

MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – APRIL 2019



EQUITIES

REDUCED ALLOCATION
IN LIGHT OF MARKET RALLY

FOCUS

IS GOODWILL AT RISK?
THE SITUATION IN THE US AND IN EUROPE

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EDITORIAL



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“APRIL. MONTH OF DUST AND LIES” (N.Mahfouz)

Dear Reader,

To be clear, we are not emphasising the above quote as a warning against fake news or supposed political lies. We would simply like you to look past the current poor economic data.

In other words, should April be another month of negative surprises on the economic front, this should not hide the underlying driving forces at work.

Take inflation for example. The current soft numbers are largely due to the decline in the oil price over the past quarter, and this will likely reverse during the second half of 2019.

Or, look at the weak GDP growth currently displayed in various countries. China will reaccelerate once the expansionary economic policy takes effect, and the mature economies' current lull in the expansion will probably dissipate given the strength of the labour markets.

We may even hear a somewhat less dovish tune coming from the central banks of mature countries.

It is important to keep in mind that financial markets are often not fully synchronised with the business cycle. The sharp correction in the markets late 2018 can be viewed as a discounting of the current state of the global economy.

In this regard, how can we qualify the 2019 rebound? It may be that the market has already looked past the current poor economic data.

In the end, it may just be a question of price. The re-rating of the stock markets, by increasing the price-earnings ratio, and the decrease in government bonds yields, have undoubtedly reduced the attractiveness of both equity and fixed-income markets for investors.

FOCUS

IS GOODWILL AT RISK? THE SITUATION IN THE US AND IN EUROPE

WHAT IS GOODWILL?

Goodwill is an intangible asset that is created when a company purchases another company. In a nutshell, it is the difference between the purchase price and the target company's book value (i.e. the value if all the assets are sold and all the liabilities are paid back).

Examples include the value linked with (among others):

- A brand's name;
- The superiority of management;
- Expected synergies with the existing business;
- A solid customer base;
- Consumer loyalty.

HOW IS GOODWILL ACCOUNTED FOR?

Goodwill is never amortised, rather, under both US GAAP (Generally Accepted Accounting Principles) and IFRS (International Financial Reporting Standards), it is tested annually for impairment. An impairment would reduce the amount of the asset on the balance sheet, and be treated as an expense on the income statement. Reversal of loss for goodwill is prohibited under both accounting standards.

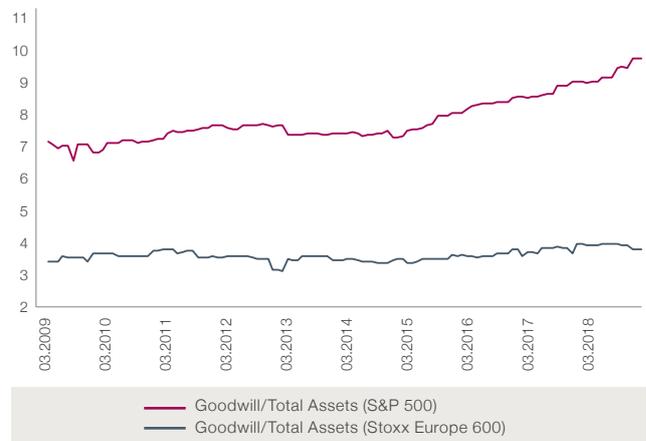
Goodwill is sometimes overlooked in the analysis of financial statements. However, recent examples have illustrated the risk of goodwill impairments. These arise when a company has paid more for an asset, or business acquisition, than it arguably should have, depending on factors such as deteriorating economic prospects, increasing competition, and departure of key executives, for example. Increasing interest rates also play a role, as they translate into higher discount rates used in the valuation of acquired companies' future prospects.

Large impairments can severely impact earnings, and thus potentially be very detrimental to the stock's performance.

THE INCREASING IMPORTANCE OF GOODWILL IN TOTAL ASSETS

Overall, the weight of goodwill in total assets of US listed companies has increased over the past few years, from a relatively stable 7% to almost 10% (S&P 500 Index), whereas in Europe, the ratio has remained stable over the past ten years, between 3% and 4% (Stoxx Europe 600 Index, see chart).

GOODWILL/TOTAL ASSETS, S&P 500 INDEX AND STOXX EUROPE 600 INDEX, %



Source: Bloomberg, Indosuez Wealth Management

Past performance does not guarantee future performance.

