Liquidity & Solvency in the Time of COVID-19

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Keep it. Simple.

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What are we talking about tonight?

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Agenda

- What is “Liquidity” and “Solvency”?
- Measures of Liquidity
- Measures of Solvency
- Considerations During COVID-19
  - “Zero”?!?
  - Survive versus Thrive
  - Borrowing from pre-revenue start-ups
- Case Study: Anheuser-Busch InBev SA NV
- Summary & Conclusion

> **“How did you go bankrupt?**
> **Two ways. Gradually and then *suddenly*.”**
>
> **— Ernest Hemingway**

Liquidity & Solvency

The analysis of liquidity & solvency is an analysis of downside and risk, *not* upside and return

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What is "Liquidity" and "Solvency"?

***Liquidity* problems eventually become *solvency* problems.**

Legal definitions & non-legal explanations

- There are legal definitions in the Companies Act:
  - **Liquidity**: *"The company being able to pay its debt as they become due in the ordinary course of business for a period of 12 months."*
  - **Solvency**: *"The assets of the company, fairly valued, being equal or exceeding the liabilities of the company."*
- What does this mean?
  - If **you were a company**, then the following would be true:
    - *Your* liquidity would be your ability to pay day-to-day living costs.
    - *Your* solvency would be your ability to pay your mortgage/debt.
  - **<u>If you lost your job, then the following scenarios could be true:</u>**
    - Even if you did not have any debt, your inability to pay day-to-day expenses would be a problem. **This is a liquidity problem.**
    - If you had some debt, then you would eventually default on your debt. **This is when a liquidity problem becomes a solvency problem.**
    - Finally, if you had tons of debt (and no assets) and you lost your job, you would probably go bankrupt (in fact, you might go bankrupt even if you kept your job). **This is a solvency problem.**

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Measures of Liquidity

If there is more cash coming *in* than going *out*, then you are still in business.

The ability to pay debts as they fall due – typically in the "current" part of B/S

- **Free cash flow**:
  - Cash flow from operations *less* capex = Rxx.xx?
  - I.e. How much actual *cash* does the company generate?
  - More is better than less…
- **Current Ratio (x)**:
  - Current asset / current liability = x.x?
  - I.e. Can liquid assets pay for immediate (<12 months) creditors?
  - >1.0x is important
- **Quick Ratio (x)**:
  - (Current assets – inventory) / current liabilities = x.x?
  - I.e. What is stock is worthless? What then? (Applicable to SABMiller having to pour beer down the drain)
  - >1.0x is great (most tend to be >0.8x)

All ratios are relative!

- **Bonus:** Net cash is a strong solvency position to be in but cash can also be used for liquidity purposes too!

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Measures of Solvency

Because of interest, debt is time sensitive. The more you have, the less *time* you have.

How much debt does a company have? Relative to what?

- **Net Debt:Equity**:
  - (Interest-bearing debt – cash) / equity = x.x%?
  - I.e. For each R1.0 of equity funding, how many Rands have been borrowed?
  - >50~100% is considered very "high" (depends on the business)
- **Debt/EBITDA**:
  - Debt / (Operating Profits + Depreciation + Amortization) = x.x?
  - I.e. If *all* cash-equivalent profits were applied to paying off debt, how many years would it take?
  - >2.5~3.5x is considered "high" (once again, depends on the business)
- **Interest Cover Ratio**:
  - Operating Profits / Net Finance Costs = x.x?
  - I.e. How many *times* can profits *halve* before the company cannot even pay its *interest* bill?
  - >2.0x means profits can *halve* before you have a problem

- **Bonus**: Check covenants & check for headroom before they are breached.

All ratios are relative!

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Considerations During COVID-19

No one modelled for zero revenue!

What does "zero" mean?!

- No one modelled for **zero revenue** before!
- Lockdowns have created major outliers straining normal ratios and what is considered reasonable liquidity and solvency situations.
- Indebted companies:
  - This creates a major solvency risk,
  - Restructuring and pushing out of capital payments buys "time", but
  - The clock is ticking & length of lockdown key.
- Ungeared companies:
  - Irrespective of debt, this creates major pressure on short-term liquidity,
  - E.g. Clicks suspended their dividend!
  - Lockdown duration is also key here.
- **I.e. Lockdown (severity &) duration is a key variable.**

Survive versus Thrive

- Not all companies effected the same:
- Essential goods & services versus Non-essential:
  - Essential still operating, thus still cash flows and, at least, lower pressure on liquidity and solvency:
    - E.g. Healthcare, hospitals, telecoms, banks, coal mining, etc.
  - Non-essential probably not operating:
    - E.g. Hotels & tourism.
- Physically-delivered versus digitally-delivered:
  - Those able to deliver non-physically are less impacted than those that cannot.
    - E.g. Casino's versus online gaming, UberEATS versus restaurants, & cloud-based offices versus open-plan offices.
- Each analysis needs to be done on a case-by-case basis...

