Investec Europe
Research Weekly
24 April 2020

Economics | Treasury | Corporate Finance | Private Client Lending

This Research Weekly takes a look at the latest economic developments at home and abroad, explains the recent turmoil in the oil market and addresses the topic of minority equity as a potential solution for some businesses for both short-term and long-term needs:

Economic Roundup: Ireland

Further evidence of the impact of COVID-19 on the domestic economy emerged during the week, although the NTMA's successful debt issuance highlighted the strong position of the public finances as the government tackles the economic consequences of the outbreak.

Deficit of 7.4% projected for this year – Wednesday 22 April

The timely publication of the Stability Programme Update (SPU) yesterday afternoon contained the Department of Finance's spring forecasts – economic and fiscal projections that incorporate the estimated impact of the current outbreak. Bleak certainly, but unsurprising given how we have seen the situation develop in recent weeks.

At a high-level, the Department projects that GDP will fall by 10.5% this year with increased government spending slightly offsetting much lower personal consumption, investment and net exports. A recovery in 2021 is expected to see GDP grow by 6%, but lost economic output will only be fully recovered by the end of 2022. The scenario underpinning the Department's forecasts is one in which containment measures are assumed to remain in place for three months with a "very gradual" recovery commencing thereafter, although we note that the projections are also contingent on the UK reaching a free trade agreement with the EU by the end of the year.

As we have seen in recent weeks, the impact on the labour market has been profound. Total employment will fall by 9.3% this year, a decrease of 220,000 jobs. Only half of these losses are expected to be regained next year with the Department expecting employment growth of 5.5% in 2021. Unemployment is expected to average 13.9% this year and, although lower, remain elevated at 9.7% in 2021. These numbers stand in stark contrast to annual employment growth of at least 3% for the past seven years.

The impact on the Exchequer will obviously be immense. A deficit of €23bn, equating to 7.4% of GDP, is envisaged. This will lead to a 10pp increase in the country's debt/GDP ratio to 69%. While a deficit of 4.1% is projected for next year, the debt ratio should not deteriorate further. In line with these projections, the NTMA has published a revised funding statement and has increased its bond funding range to €20-24bn for this year, a €10bn increase to both ends of the range. However it is already well on its way towards the revised target, and has raised €11bn of long-term funding in the year to date, including €6bn of seven-year debt at a cost of just 24bps.

One positive to take from all of the above is that the progress that the country has made in repairing the state of its public finances will now stand to its benefit. Significant borrowing will be required but, based on current conditions in sovereign bond markets, the cost of this borrowing will not be a significant burden.

Latest reminder of employment collapse – Tuesday 21 April
The latest update from the Department of Employment Affairs and Social Protection added more than 50,000 to the numbers unemployed as a result of the current outbreak and suggests that pre-crisis employment has fallen by one-third.

The Department yesterday issued payments to 584,000 people through the COVID-19 Pandemic Unemployment Payment scheme, a net increase of 51,000 from the update last week. Figures for those benefitting from the Wage Subsidy Scheme were not updated yesterday but last week's release showed that 255,000 people had received a payment under this scheme. Aggregating these sums is not ideal given the different reference time periods and given that there is transfers between the schemes over time as business circumstances changes, nevertheless they suggest that around 840,000 people have suffered COVID-19 related unemployment or are being supported by the State through the wage subsidy scheme. This equates to almost 35% of the workforce and suggests that regular employment has fallen from 2.4m pre-crisis to 1.5m now.

It is a sign of the scale of the current crisis that additional unemployment of 50,000 people in a week doesn't change the arithmetic significantly. It also illustrates the fine line that the government will need to tread between keeping the virus in check and gradually reopening the economy to mitigate the unprecedented economic damage, although it will be far from alone in that regard.

Residential Sector: The last of the normal – Monday 20 April
Data from the CSO on Friday showed that residential property price growth was close to unchanged in February. National prices were -0.1% m/m and the annual rate of growth remained at +1.1%. This picture will of course begin to look very different once we get data for March, and even more so for April. The strongest immediate impact will be in transaction figures which are likely to plummet, as both logistical difficulties in closing sales and confidence issues in proceeding with in-course transactions escalate. This will have serious consequences both for market liquidity and even the compilation of price indices, such as the CSO's.

Looking beyond the short-term isn't particularly easy either. As with much of the economic impacts of the virus outbreak, a lot will depend on how much of the immediate economic damage can be contained and reversed once restrictions on businesses ease. One of the objectives of the government's unprecedented response package is to enable the economy to bounce back as much as possible once that happens. However, with around one-third of pre-outbreak employment now either gone or requiring government support (through the wage subsidy scheme) and significant question marks about how the economy will be restarted, longer-term effects remain foggy.

