchants** with a rumoured price-tag of $2bn (AGRO will be well known to many of our Irish clients as the owners of large facilities in Co. Monaghan and Sawyers Transport based in Co. Armagh)
- Closer to home, the Irish fund, **Renatus Capital**, has invested in recent weeks in **CRS Mobile Cold Storage**, a specialist in cold chain services for the pharmaceutical sector in Ireland and the UK

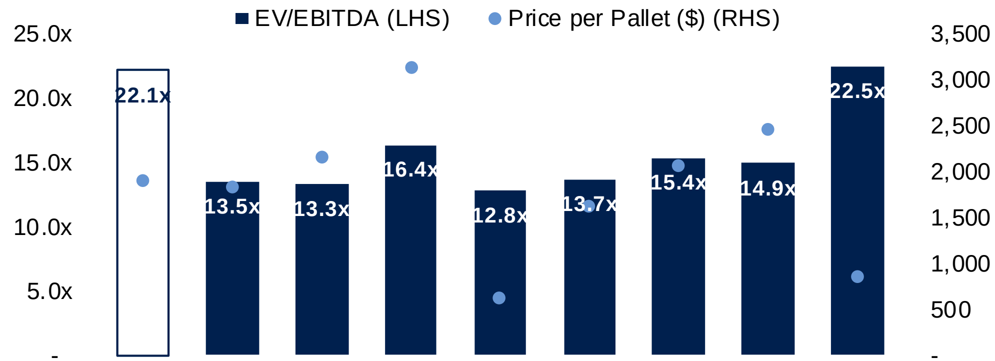
Investec Corporate Finance and Investment

Fig. 3: Sector Valuation – Share Price Performance



Source: S&P CapIQ, share pricing as at 06 Oct 20

Fig.4: Sector Valuation – Selected Data Points



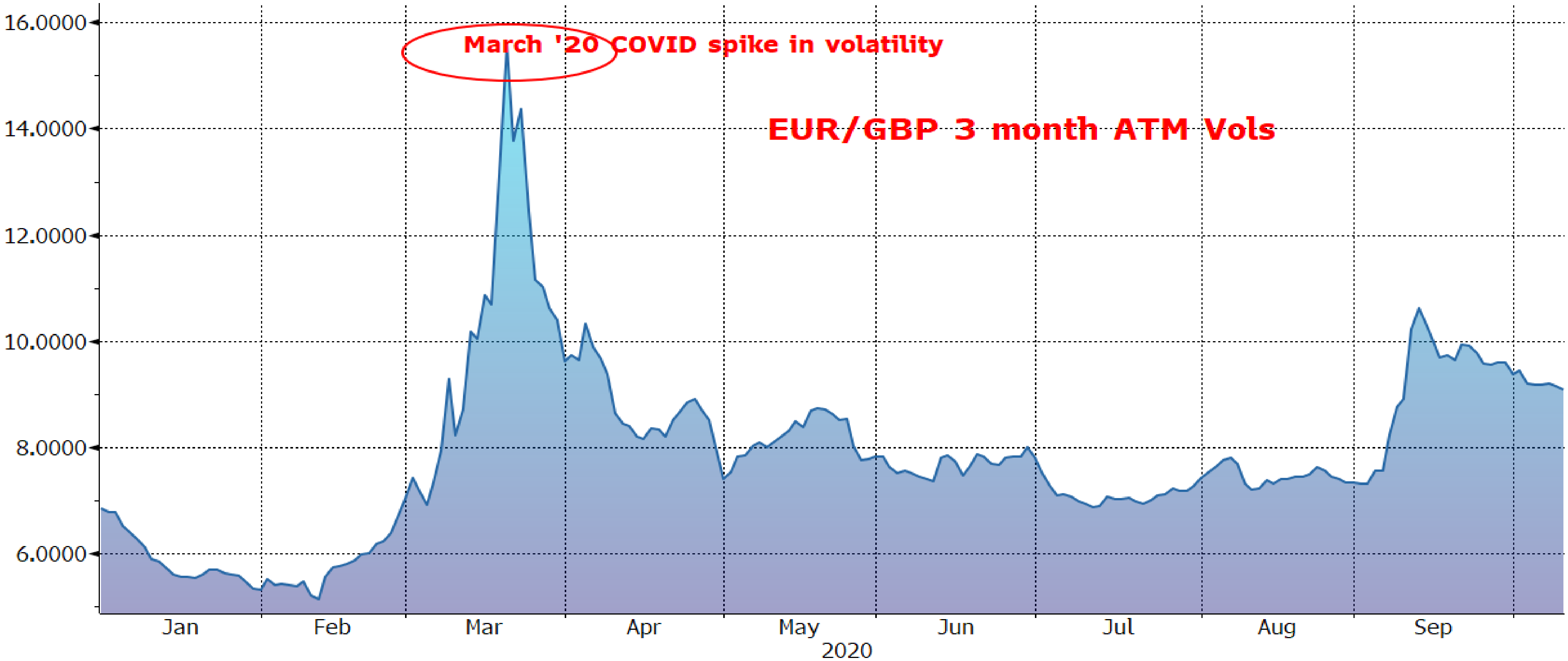
Date	*Americold Trading Multiple*	Sep-20	Jan-20	Nov-19	Nov-19	May-19	Apr-19	Jan-19	Nov-18
Target		AMC	Newport Cold	Nova Cold	2x MHW Facilities	Lanier Cold	Cloverleaf Cold	Portfresh	Harry Yearsley
Acquirer		Americold	Americold	Americold	Americold	Americold	Americold	Americold	Lineage
EV	$9.4bn	$82.5m	$56.0m	$253.7m	$54.2m	$82.6m	$1.2bn	$90.9m	£246.0m