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Considerations During COVID-19 (cont.)

Pre-revenue start-ups teach us about zero revenue.

Borrowing from pre-revenue start-ups...

- Some start-ups are pre-revenue, i.e. **zero revenue.**
- As one would do for a pre-revenue start-up, *also* consider the following:
  - **Ensure all discretionary capital spend is zero:**
    - No dividends,
    - No bonuses, &
    - No other major acquisitions and/or discretionary draws on capital.
  - **Cash burn:**
    - Cash / annual expenses = how many years "runway" does a company have before its ungeared cash resources run out.
    - In a geared company, make sure to consider servicing costs and capital repayments of debt.
  - **Overhead cover:**
    - Cash / operating (cash) expenses = how many years does a company have to service only its "center" (i.e. head office) without a single sale.
- Perhaps even worth considering how deep pocketed major shareholders are? Could they fund a capital raise? Could they extend credit to save the company?

Case Study: Anheuser-Busch InBev SA NV

Liquidity and solvency need to be analysed <u>together</u> and <u>within context</u>

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Case Study: Anheuser-Busch InBev SA NV

AB InBev

Context: Q1:20 bad & Q2's will be a horror show...

- AB InBev released weak Q1:20 results (ending March 2020):
  - Total volumes -9.3%
  - Total revenue -5.8%
  - Underlying EPS decreasing by -30% from $0.73 to $0.51
- The Group's guidance for Q2:20 was even worse:
  - April volumes were -32% already in Q2!
  - 1/3rd of Group's volumes sold "on-premise" (i.e. bars, clubs, restaurants & festivals) = almost universally closed (so far) in Q2.
  - Some countries have full shutdown ~ zero revenue!

- **Question: Will the world stop drinking beer? Forever!?**
- **Answer: Beer has been drunk since Ancient Egyptians discovered it. The consumption of beer has outlasted the Roman & Ottoman Empires, Genghis Khan & *all* the Chinese Dynasties put together. Beer even pre-dates all major modern religions! So I think it is unlikely to stop being consumed.**

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Case Study: Anheuser-Busch InBev SA NV

AB InBev

Highly indebted...

- **Net Debt:Equity*:**
  - Net Debt of c.$95.7bn
  - Equity of c.$75.7bn
  - Thus, **Net D:E = 126%**
- **Debt/EBITDA*:**
  - Q1:20 Normalized EBITDA of $4.8bn ~ Annualizes at c.$19.2bn
  - Using Net Debt above, **Debt/EBITDA = 5.0x**
- **Interest Cover Ratio:**
  - Q1:20 Normalized EBIT (i.e. Operating Profit) of $2.8bn
  - Q1:20 Net finance costs of $1.9bn (excluding mark-to-market losses)
  - Thus, annualized **1.5x Interest Cover**
- **Conclusion: AB InBev is very highly geared. Surely this is bad? Depends...**

** Some numbers only disclosed in year-end report (till December 2019)*

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Case Study: Anheuser-Busch InBev SA NV (cont.)

ABInBev

...but the Group remains liquid.

- **Free cash flow*:**
  - Cash from operations is c.$13.4bn per annum
  - Capex is c.$5bn
  - Free Cash Flow is c.$8.4bn, i.e. **generated billions of free cash flow per year**
- **Current Ratio (x)*:**
  - Current assets are $28.8bn + $11bn RCF + $10.5 new bond placements in April 2020 = $50.3bn
  - Current liabilities are $34.8bn
  - **Current Ratio is 1.44x**
- **Quick Ratio (x)*:**
  - Beer is a perishable product, thus this ratio in a complete lockdown is very relevant.
  - Stock is c.$4.5bn, thus, Current Assets minus stock = $45.8bn
  - **Quick Ratio is 1.3x**
- **Conclusion: AB InBev is comfortably liquid, for now...**