On the other hand, new housing supply has also ground to a halt and it is hard to see how a significant y/y drop in output can be avoided (the Central Bank of Ireland has referenced a potential 25% fall in 2020) as well as negative ramifications for supply in future years emerging. With demographic and population pressures persisting (albeit possibly softened by a drop in net inward migration), the undersupply in new housing, which has been a driving force behind price growth in recent years, is set to continue and perhaps intensify.

Economic Roundup: International

The economic data continues to be ugly, with the focus this week on the depth of the falls in the Eurozone. EU leaders agreed late on Thursday to set up a recovery fund under the auspices of the EU Commission but, disappointingly, differences remain over the size of the fund, what form the aid will take and who will dole it out. Old divisions have not yet been bridged – southern European states are leading demands for grants to troubled industries and countries while northern states are insisting aid is repaid in time. Notably however, the French position is now more closely aligned with the "south".

April's Composite PMI for the Euro area fell deeper into contractionary territory, marking a new record low of 13.5 which compares with the March figure of 29.7. Once again the service sector bore the brunt of the weakness, the survey falling to a new record low of 11.7. Manufacturing also remained deep in recessionary territory to at 33.6; more importantly however the manufacturing output index plummeted to 18.4. As to be expected coronavirus and the enforced government restrictions took its toll amongst businesses with the April survey offering a more complete picture given that the introduction of 'lockdowns' varied across countries in March. Meanwhile the details of the survey were equally as gloomy as the headlines, with employment levels being cut at their fastest pace on record and new business also falling at the fastest pace on record in both the service and manufacturing sectors. Whether April's survey will be the trough remains to be seen, but with the very gradual easing of restrictions being announced in various countries over the past week the survey may stabilise here. Bleak PMI readings also came in from further afield this week, including from Japan and Australia.

In the UK, the 'flash' composite PMI for April also reflected the sharp slowdown in economic activity – the composite output index dropped to 12.9 (from an already gloomy 36.0), a record low for the survey's 22-year history. IHS Markit, who produce the PMIs, noted that these results were consistent with GDP falling at a quarterly pace of around 6.5%. Elsewhere, UK retail sales figures for March fell by 5.1%, the biggest decline since the series began in 1996 but in line with what had been expected. It is worth noting that these figures, released today, cover 1 March to 4 April, meaning that only two weeks of the five-week period was affected by the social distancing measures. The next release, spanning the four weeks up to 2 May, will consequently be even uglier. Responding to growing calls for a more comprehensive government response, the Chancellor is reportedly preparing to offer 100% guarantees on loans to small businesses in the UK. Loans of up to £25k to one million "micro-SMEs" struggling to get credit are reportedly being considered.

In the US, the House of Representatives last night passed a bill that will increase its fiscal package by $484bn, paving the way for President Trump to sign the bill in to law. Two-thirds of the funding which will be used to replenishing the Paycheck Protection Program for small businesses. On Thursday it was revealed that 4.4m Americans filed for first-time unemployment benefits last week. Although this was down from 5.2m in the previous week, it takes the total number of claims in the past five weeks to 26m and surpassing the total number of jobs created since the last financial crisis.

Investec Treasury

The dynamics of the oil market

Background

As a result of government lockdowns across most of Europe, USA, India, and other countries, demand for crude oil products has plummeted. According to some estimates, about 40% of the world's population are currently advised to stay home to limit the spread of COVID-19. The shutdown orders have contributed to significant contractions in service industries with extraordinary knock on effects for energy markets, the travel sector and manufacturing worldwide.

Supply and Demand Dynamics

- Global demand for crude oil in 2019 amounted to 100.75 million barrels per day – according to the International Energy Agency demand in May 2020 will fall by 26m barrels per day.
- Global crude oil production in 2019 amounted to 100.57 million barrels per day – according to the International Energy Agency production in May 2020 will fall by 10m barrels per day.
- Approximately 58.5 million barrels per day of global oil production comes from the top ten countries – US 15m, Saudi Arabia 12m, Russia 11m, Iraq 4.5m, Iran 4m, Canada 3.5m, UAE 3m, Kuwait 3m, Brazil 2.5m.
- The Organisation of the Petroleum Exporting Countries (OPEC) is an intergovernmental organization of 13 nations, founded on 14 September 1960 in Baghdad by the first five members (Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela) – according to 2019 data OPEC member countries produce over 30 percent of the world's crude oil which is roughly 32 million barrels per day.