Source: S&P CapIQ, Industry press releases, Mergermarket, Investec analysis

- **High valuations** – cold chain assets are valued using different methods depending on the nature of the particular business and its geographical location, but in general the most common metrics are the enterprise-value multiple of cashflow (EV/EBITDA), EV per pallet, and cap-rate (net operating income as a per cent of value of the asset, which is the preferred metric used by property investors)
- The aforementioned Lineage equity raise was completed at a high-teens EV/EBITDA multiple which equates to a cap rate of just over 5%. While that sounds expensive, it is a discount to Americold, which currently trades at 22x EV/EBITDA
- **Positive trends** – while the valuations mentioned above (see fig. 3 and 4) appear high, the sector does possess strong fundamental drivers of future growth including;
  - Global trends towards longer-term contracts between cold asset operators and their key customers
  - Increased home delivery of chilled / frozen food items, especially in and around large urban areas
  - Rediscovery of frozen foods due to COVID (which led to a surge in home freezer purchases), more investment in new product development & branding, environmental-friendly features of less wastage and reduced use of single-serve plastic packaging, and a resurgence in home cooking
  - High volume demand from China for frozen pork and beef cuts to replace Chinese output which has been decimated by ASF disease
  - Increased stocking of supply chains to hedge against supply disruptions caused by Brexit and Covid-19
- Lineage and AGRO are now of such a scale that they could readily list their shares on the stock market, thereby creating an opportunity for private individuals or companies to invest in specialist operators in the sector. But in the meantime, the only companies traded on the market with high exposure to the sector are **Americold** on the NYSE (which listed in 2018 and has since doubled in price), **Nichirei** listed on the Tokyo Stock Exchange, and **Norish plc** listed on AIM segment of the London Stock Exchange

Keep your hedging options open

EUR/GBP currency volatility



Source: Bloomberg

- Irish businesses are currently facing unprecedented complexity in navigating foreign exchange risk. As well as adjusting to the post-Covid-19 “new normal”, in the coming weeks companies must also contend with the prospect of the UK leaving the European Union without a trade deal and a potentially contentious US election.