Today, goodwill represents more than a third of total assets for 22% of the companies in the S&P 500 Index, and for 15% of the companies in the Stoxx Europe 600. In the US, the proportion has increased from 15% to 22% over the past 9 years, as depicted in the chart below.

PERCENTAGE OF INDEX COMPANIES FOR WHICH GOODWILL REPRESENTS MORE THAN A THIRD OF TOTAL ASSETS, S&P 500 INDEX AND EUROPE 600 INDEX



Source: Bloomberg, Indosuez Wealth Management

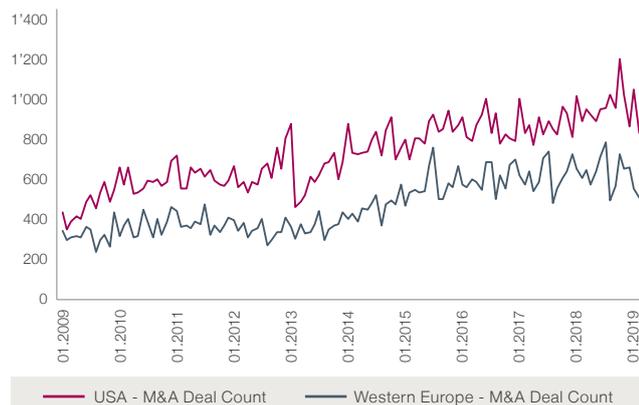
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The difference between the level of goodwill in the US and in Europe is also reflected in the higher premiums paid on company acquisitions in the US, and in the faster increase in the number of deals completed over the past three years.

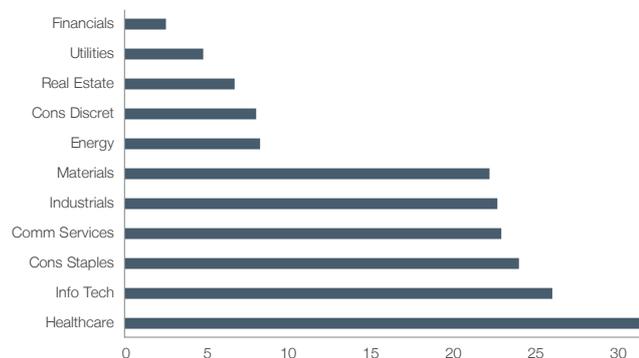
NUMBER OF M&A DEALS, US AND EUROPE



Source: Bloomberg, Indosuez Wealth Management
Past performance does not guarantee future performance.

Moreover, sectors that traditionally rely on M&A for growth (consumer staples, healthcare), and growth sectors where future growth prospects of companies make up a large part of the price paid on acquisitions (information technology, communication services), will show more goodwill in proportion of total assets. With its exposure to financials, a sector with low goodwill (the value of a financial company being more closely tied to its balance sheet), we understand that the Stoxx Europe 600 is somewhat less concerned by goodwill.

GOODWILL/TOTAL ASSETS, S&P 500 SECTORAL INDICES, %



Source: Bloomberg, Indosuez Wealth Management
Past performance does not guarantee future performance.

Should we worry? So far, investors have kept “paying” for higher goodwill, as illustrated by the fact that the increase in market capitalisation has followed the increase in goodwill. This arguably increases the potential impact of impairments on equity prices, and all the more so if goodwill is significant in proportion to total assets. Impairments of goodwill for publicly traded US companies amounted to USD 35.1 billion in 2017, up from 28.5 billion in 2016 (Duff & Phelps LLC). Preliminary numbers indicate that major goodwill impairments reported in 2018 already exceeded USD 40 billion by mid-December.

BOTTOM LINE

While the overall value of impairments has increased, the number of such large impairments remains low. As such, we do not think that there is a broad market risk of goodwill impairments. Having said that, we have identified the sectors that are more exposed to this risk which we think investors should not ignore.

In particular, risks rise when goodwill is concentrated in a few acquisitions (“diversified” goodwill is less at risk), and when acquired companies are operating in industries marked by increased competition or structural changes (such as in customer preferences), making them more subject to downward revisions in profitability. Changes in a company’s chief executive have also been related to a higher probability of impairment for companies with high levels of goodwill.

Ultimately, the issue remains stock-specific, and investors would do well to keep an eye on companies with a high percentage of goodwill in their total assets.

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