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Equity opportunities in the Coronavirus crisis

The global equity sell-off sparked by the Coronavirus crisis in March hit South African stocks especially hard, with the FTSE/JSE All Share Index (ALSI) falling over 12% during the month. Coming on top of the prevailing negative sentiment, the local market lost over a third of its value in total from late February to its trough on 23 March. With the government forced to impose the lockdown and the economy already in recession, investors opted to sell down their equity holdings on the back of uncertainty over the duration of the lockdown and the extent of the ultimate damage done to corporate earnings and dividends, not only immediately, but over the medium-term as well.

This high uncertainty was reflected in the exceptionally low valuations of the ALSI, which traded at a price-to-book-value ratio (P/B) of 1.1X at the end of March, its lowest in over 40 years and even lower than during the Global Financial Crisis. By the end of April the market had recovered to 1.34X, but this valuation was still very low, in line with levels last seen in previous crises.

But as we all know, in adversity comes opportunity. Active investment managers like Prudential have seen excellent buying opportunities in the downturn, although this has been tempered somewhat by caution over the higher risk that has emerged for many companies. Faced with much lower (or even zero) earnings for an uncertain period of time, most must still pay fixed costs like wages and rent, and service their debt, putting extra strain on balance sheets. As such, investors need to carefully assess whether the lower share prices on offer fully reflect the risks of a company being unable to generate cash or pay dividends, or even going bankrupt, as in the case of Edcon.

While we have seen many opportunities in the past few weeks, three examples of where we have taken advantage of excellent valuations to add exposure to top companies, while taking of account the risks involved, include Bidcorp, MTN and Growthpoint Properties.

Bidcorp

Bidcorp, the food service business with operations across the UK, Europe, Australasia and emerging markets (including South Africa), has found itself in the "eye of the storm" over the past three months given that it focuses on providing services to hotels, restaurants, business canteens, etc., and the global hospitality industry has been among the hardest hit in the Coronavirus crisis. Worries over an earnings collapse and the duration of the crisis drove Bidcorp's share price down by some 44%, from around R350 at the start of the year to its lowest point in mid-March of just under R190.

From 2013 up until the March downturn we had considered Bidcorp expensive and had been underweighting it in the Prudential Equity Fund, as the share consistently traded above what we estimated to be its "fair value" multiple of 12.5X as measured by its enterprise value/operating profit ratio. In March this multiple fell to less than 10X, and we took advantage of this to buy up shares and close our underweight position. Bidcorp is a high-quality global business, as demonstrated by its history of delivering steady compound growth in profits over time, as well as having a strong balance sheet with low debt levels (less than 0.6X net debt/profit). It also has geographically diversified earnings and is a beneficiary of rand weakness given that it earns a greater share of its profits outside of South Africa than locally.

MTN

The share price of mobile telecoms provider MTN plunged by as much as 64% in the three months to end March – from around R85 to around R30 at its low – as investors worried about the company's relatively high debt levels (of which approximately 60% is denominated in US$) and economic turmoil in the main countries in which the company operates. Outside of South Africa, the group sources its earnings primarily from Nigeria, and to a lesser extent Ghana, as well as numerous smaller countries across southern Africa and the Middle East like Cameroon, DR Congo, Côte d'Ivoire, Iran and Sudan. Many of these economies are oil producers and have suffered from the crash in the oil price and substantial currency depreciation, with more potentially to come. So apart from reduced earnings, investors have been concerned about the company's dependency on uncertain cash flows in cheaper currencies to service its dollar-based debt held at the holding company level.

According to Prudential's analysis, taking the estimated value of each MTN business as a "sum of the parts" using the prevailing exchange rates and deducting its total debt, we estimated MTN's "fair value" share price at around R116. We then discounted from this a further possible 50% devaluation of the Nigerian naira and the Ghanaian cedi, as well as the potential for more losses in other operations, to conservatively assign the company a fair value share price of around R71. So with the share price falling below R40 in March, we used the opportunity to add to our position in MTN in our client portfolios. We believe there is nearly 40% upside potential in the share price, even in an extreme scenario. At the same time, our analysis showed that MTN would still be able to cover the finance cost of debt from its South African operations should the need arise (should it not be able to get its cash out of Nigeria and/or Ghana), but it would have to suspend its dividend. This makes us less concerned about the company's ability to repay its debt, and see a low risk of MTN needing to raise new capital from its shareholders.

Growthpoint Properties

Growthpoint, the largest listed real estate investment trust (REIT) in South Africa, owns a diversified mix of retail, industrial and office properties across the country, including 50% of the V&A Waterfront and other prestigious developments. It also owns just under 30% of London-listed Globalworth, a company with properties in Romania and Poland, and a 66% stake in Growthpoint Australia, which has some 57 property investments on its books.

Growthpoint lost over 50% of its value in the three months to end March as its share price dropped from around R22.50 to around R11 at its lowest point. Investors worried about the impact of the lockdown on retailers' ability to pay their rent, the higher likelihood of rental reductions in leases going forward, rising vacancies, the company's offshore debt obligations, and possible cuts in distributions going forward. At Prudential we analysed how much of this bad news was reflected in the share price compared to its net asset value (NAV, the total value of all the underlying properties less total debt), and found that the company's price to NAV was 0.5X, meaning that its property assets could be purchased in March for a 50% discount to their underlying carrying value. By excluding the market value of Growthpoint's listed investments, Globalworth and Growthpoint Australia, we calculated its SA portfolio of properties (including the V&A Waterfront) was trading at a 61% discount to its NAV.

We also found that Growthpoint's SA assets were trading at an attractive implied distribution yield of over 50% at its low point in March. With the subsequent recovery in Growthpoint's share price, this implied yield on the SA portfolio fell to 27% in April-May, but is still a very high yield for investors. Using a conservative scenario, taking another 25% reduction in this distribution yield to account for the portion of income derived from financial engineering, this still amounts to a 20% yield - more than double the current 9.5% yield offered by the government's 10-year bond. As such, we would argue that all of the market's concerns have been factored into the share price, and the distribution yield adequately compensates shareholders for the risks involved. We also take comfort in Growthpoint's latest trading update, which suggested that retail activity and rental income had already improved in April.

Building exceptional client portfolios

From the above, it's easy to see how investment managers like Prudential, with careful analysis and risk management, can exploit the opportunities created by exceptional circumstances like the Coronavirus crisis to build exceptional portfolios for our clients. By adding exposure to stocks with such high potential upside (MTN), and high-quality companies (Bidcorp, Growthpoint) at attractive valuations, we enhance the potential for our funds to deliver market-beating returns over time. We are confident that these choices (and others) will add value to the Prudential Equity Fund and other Prudential portfolios going forward.

For more information, please speak to your financial adviser or contact our Client Services Team on 0860 105 77 or **query@prudential.co.za**.