What does life after lockdown look like for business?

The global Covid-19 pandemic has made its presence felt in South African retail and consumer-focused businesses, especially in tourism and hospitality, but the full impact on earnings, cash flow and employment will last far longer than a three-week lockdown.

Jason Hamilton, director at First River Capital

With the 21-day nationwide lockdown in place, the full effects will now ripple through all sectors and industries at least until the end of this year – in an “economic cycle like no other we have ever seen”, says Jason Hamilton, director at First River Capital.

Hamilton said with the South African economy already under severe pressure – the SA Reserve Bank (SARB) having revised its GDP forecast down to 0.2% for 2020 – it was expected that the impact of slowed-down global growth (expected to contract by 2.1%) due to the pandemic would see South Africa’s GDP retracting by between 2.5% to 3.5% with some models estimating up to 5%.

Moody’s recent downgrade of South Africa’s credit rating would result in further outflows which the country can ill afford, he said, and the cost of debt would increase.

“Up to the lockdown businesses were able to trade and generate some earnings to keep the lights on, keeping employees employed and earning some level of income. A total lockdown will bring significant retrenchments across all sectors and industries, with cashflow and earnings under threat in businesses of all sizes.

“It is also looking likely that some form of control and restrictive measures will remain in place for months to come, which means we will be dealing with this until the end of the year – even if we look to China, which now has a flattening curve, they are more than five months into the battle against the disease while trying to keep their economy alive,” Hamilton said.

Data from the last 11 global recessions indicate that it takes on average a year-and-a-half for the economy to start recovering, but the current economic cycle is unlike any other.

“Recessions we have seen, and we have traded through them, and the average of 18 months to the start of recovery, in theory, gives us a timeline to follow. But the market sell-offs and economic cycle (reduced GDP growth or recession) we are busy entering is based on an event, not on fundamentals or underlying economic systems issues, which means it’s very difficult to predict how long and how impactful it will be.

“What we can, however, focus on is that it is event-driven and hence the recovery and comeback should be quick, the question is just when,” said Hamilton.

Interest rates – room to move

Unlike many developed economies where interest rates are already close to zero, Hamilton said it was positive that the SARB still had “significant room to provide support of at least 300 basis points” even after the repo rate was lowered by 100 basis points, as the inflation outlook remains within the target midpoint.

“We have seen significant cuts in short succession from the economic powerhouses (US, UK, Germany, France etc.) acting very quickly, which further supports the view that South Africa has further room and drastic action can and should be taken. The balancing act is, however, on inflation targeting and the exchange rate,” he said.

Access to liquidity will be key in the months ahead, he said, which would require direct action from government.

“Credit will need to be extended and/or restructured to individuals and companies to bridge cash flows as the trading environment tightens or, as in the case of a lockdown, grinds to a halt for many industries. This will require support from government, and the announcement by President Cyril Ramaphosa of the first phase of these is to be welcomed.”

Government and business support welcomed

Hamilton said the use of the tax system to assist firms with liquidity at the employee level by fast-tracking claims and reimbursements and to delay up to 20% of PAYE for smaller businesses, was a positive move that would assist business – and recommended that further stimulus could come from deferment of VAT, provisional and income tax, and a higher percentage of PAYE deferred.

“The clear focus on SMEs and vulnerable sectors like the informal sector, with establishment of the independent Solidarity

Fund, will support the public sector's efforts and it is hoped that large businesses will follow the lead of the Rupert and Oppenheimer families which have allocated R1-billion each to the support initiatives," he said.

Financiers (banks) have indicated their commitment to the national efforts and Hamilton said this would entail a case-by-case restructuring of loans, likely through payment holidays or deferments to assist companies (and individuals) with three to six months' grace to improve the underlying cash flows.

"This has been made slightly easier through relaxed regulatory requirements to free up headroom from a capital holding point of view.

"Last week we saw the SARB taking further action to provide liquidity to the market through an active bond-buying programme announced and increasing its refinancing operations to 3 months, and it's likely that we will shortly see longer tenors on offer of 6 and 12 months," Hamilton said.

Highlighting the knock-on effect of the economic challenges, he said further clarity would be needed in the real estate sector, as landlords would need the support of their funders or backers if they are to assist tenants with rent moratoriums.