Timeline of Recent Events

- On 8 March 2020, Saudi Arabia initiated a price war with Russia by opting to increase oil production, facilitating a 65% quarterly fall in the price of oil. The price war was triggered by a breakup in dialogue between (OPEC) and Russia over proposed oil-production cuts in the midst of the 2019–20 coronavirus pandemic. Russia walked out of the agreement, leading to the fall of the OPEC+ alliance.
- On the 9 April 2020 OPEC and allies including Russia agreed to an historic 10 million barrel per day production cut.
- Brent Crude oil prices have fallen over 70% since the start of 2020. From $66/barrel to low $18/barrel (21 April 20).
- US West Texas Crude oil prices have fallen over 150% since the start of 2020. From $60/barrel to low -$40/barrel (20 April 2020).
- On the 20 April 2020 US Oil prices plunged into negative territory for the first time on record. Sharp selling comes as uncertainty mounts around storage. The dynamic of negative prices is playing out amid worry that key storage facilities in the US are nearing capacity.

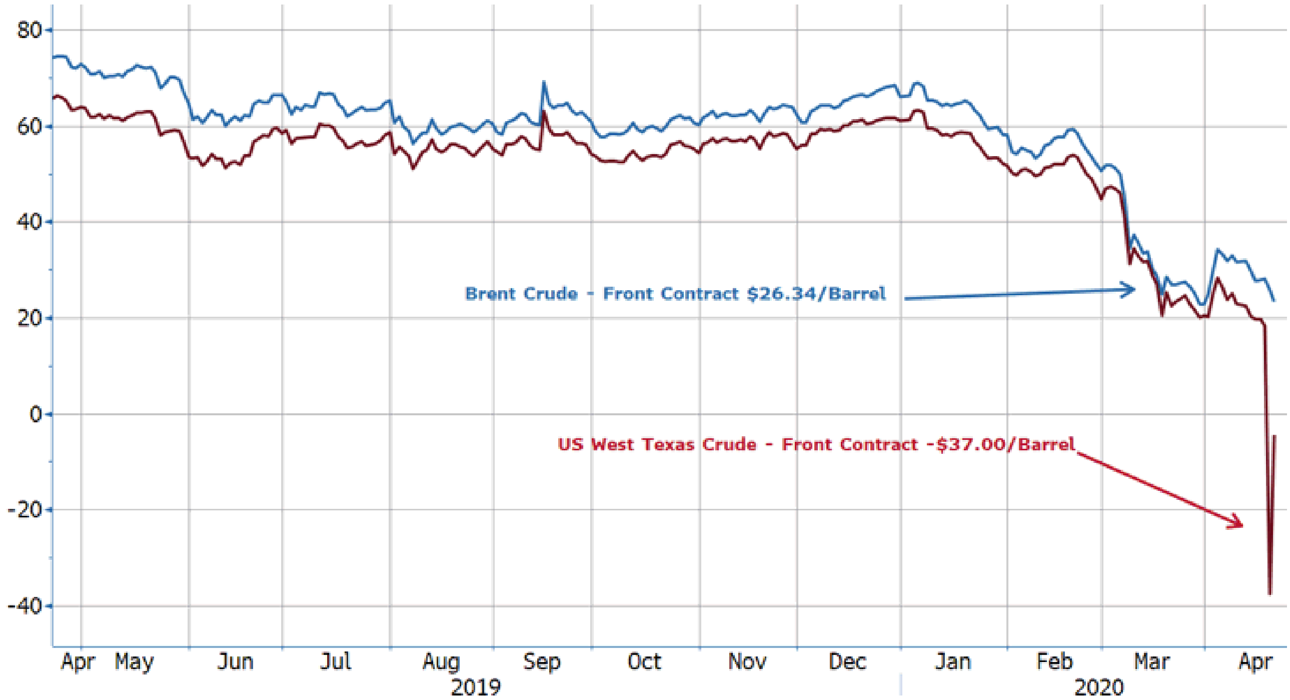
Can Brent Crude Oil follow US Oil and trade at negative prices?

West Texas crude oil storage in the U.S. is limited as well as landlocked, making transportation more difficult which can lead to a supply glut and negative prices as we saw 20 April 2020. Crude stockpiles at Cushing, Oklahoma, America's key storage hub and delivery point of the West Texas Intermediate contracts was at an estimated 55 million barrels at the end of February 2020. The hub has working storage capacity of 76 million according to the Energy Information Administration. It is assumed that the Cushing, Oklahoma facilities reached capacity leading to oil contracts being sold at negative prices.

