Ryan Watson, MBA, CFA

The "Resilients"

By many indications we are now in the late stage of the business cycle. We cannot accurately predict when the next recession will occur, as the current cycle has defied historical average timelines. Though, when it comes to predictions, we believe time is better served trying to identify businesses that have the highest odds of long-term success.

Earlier this week, Deutsche Bank – a large, global diversified bank headquartered in Germany – announced a strategic transformation that the CEO feels will create "a bank that will be more profitable, leaner, more innovative and more resilient." The restructuring will involve exiting non-core areas of the business and laying off nearly 20 percent of its workforce. It will also require a halt to its common equity dividends and share repurchases until 2022. Coming out of the Financial Crisis, Deutsche Bank struggled to regain the consistent earnings per share growth it enjoyed in the six years leading up to 2008. The shares of this nearly 150-year old franchise have suffered; in 2007 they traded at 2.1x price-to-tangible book value, and now they trade at 0.2x. In our experience, an aggressive pursuit of growth outside of a company's competitive strengths usually leads to challenges. Though, it would be interesting to hear management's view on past missteps that have led to these bold actions being taken at such a precarious time in the cycle. While many companies are looking to cut costs in order to sustain today's high profit margins, Deutsche Bank is taking big steps merely to return to profitability after four consecutive years of losses.

Resiliency should be measured by more than just the number of years since a brand was established. In May 2019, business consulting firm McKinsey published a study investigating the characteristics that help companies thrive through downturns. From a sample of 1,100 publicly traded companies, it tried to identify the qualities of the 10% that fared materially better through the last downturn in terms of total returns to shareholders (TSR) – a group it aptly calls the "resilients". The findings include three key actions, of which two are highlighted below (with the third pertaining only to companies in countercyclical sectors):

1) Creating flexibility (a safety buffer) – the resilients cleaned up their balance sheets before the trough, setting them up for acquisitions at signs of an economic recovery.

2) Cutting costs ahead of the curve – the resilients "prepared earlier, moved faster, and cut deeper when recessionary signs were emerging."

The results of the study also suggest that the outperformance in TSR by the resilients tends to persist, i.e. nearly 70 percent remained top-quintile performers in their sector over the 10-year sample period. Therefore, companies striving to be best-in-class should consider these initiatives.

The QV Canadian Equity team recently sat down with management from RioCan REIT – Canada's second largest real estate investment trust, which manages and develops retail-focused properties. We are not currently invested in RioCan due to valuation, but we do believe it is a well-run business within its sector. Management has displayed thoughtful decision-making over time, in line with the strategies mentioned above. For instance, RioCan has typically held one of the strongest balance sheets amongst its peers. In the aftermath of 2009, RioCan's relatively conservative leverage ratio allowed it to acquire properties south of the border at cheap valuations. In 2016, as the US property market recovered, it seized an opportunity to maximize return by selling these assets to a US-based alternative asset manager. RioCan was again able to reduce its leverage ratio and fund development opportunities within its core market of Canada. Never standing still, in 2017, the company accelerated its disposition of certain properties in order to focus on Canada's six major cities of growth. RioCan's strategy has been met with bumps in the road, but we applaud its ability to learn from mistakes and stay the course.

RioCan's disciplined management style through past cycles should be recognized. As for Deutsche Bank, time will tell if its new action plan is effective enough to launch it towards resiliency.