Real World, Real Businesses, Real Values

Fear the Zombies – Part II

We wrote about zombie companies a year ago—companies that survived the Covid 19 lock-down, but that are not profitable enough to service debt and invest for the future at the same time. The inflation story has played out pretty much as expected, which continues to depress their margins. Now they face rising interest rates, which makes funding their businesses increasingly expensive. In many cases, these companies are no longer able to cover their interest expense, much less turn a profit. After a decade of an extraordinarily accommodative Fed and cheap money, they now face an existential threat.

According to a recent Bloomberg report, **zombie companies make up about 1/5th of the country's largest 3,000 publicly traded companies**, saddled with $900 billion in debt. They were shock absorbers to inflation, and now face higher borrowing costs and more difficult credit conditions. They also make up a significant part of passive indices. For instance, we estimate zombies account for about a third of the Russell 2500 Value.

In addition to crosscurrents from Inflation, a war in Ukraine, rising interest rates (falling bond prices) and contracting equity multiples, investors now face the increasing risk of zombies. As an equity investor, the question of whether they survive (many will not) is less relevant than the question of equity value impairment. Citing the same Bloomberg report from above, 620 companies in the Russell 3000 index failed to generate enough operating profits over the last 12 months to cover their interest expense. We believe that list grows over the next year as the Fed raises interest rates.

We are already seeing this problem escalate in the debt markets. For example, cruise line operator Carnival recently sold $1 billion of 8-year debt at a 10.5% yield. Their debt has swelled to $36 billion vs pre-pandemic levels of $11.5 billion. The good news is revenue is expected to jump 660% this year. The bad news is analysts still expect them to lose $2.5 billion. If analysts are correct and they grow another 52% in 2023, they are expected to finally turn a profit – a profit of $1.6bn – for a company with an Enterprise Value (market cap plus net debt) of $45 billion. In their best year ever, they only earned $3.1 billion. Since the book value of that debt does not change, guess who gets left holding the bag? The equity holders of course. If we get a recession, “Katy bar the door.”

Medical professionals take the Hippocratic Oath, “First, do no harm”. That is how we feel about investing – first, own no zombies. (Second is own no airlines.) Although there are certain periods of a business cycle that owning an inexpensive, passive index fund makes sense, we strongly believe this is not one of those periods, especially in in SMid and Small Cap. We believe there are simply too many global risks and crosscurrents to blindly throw money at stocks at the moment. We focus on owning businesses that can fund themselves (and their growth), with strong management teams able to operate and, more importantly, quickly adapt to the rapidly changing landscape.

Below is the linked to the Bloomberg article we referenced:
https://www.bloomberg.com/news/articles/2022-05-31/america-s-zombie-firms-face-slow-death-as-easy-credit-era-ends?srnd=premium&sref=vfD06998

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