Brent crude is priced in the middle of the North Sea, where tanker storage is ample and very accessible so product can be moved at a faster pace and to anywhere in the world if required, not to say it can't/won't happen but it will be more difficult for prices to trade below zero. The global oil tanker fleet has a capacity to hold around 4 billion barrels of oil products. Oil tankers account for around 29 percent of global seaborne trade.

There's another important difference between the two contracts. While the Brent futures contract is cash settled against the value of the Brent index price, the WTI contract is physically settled, meaning a trader must take delivery of barrels of oil at Cushing in Oklahoma!

Brent & WTI Crude – Front Contracts 20 April 2020



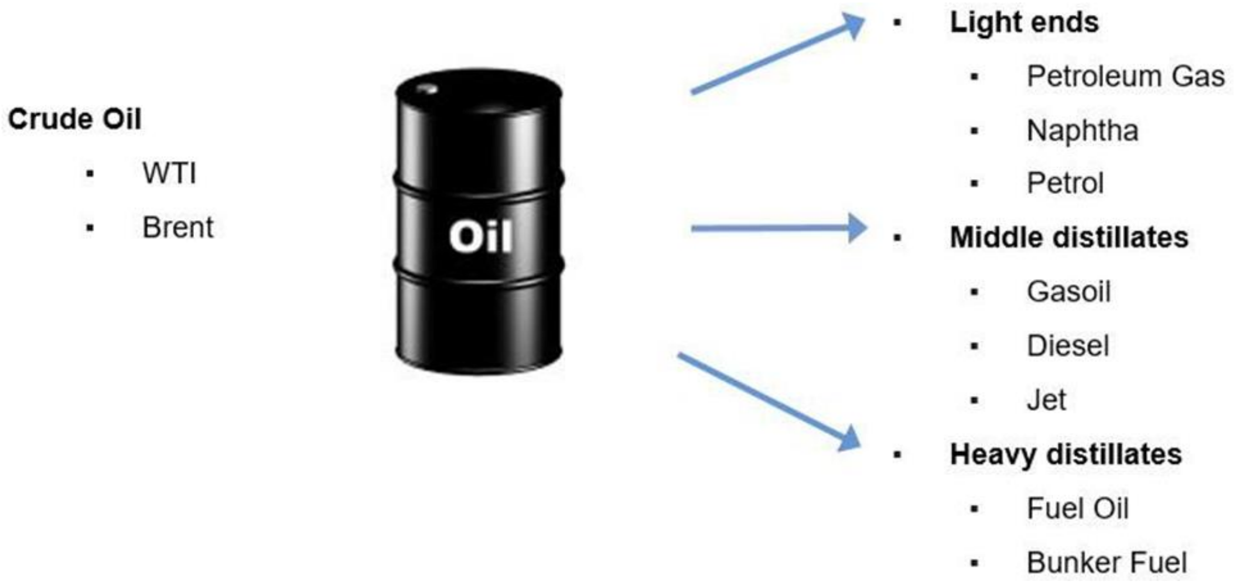
Source: Bloomberg

Three ways the market can stabilise over the coming months according to IEA estimates

1. The OPEC+ production cut in May of 10 million barrels per day will provide some immediate relief from the supply surplus in the coming weeks, lowering the peak of the build-up of oil stocks
2. Four countries (China, India, Korea and the United States) have offered their strategic storage capacity to industry to temporarily park unwanted barrels or are considering increasing their strategic stocks to take advantage of lower prices. This will create extra headroom for the impending stock build-up, helping the market get past the hump.
3. Other producers, with the United States and Canada likely to be the largest contributors, could see oil production fall by around 3.5 million barrels per day in the coming months due to the impact of lower prices.

Crude oil products

A barrel of Crude Oil is refined in to various products. The more you refine a product the higher it costs. Example petrol (light end) more expensive than diesel (middle distillate).



A 42-U.S. gallon barrel of oil yields about 45 gallons of petroleum products:

1. Gasoline makes about 20 gallons of oil.
2. Diesel makes up about 12 gallons.
3. Jet fuel makes up about 4 gallons.
4. 6 gallons of a barrel of oil makes a range of other petroleum products, example Heavy Fuel Oil.

Investec Corporate Finance

Minority Equity - A timely solution in the Short-Term to fund liquidity and in the Longer-Term to fund Growth Strategies and exploit the opportunities that will inevitably emerge in the up-turn

Liquidity Shortfalls

COVID-19 is having a materially adverse impact on the liquidity positions, and by extension the financial standing of many businesses. Entire parts of the economy have closed down and revenues have fallen away, if not collapsed in many cases.