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Investec Treasury: Currencies

Keep your hedging options open

- Irish businesses are currently facing unprecedented complexity in navigating foreign exchange risk. As well as adjusting to the post-Covid-19 “new normal”, in the coming weeks companies must also contend with the prospect of the UK leaving the European Union without a trade deal and a potentially contentious US election.

- Adapting your approach to FX risk management in light of potential risk events is nothing new. Before the pandemic, many Irish companies had already adjusted their currency hedging strategies after the Brexit referendum in 2016. Now, this process of revaluation has been accelerated by Covid-19 and the disruption to supply chains. Forecasting has also been complicated by the potential for a second possibly larger wave along with the impact on consumption and consumer sentiment. As a result, many companies have entered unknown waters. Some businesses will see acute changes in sales, while others could also see varying levels of disruption to supply chains.

- As we move through the crisis, we see more and more businesses that don’t have the same confidence in their revenue or cash flow forecasts are finding the traditional practice of using forward contracts to hedge foreign currency risk may not be as appropriate as they once were. While forwards have typically allowed businesses to lock in FX rates to create better visibility around forecasting and protecting margins, there is little flexibility. The crisis has prompted businesses to consider alternative ways of minimising foreign exchange risk and we will increasingly see treasury functions, chief financial officers and financial directors seek more flexible ways to manage risk. The good news is that there are solutions that can be tailored to help business mitigate risk and build greater layers of predictability and visibility.

- Given this volatile landscape, corporates need to be careful about how they will hedge this year’s currency requirement with ongoing fixed hedging obligations. Blindly moving forward with fixed forward obligations for 12 months ahead is unlikely to be an effective risk-mitigating strategy or appropriate given the potential for uncertain cash flows, uncertainty surrounding supply chains and rapidly changing demand. Clients can instead access solutions where they can still ensure guaranteed cover on risk, but have flexibility on the amount of foreign currency they purchase – effectively an options strategy.

- Adopting options strategies to currency risk is now much more broadly understood and used by an increasing number of corporates. Forward foreign exchange contracts allow businesses to lock in a future exchange rate but the contracts are binding and not always that flexible. In contrast, options give the company the flexibility, but not the obligation, to buy or sell a currency at a specified exchange rate on or by a given date. Clients can access a full spectrum of FX options – from plain vanilla options which is an insurance type solution with a premium paid upfront to tailored solutions with zero premium by engineering flexibility on a given percentage by fixing the protected rate slightly lower than a forward rate. Always remembering, that as volatility increases so will the cost of any vanilla option premiums.

- What is most important is that your FX hedging provider fully understands your business and requirements which will allow them provide you with tailored solutions that fit your individual business.

Investec Treasury: Commodities

Oil holds above $40/barrel as Hurricane Delta makes landfall in the U.S.

Brent Crude Front Contract

Source: Bloomberg

- Brent crude has held above $40/barrel and remains on track or a 10% weekly advance as Hurricane Delta nears landfall on the U.S. Gulf Coast and a strike in Norway hampers a large amount of crude production.

- OPEC also released a report in which it expects Oil to remain the world fuel of choice through to 2045. In its assessment, the COVID-19 pandemic pushed the global economy into a deep recession as public health measures were put in place to contain the virus. As a result, “the oil market experienced a historic shock that was sudden, extreme and global in scale.” There are signs now that the oil market is starting to rebalance after we saw a 23 million barrel per day contraction in oil demand in April 2020.

- However with the massive build in oil inventory due to world-wide shutdowns, there is still a long way to go to eliminate the stock overhang and for the markets to return to balance and stability. OPEC estimates world oil demand was down 9 million barrels per day in 2020 to 90.7 million barrels a day, however oil demand is expected to rise by 7 million barrels per day in 2021 and see increases each year to 2025.