** Some numbers only disclosed in year-end report (till December 2019)*

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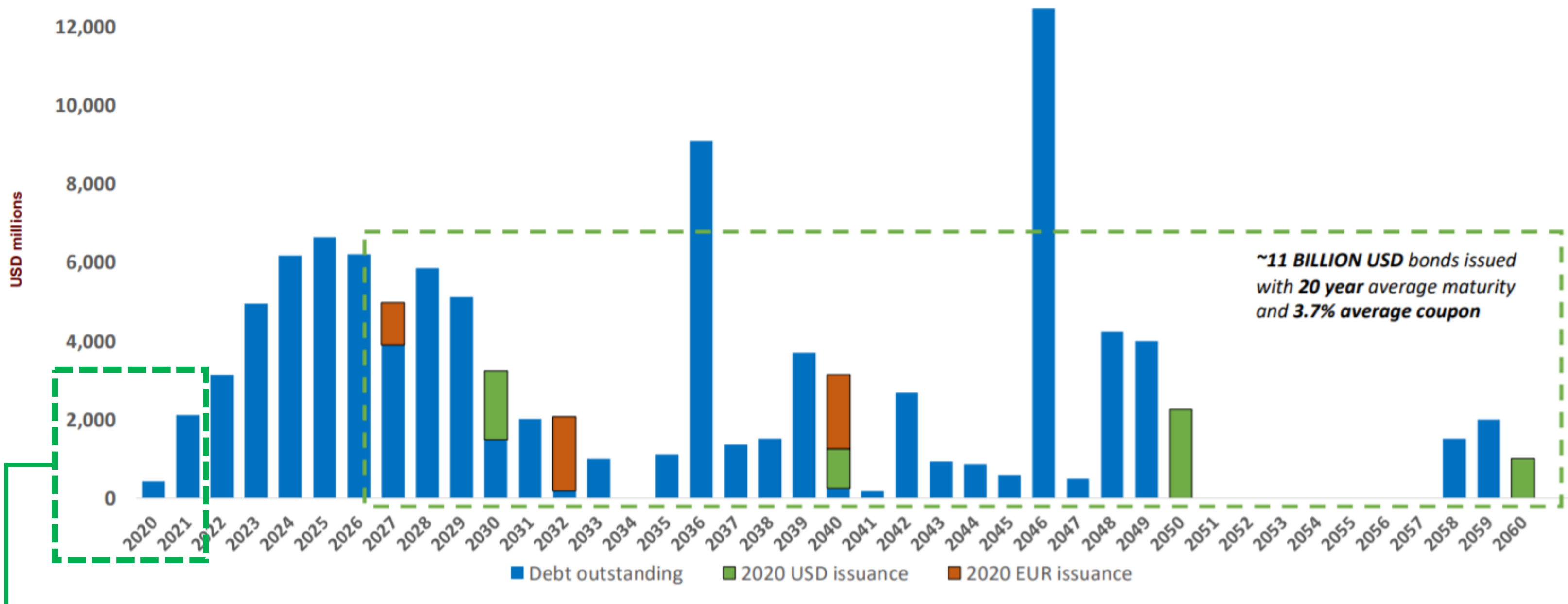
Case Study: Anheuser-Busch InBev SA NV (cont.)

Perhaps most importantly, their liquidity & solvency *profile* is very healthy!

Pro forma AB InBev Bond Maturity Profile as of April 2020*



Source: AB InBev's Q1:20 Results Presentation

e: Represents full bond portfolio, before hedging, valuing all bonds at par as of 31 March 2020, pro forma for 1H20 bond issuances which settled in April 2020

- Only c.**$2bn of debt matures in the next about two years!**
- Weighted Average Debt Maturity is **15 years** with **95% of its fixed rate** and at a pre-tax **interest rate of 4.0%** pa!
- Importantly, the debt has **no financial covenants** attached!
- **Conclusion: AB InBev is highly geared but has a *great* debt profile and good liquidity. This means that the Group has *time* to degear and/or make a plan and/or survive "zero" for maybe even a year or two.**

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Summary & Conclusion

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- **The analysis is liquidity & solvency is an analysis of <u>downside and risk</u>, *not* <u>upside and return</u>.**

- **“Liquidity” is like earning a salary – important to keep paying your bills.**
  - If you have more cash coming in than going out, you are in business.
- **“Solvency” is debt’s relation to net worth – important to be able to pay back your debt.**
  - If you have more debt than assets, you are insolvent.
- **Liquidity and solvency are linked**:
  - Liquidity problems eventually become solvency problems.
  - Solvency problems suck up liquidity.
- Financial ratios.
- COVID-19 has introduced other considerations:
  - No one modelled for “zero”!
  - Not all businesses equally effected.
- Finally: **Liquidity and solvency need to be analyzed *together* and *within context!***

“How did you go bankrupt?
Two ways. Gradually and then *suddenly*.”

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Questions?

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