Thinking like a CEO: using the Life Cycle to navigate the crisis

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Will Kenney explains how our Global Equities team's proprietary Corporate Life Cycle model has helped to make sense of the challenges facing different companies through the pandemic, giving strong clues about how their management teams can best deploy capital to create long-term value for shareholders.

Covid-19 has posed huge challenges for companies. The sheer speed that the initial lockdown was imposed, first in China, which affected global supply chains, then across Europe and the US, was staggering. But the exit hasn't been as quick as initially expected and many restrictions will remain in place for some time yet.

While governments and central banks have worked hard to soften the impact, introducing stimulus packages unprecedented in scale and speed, many CEOs have struggled to outline a coherent plan for emerging from the crisis. While acknowledging that the pandemic was a once-in-a-century crisis, some early corporate communications had a surprising 'rabbit in the headlights' feel.

This was by no means true for all, however, with the most capable CEOs and management teams understanding how the pandemic had changed the world and reshaping their strategies accordingly. For investors, it wasn't just a case of airline, leisure and retail companies struggling, while technology and healthcare companies flourished. Share prices discounted a lot of the immediate impact, although this was offset in many cases by governmental support.

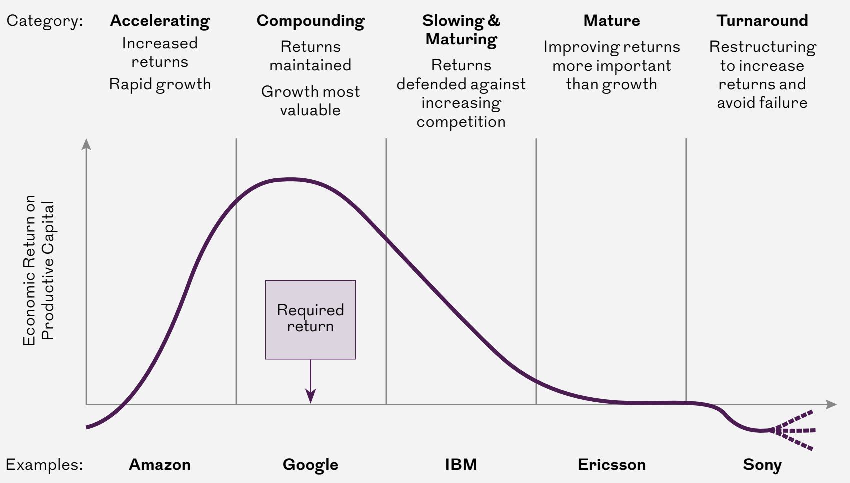
The converse was also true when the positive vaccines data initially emerged in November, with an apparently indiscriminate rotation back into the most Covid-impacted stocks, although some of the price moves were driven more by short covering. Nonetheless, share prices moved very quickly to discount the vaccines-related optimism.

But how can we make sense of the medium to longer term? One tool that we have found particularly helpful is our proprietary Corporate Life Cycle model, which helps us to consider companies at different stages of evolution.

Introducing the Corporate Life Cycle

Our investment universe comprises around 6,000 stocks. We are fundamental, bottom-up investors, so we need a way to understand the world and categorise companies that isn't rooted in top-down macroeconomics. The broad economic environment will have an effect, of course, but we believe that good companies perform well across the economic cycle. What matters more is how a company is using its capital.

Figure 1: Making sense of our investment universe – our proprietary Corporate Life Cycle model



Source: RLAM for illustrative purposes only. Portfolio holdings are subject to change, for information only and are not investment recommendations.

Through a proprietary algorithm, our Corporate Life Cycle model categorises companies according to their stage of development. Quantitative analysis helps us to identify potential opportunities by scoring stocks across a range of detailed financial factors. We then apply our scoring system to rank characteristics to identify which companies to conduct further fundamental research into, for possible inclusion in the portfolio.

As figure 1 on previous page shows, the Corporate Life Cycle plots economic returns against required returns (that is to say, cost of capital) and describes a typical corporate journey. It describes five distinct phases:

Accelerating, Compounding, Slowing & Maturing, Mature and Turnaround. These help us to understand where companies are in their journey and how to analyse them to pick the real winners – and, perhaps more importantly, avoid the potential losers.

