Business Immunity through Flexibility

What determined the magnitude of the losses or growth in different companies and industries of Nepal, as well as international markets in the face of the Covid 19 economic crisis?

Starting mid-February 2020, global markets entered a state of panic as a result of the Covid 19 crisis. The uncertainty caused by the pandemic led to large-scale market sell-off and many businesses were affected on multiple fronts. Nine months into the pandemic with substantial data, by assessing various business reports, market trends and existing research, it was evident that factors such as size, level of debt, cost structures and business life cycle positioning were a few of the many defining factors that determined the effects of the Covid 19 crisis on businesses.

When broken down fundamentally, all these factors ultimately point to the importance of flexibility. The relatively flexible industries seemed to be less of a panic sell to investors in financial markets and in terms of their operations, more resilient to the detrimental effects of the crisis as compared to other industries. In the same way, even the businesses within industries with more flexible models fared better than their counterparts. So, it is important to ask what is flexibility apart from the capability to shift to a work-from-home system and why is it so important during turbulent times? Flexibility in businesses can come in different forms.

One of these is the operating flexibility. This measures the effects on the operating profitability of a business in relation to the change in revenues. It is possible to get a good idea of the operating flexibility by analysing the ratio of fixed costs to variable costs of a business. The hospitality stocks in Nepal's equity market took the biggest haircuts in their prices of 45% on average and are still one of the slowest ones to recover. Of course, the lack of tourists is the obvious reason, however on the back end, the business structure with a lack of operational flexibility made situations worse.

As per CBRE's report the global gross margin average for hotels in 2019 stood at 11.6% which shows low operating flexibility in the industry. During the peak of the pandemic, these businesses with almost non-existent revenues, yet labour-intensive structures and frequent maintenance expenses that contributed to high fixed costs, suffered from significantly declined profitability if any at all. On the other hand, manufacturing industries that saw a decline in revenues and resultantly a decline in profits, held up relatively better due to their operationally flexible business nature. Within manufacturers of various goods, those with higher gross margins attributable to the higher variable costs were able to maintain profit margins better even though the profits themselves were low.

Another form to consider is investment flexibility. This measures the level of reinvestment needed for a company to grow and how long it takes to recoup the investment. Companies that require massive capital expenditure in order to grow and have longer payback periods for their investments are considered less flexible. Recent financial reports highlight this argument as large infrastructure companies showed big declines in profits. Hotels, airlines and certain manufacturing companies that had the lowest revenue to invested capital ratios were the ones that the market punished the most. Due to the high uncertainty of the pandemic, investors were unwilling to bet on companies with projects that had long payback periods. Thus, making risk adjusted returns for these companies look unattractive. Contrastingly, businesses with high investment flexibility or those that can rapidly scale up or down at relatively low costs fared best during the pandemic. Less capital-intensive service businesses and technology companies were the least affected and, in some cases, were even graced with a stay-at-home environment.

Lastly, financial flexibility also determined the magnitude of the 'Covid 19 effect' across all sectors and their industries. Even in normal economic times, a rock-solid balance sheet is key for a successful business. This crisis has proved this to be even more important. One of the core determinants of a strong balance sheet is the level of debt of the company. A higher level of debt in comparison to equity in a company decreases its financial flexibility. A company with significantly high debt has an added burden of interest payments as a cost of financing. Sadly, this becomes more of a fact for emerging markets like Nepal where central banks and governments lack the resources to cushion their private sector. Even from an operating flexibility standpoint, increasing levels of debt contributes to higher fixed costs for the company. On the other hand, companies with the least investment flexibility due to their high capital reinvestment are more often than not funded more by debt as compared to capital light businesses. Thus, debt is the single most driving factor affecting the overall flexibility of a business. Diving into the scene of the global and Nepali equity markets, companies with low debt have been the lesser victim of the brutal market sell-off.

Different companies have individual situations of their own and amid the pandemic in most cases, any one the forms of flexibility cushions the businesses whereas their inflexibilities hurt them. Global markets anticipate the emergence of a more digitised flexible business. Nepal itself has seen the number of e-commerce businesses multiply exponentially in the recent months. Statistically businesses have seldom found success through herding behaviours. Rather, value can be found by re-entering the drawing board to address the inflexibility in business models.

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