Similarly, some firms might be able to approach their insurance companies with claims for loss of income, although this will in turn place the insurance companies under threat and likely facing liquidity concerns themselves.

National finances

With South Africa's budget deficit projected to be just under 7% of GDP by 2021, the national finances are already under great pressure, Hamilton said.

Moody's previously hinted towards giving South Africa time to recover, however, any runway is now gone with the impact of the pandemic felt globally, and as such on 27 March 2020 they downgraded the country to below investment grade (Ba1) and maintained a negative outlook.

"A downgrade will result in further outflows which we don't need right now, with foreign investors selling more than $41 billion in emerging market stocks and bonds since the beginning of the year, which is double that seen during the 2008 financial crisis," Hamilton said.

There is a slight reprieve, he said, in that the other ratings agencies have since 2017 rated South Africa as junk, which has seen investors price and treat the country as such since then, which has come through in the spreads of the credit default swap (CDS) markets.

"Although with this downgrade the debt cost will increase," he said.

He said government remained in a difficult position with a projected 6.8% GDP deficit, about R370bn, to address, and "now also a stimulus package required to limit or soften the blow of the Covid-19 pandemic".

"Moody's in its statement reviewed this number up to 8.5% although in my view it will likely be at 10%, which means SA will over the medium term require much higher debt levels than previous modelled and for much longer," Hamilton said.

Although economies around the globe have made available funds of between 1% to 4% of GDP, he said it was unlikely that South Africa would require the upper limit of such stimulus – "but this still implies a need of between R80 billion to R170 billion". The UK and Germany have announced stimulus of at least 15% of GDP and the US 30%.

"The impact will be felt but most of these funds could be sourced from within the current budget through reallocation of non-essential or non-critical spending. Yes, there is an element of borrowing from the future in this strategy, but current circumstances require drastic action, this is also in line with what we are seeing globally."

Economic sector outlook

Accommodation and travel booking cancellations are the “first wave” of the impact on the tourism sector, with effects now moving into the hospitality sector, such as restaurants, bars and coffee shops.

The manufacturing sector has seen some factories close and Hamilton said it was likely that many would retool to assist with the manufacturing of medical equipment.

“The agricultural sector is a key driver of the economy and very reliant on international trade. As they are in the food supply chain, they will maintain a level of trading although, with all the markets globally also facing a recession or lockdown, luxury agricultural products will suffer while staple foods are set to show more resilience,” he said.

Consumer-focused businesses will remain attractive for investors, Hamilton predicts, with those that have adopted online strategies “likely to weather the storm successfully as they have managed to adapt or pivot quickly in the response to the crisis and are best placed for what might be a big shift in buying behaviour post the pandemic”.

The key growth driver has been the Business and Financial Services sector and as they are also positioned to service clients remotely, they are likely poised to be able to bounce back quickly.

“The only sectors that will not be affected, or suffer the least damage, will be the essential service providers, being the food suppliers, food and medical supply chains and medical support providers,” he said.

No sector is immune to the impact and fall out of the crisis and survival has a lot to do with cash reserves and low debt positions, hence firms with net debt to EBITDA of less than one and healthy pre-crisis operating margins are best placed to navigate the next few months successfully.

Investors

“How investors will navigate this crisis from an investment and cash flow management point of view, is also an important consideration. Globally, and this holds true for South Africa as well, there are significant amounts of capital allocated for new and follow-on investments – available capital sums are at historic highs.

“This also suggests that investors in SME’s and other private businesses, and the listed space as well, have the ability to inject further funds through debt and equity packages into investee companies to support and navigate the coming months,” Hamilton said.

This will have a lasting impact on the companies’ finance and potentially their shareholding structures, as any equity raised or injected will come with very specific conditions.

He said some of the development finance institutions (DFIs) active on the continent had specifically stated their support to investee companies in ensuring employees can be supported through these times. Similarly, in South Africa, the IDC and the Department of Trade and Industry have allocated R3-billion for specific investments in critical businesses, with applications to be fast-tracked.

Hamilton concludes that “2020 is viewed as a lost year for many but we also have to look back in history and see what has been overcome before.

“It is up to all of us, the people and nation of South Africa, to unite and jointly fight this pandemic and with government, business and the public aligned we will overcome.