Thinking like a CEO

One of the advantages of our Life Cycle framework is that it helps us to think like a CEO: where to deploy capital, what the returns are on that capital and should we be shrinking or growing capital deployed to certain divisions?

Depending on where businesses are in the Life Cycle, they should have approached the crisis differently. Companies in the 'Accelerating' stage have had the opportunity to grow quickly and should have taken advantage of this. They are often innovators and are culturally more flexible and able to embrace change. This can be a huge advantage in uncertain times and that innovation can disrupt other markets, some of them large.

Amazon has been a poster child for this, both on the home delivery shopping side, where before the pandemic it was rolling out additional capacity to move towards next day delivery in the US. Its cloud business Amazon Web Services (AWS) has also been a major beneficiary of the pandemic, as it enables businesses to scale up computing power in a very short time. Most people working from home will be using remote desktops systems, many of which will be hosted on AWS. Furthermore, Netflix hosts its online streaming content on the AWS platform, despite being a competitor of Amazon Prime Video. In lockdown, many people used both of these services more and Amazon has increased the competitive advantage that it enjoyed going into the crisis.

Ocado, the UK grocery delivery service and technology platform provider, has been another beneficiary of the crisis. Having spent almost 20 years developing its online grocery delivery platform, the company is a global leader and has licenced the technology to supermarket chains internationally. The pandemic has favoured the business versus its competitors, accelerating its development and customer demand. Ocado also raised capital to take advantage of these additional opportunities.

Companies in the 'Slowing & Maturing' category of the Life Cycle frequently have a mix of business operations or divisions. The current challenging environment is an opportunity to re-evaluate their core competencies and areas of competitive advantage. The crisis provides an opportunity for greater discipline around where to reinvest capital, considering the returns available. In contrast, less well-managed companies will be 'treading water' until the global economy fully reopens. They may be left behind by the pace of change.

The pandemic has a different footprint around the world, with many Asian countries far less impacted relative to Europe or the US. This might be an opportunity to shrink underperforming divisions and allocate that capital to areas of higher return. As an example, Tesco sold some of its international operations to focus more on its core business.

Potential losers?

'Turnarounds' are some of the businesses that are under most threat from the crisis. These are companies that already have low returns on capital and, to create wealth for shareholders, need to turnaround and improve those returns. The pandemic has made this even more challenging.

The reward for management teams that are prepared to take the initiative and have a balance sheet that matches the operational volatility side of their business should be positive. There will be opportunities as competitors struggle, go bankrupt or have to raise capital at punitive rates. Cost cutting should be easier as the business rationale is easily understood and, in many cases, there are government schemes to help. **Bridgestone**, the Japanese tyre manufacturer, recently announced that it intends to close 40% of its manufacturing footprint by 2023. It is unlikely that the company would have been able to take such drastic action without impetus from the current crisis.

Having an appropriate balance sheet will help some businesses prosper over others that have taken on too much leverage. Those that can survive should enjoy higher returns in the next cycle as capital will exit some industries. While this is a challenging area to invest in, it is also where valuations are most attractive. The data show that it is less well covered by analysts, so there are likely to be more opportunities.

Identifying alpha

Overall, we believe that the crisis will result in strong companies (high returns and strong balance sheets) getting stronger as they are better able to take advantage of opportunities, whether through new areas of demand or having better balance sheets to navigate through lower levels of cash generation in most industries.

No single model or analysis is a magic bullet for investing but seeing the world as a company's management sees it, helps to identify those that are actively responding to the crisis. Owning companies that merely survive the pandemic won't deliver outperformance. We have been investing in the 'Accelerators' that have increased investment to take full advantage of the challenging environment, and 'Slowing & Maturing' or 'Turnaround' companies that are doubling down on restructuring.

To find out more about our Global Equities capabilities, please call your RLAM contact.

Contact us

For more information about our range of products and services, please contact us.

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