Investec Private Finance Ireland Limited (IPFIL)

Commercial Real Estate Finance Update

- Casting our mind back to Q1 2020 may seem like another world.
- Just nine short months ago debt available to deploy into Irish Commercial Real Estate (CRE) was significant and the range of options available varied greatly.
- The players ranged from local banks to a significant cohort of locally based alternative property finance houses that emerged from the Global Financial Crisis of 2008.
- This market formation saw both developers and investors/private clients often move away from more conservative senior banks to players that provide flexibility and greater leverage, albeit at a higher coupon.
- Many clients used the services of debt advisors that emerged in the Corporate Finance sector and leading accounting firms or went through ex-property finance professionals who provide often higher quality information to lenders.
- This led to a dynamic competitive space which could only be seen as positive for the Irish property sector.
- However, not unexpectedly, the impact of COVID-19 has led to the majority of players devoting significant time to existing loan books and the various challenges caused by the pandemic, such as:
  - Increased oversight and access requests from funders
  - Facilitating payment breaks or holidays in line with actions taken by regulated firms
  - Understanding the longer term implications of tenant failure
- This has led to an unfortunate contraction in the supply of debt and limited appetite for new business although pockets remain active.
- In addition we have seen Pepper Money exit CRE lending in Ireland entirely with other players also in hold patterns or considering exits.

The 76-78 Harcourt Street site occupies a high-profile position in Dublin's central business district. Listed in the Irish Times at €21m, September 2020.

- IPFIL are pleased to confirm our expansion into CRE lending, supporting experienced promoters acquiring or refinancing assets in a €3m-€20m range.
- In addition our colleagues at Investec Europe have wide-ranging debt advisory capabilities and a capability to hedge interest rates on third-party debt facilities.

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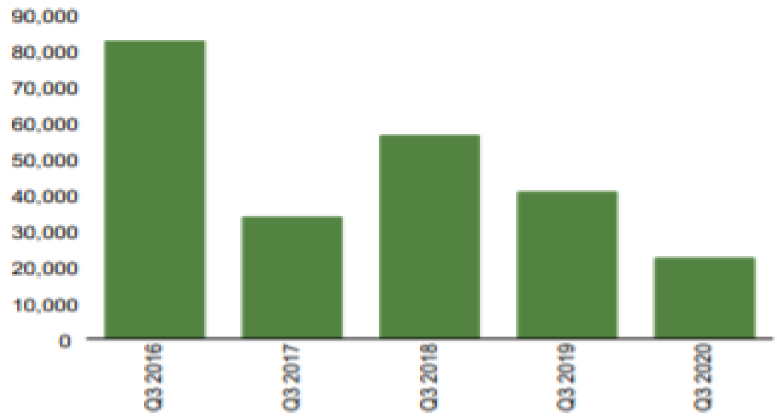
Investec Private Finance Ireland Limited (IPFIL)

Commercial Real Estate: Dublin Office Snapshot

Figure 2: Dublin Office Take-Up Q3 2016 - Q3 2020



Source: CBRE, Q3 2020

- Office take-up in Dublin during Q3 2020 reached 22,194m2 (131,263 m2 YTD) – double the volume of lettings achieved Q2.
- Take-up YTD is -32% YOY.
- 29 office leasing transactions completed in Dublin during Q3 bringing the total number of transactions YTD to 75, compared to 136 in the same period last year.
- The volume of overall demand fell by a further 13% quarter-on-quarter, with demand standing at more than 237,500m2 at the end of September.
- Only 14% of leasing activity in Dublin in Q3 2020 occurred in the suburbs, while 54% of city centre take-up in the quarter occurred in the Dublin 2/4 postcode.
- The overall rate of vacancy in Dublin at the end of Q3 2020 rose to 8.64% while the city centre vacancy rate rose to 8.49%.
- Prime headline rents declined by 4% quarter-on-quarter standing at €62.50 per sq. ft. at the end of September.
- Prime office yields remain c. 4%.

Source: CBRE Dublin Office Marketview Q3 2020

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