The typical response, similar to other crises, has been to draw on existing liquidity sources and reserves, reduce costs and avail of various Government support packages. However, existing liquidity sources and reserves are finite and costs cannot be reduced as quickly as revenues fall and many costs are fixed or semi-fixed in nature.

Furthermore:

- The length of the crisis remains highly uncertain and financial planning is extremely difficult
- Government support and initiatives provide some relief but only in the short term and only partially, and
- Whilst banking support is a further source of help and much appreciated by businesses, this debt remains outstanding and awaits to be repaid by businesses who must work at rebuilding their revenues and profitability

The combination of pre COVID-19 reserves, self-help measures (in the main, cost reductions but also others such as non-core asset disposals, stretching supplier payments and sale & leasebacks) together with Government and Banking supports will hopefully for many companies be sufficient to enable them survive and get back to a position of thriving. However, they will emerge into a transition period of reduced annual investment in growth plans and an inability to exploit any opportunities that may present themselves, as we wait for economic activity to fully recover to pre COVID-19 levels.

In the Global Financial Crisis of 2008 and subsequent years, many companies had what we would describe as good downturns. They right sized their businesses and addressed debt levels to ensure a more appropriate capital structure, and were in a position to execute on their growth strategies both planned and opportunistic, when the economy turned.
Hence, companies should consider more flexible and longer term permanent sources of capital to (i) support their current multiple stakeholders, (ii) hold their competitive position in their existing markets but also, (iii) to ensure they are in a position to execute on their growth strategies going forward.

Institutional Private Capital – Private Equity and Growth Capital Funds
It has been widely reported for some time now that private equity and growth capital investors have historically record levels of funding available. Whilst the current situation will have tempered this somewhat and they will naturally proceed with greater caution, be more discerning in general, and particularly be focused on how potential new investments have performed in the current environment and how resilient they have been, there is still a need for them to deploy capital.

Unlike during the Global Financial Crisis, there is now a developed indigenous private equity and growth capital sector in Ireland. In addition, there is the increasingly active and direct investing Irish Strategic Infrastructure Fund as well as UK based funds, and in particular, with respect to the technology sector the increased prevalence of US funds. In our quarterly M&A Survey we noted there were three funds who completed their first ever investments in Irish companies during Q1 2020.

Other Sources of Private Capital – Family Offices & Serial Investors
Fortunately there are also a large number of Family Offices or significant high net worth serial investors, who have been active in the Irish market. For many of the latter, the source of their capital is from existing business interests or from realising significant proceeds from the sale of previously owned businesses. In addition to capital, they will often bring a track record of owning and operating businesses. We have worked on several mandates over the years, raising equity from these sources of capital who, in addition to sector expertise and management support, often bring more flexible, if somewhat lower quantums of capital.

Minority Equity – Addressing both Liquidity Requirements & Funding Growth Strategies
Whilst understandably focusing on the challenges here and now, those companies which also take time to look further ahead and will potentially identify further funding requirements to support their growth strategies and exploit the inevitable opportunities that will arise, as economic activity recovers and normalises.

Procuring equity investment now would enable companies to address (i) Current Liquidity Requirements, and (ii) Funding requirements for future growth. However, reaching agreement on valuation will be, all things equal and for the vast majority if not nearly all companies, a greater challenge now than would ordinarily be the case. This is further accentuated in the case of a majority equity investment.

A way to address this, would be to consider a minority equity investment which is attractive from a number of perspectives, including:

- Valuation – less of an issue given a smaller stake is sold. Additionally, preference share and convertible mechanisms can be used to mitigate valuation issues
- Control – existing shareholders maintain control of the company while reducing their own risk, and
- Capital – the new Minority Equity investor provides capital to fund both current liquidity and future growth strategy (both planned and opportunistic) requirements when economic activity recovers and normalises.

As mentioned above, there are many Private Equity Funds with minority equity mandates, as well as Growth Capital Funds, who are a rich source of capital. In addition, there are increasingly active non-Institutional equity providers in the form of Family Offices and significant high net worth serial investors. We have a strong track record of raising minority equity investment from all of these sources for many Irish companies including ATA, Staycity, Green Isle Foods, Mainstream Renewable Power, Crowley Carbon, SuperAwesome and Canford Healthcare.

If on reading this piece there is anything that resonates with you and your company, and you recognize the benefit of having a good downturn and would like to understand the process around and appetite for minority equity investment, please do not hesitate to contact any member of the Corporate Finance team.

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Currency Pairs: EUR/GBP (white, LHS); EUR/USD (blue, RHS)

Source: Bloomberg

Stock Market Indices (indexed to 100): ISEQ (white); S&P 500 (blue); Eurostoxx 50 (orange)

Source: Bloomberg

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