Market Commentary on the FY2020 Results Season:

Managing Expectations in an Exuberant Market?

Being by now in the third week of the FY2020 results season and having followed more than a dozen analyst calls from different industries in Europe and North America - ranging from banking to pharmaceuticals, semiconductors, telecoms, energy and manufacturing – we thought it is time to review both the key themes highlighted by corporates so far, and topics of special interest for institutional investors and professional analysts.

At a time of an exceptional stock market rally – notwithstanding the ongoing corona pandemic, global supply chain disruption, inflationary pressure from higher costs of raw materials, feedstock, container shipping, etc. – the challenge is to realign exuberant market expectations with the economic reality of companies trying to adjust to the second year of an unprecedented healthcare crisis. While some senior executives talked about the "challenge of a lifetime", described by one US-based CEO in the context of electrification, connectivity and climate change,[i] there is a broad consensus about the global pandemic having accelerated structural trends towards more digital usage, higher mobility and flexibility at the workplace.

This debate was further elevated within a broader ESG context in January 2021 when Larry Fink, Chairman of BlackRock, spoke about a "tectonic shift" in the investment landscape due to climate risk and urged investee companies to commit to achieving net zero emissions by 2050.[ii] This was echoed by a group of some of the largest asset managers worldwide, as well as by growing shareholder activism running specific campaigns to force companies to further cut carbon emissions.[iii] Some of the relevant questions from analysts were a) what have companies learned from their experience in 2020, specifically with regards to customer behaviour;[iv] and b) what digital skills at a Board level are required after the corona disruption and whether this was one of the reasons for extensive Board replacements in recent months.[v]

While this is not the place to speculate whether we are heading towards a new stock market bubble and/or whether new valuation metrics are required to justify prevailing investor optimism,[vi] we are more concerned about the growing disconnect between market exuberance and the kind of economic and social reality companies face on a daily basis. Hence our key focus will be on the operational side, notably on cost factors, M&A activity and further consolidation, the "sustainability premium" companies aim for in the current ESG investor campaign and, finally, on the economic outlook and how companies address guidance and shareholder return themes.

THE SECOND WAVE OF COST SAVINGS

Despite the start of the corona vaccination and hence growing optimism about economic recovery, there is no doubt that companies will have to go through a second wave of cost savings in 2021 and that it will take major investments to extract additional cost savings compared with the previous year. One of the most eloquent and open explanations we have heard so far came

from the CFO of KPN, Chris Figee, when he elaborated on the “low hanging fruits” in 2020 (travel, entertainment, consulting, etc.) compared with the ongoing structural and operational adjustments, whether this includes the setting up of IT for employees’ home office or changing the usage of leased cars.[vii] Others, notably investment banks, talked openly about having to go through significant redundancies implying high restructuring costs in 2021.[viii] A third discussion point in this respect was that costs on travel, entertainment, etc., which had been cut across the board in 2020, will slowly come back in 2021 albeit at lower levels. In addition, higher production volumes would naturally lead to increased costs, while some industrial companies tried to quantify both discretionary and permanent cost actions in their outlook for 2021.[ix] Finally, professional analysts frequently asked about inflationary pressure from higher costs of raw materials, feedstock, container shipping, etc. and the implications for operational expenses in 2021.[x]

M&A ACTIVITY & INDUSTRY CONSOLIDATION

There is an extensive debate to what extent the global pandemic helped to deepen the gulf between the largest, best-financed companies and those lacking scale, leading brands and/or robust balance sheets, which has been described by some market commentators as an unequal, “K-shaped” recovery for corporate America.[xi] Important for our discussion here is to what extent companies have recently talked about their M&A ambition, investment rationale and criteria. And this has been extensive, to say the least, irrespective of the companies’ size of market cap. Companies with an established M&A track record perceive the current crisis as a great opportunity and point to their capital strength and integration skills.[xii] Others are trying to embed their M&A strategy within the existing financial framework and capital allocation priorities, with the oil majors being particularly challenged by analysts on their credit rating ambition.[xiii] From our perspective, the most interesting theme in this debate has been how best to integrate the acquired assets at a time of the global pandemic, with all the difficulties of moving people and physical assets around, and how to ensure that the newly acquired company can be aligned with the parents’ strategy.

SUSTAINABILITY PREMIUM

With all the market noise and public pressure in the wake of the corona pandemic, it was perhaps not surprising that almost every company we had followed so far spent some considerable time elaborating on their recent ESG effort, with a specific focus on climate change, as well as on the disruptions caused by the current healthcare crisis. However, we would make two observations about how it was received by the professional analyst and investor community so far: a) for some, it appeared somewhat disconnected from the current economic and social reality and was seen more as a PR and marketing effort, perhaps in connection with recent ESG rating ambition;[xiv] b) in case of others, analysts requested more measurable non-financial KPIs to better understand the implication for changing business models through climate change, and to obtain more thorough analytics for sustainability reporting and carbon emission.[xv] Clearly, with all the pressure from the professional fund management industry to explain climate change induced risks to companies’ business model but also increasingly to commit to net zero carbon emission by 2050, the heat is on for corporates to depart from previous business practices and showcase to the investment community where they are going to make a real and tangible difference. At the same time, professional analysts and investors are all too well trained to look behind “greenwashing” and

have learned and adopted new analytical skills for sustainability in recent years, with some market commentators describing a new "ESG bubble" given all the institutional money invested.[xvi]

ECONOMIC OUTLOOK

There is no doubt that the start of 2021 has triggered new market optimism, following the new Biden administration's focus on fiscal stimulus and the "blue wave" trade as a result of the Georgia Senate poll in January,[xvii] supported by the roll-out of vaccination programmes across the world, which has led many corporate executives to talk about the "light at the end of the tunnel".[xviii] At the same time, the bond and currency markets implied higher US inflation, with hopes for stronger corporate earnings from improving economic growth potentially undermined by the negative impact of higher interest rates.[xix]From our perspective, the more pressing short-term issue, however, is the difference in growth rates of big economies, with the slow vaccination roll-out in Europe and further disruptions of the movement of people and goods after renewed lockdowns "accelerating the fall into a double-dip recession".[xx] This immediate economic hit that most European economies have faced in recent weeks could delay subsequent recovery, with short-term problems being more likely to become structural ones.

Against this backdrop, it is not surprising that professional analysts and investors have increasingly focused on two themes with regard to the economic outlook: a) to what extent the current macro-economic environment supports a company's recovery phase, with a special focus on its major markets of operation; and b) to what extent the future upturn differs from previous recessions this time, notably compared to the financial crisis in 2007-08.[xxi] While most US companies we had followed so far adopted a very positive outlook, indicating a strong recovery through pent-up demand in the second half of 2021, European peers appeared much more cautious across different industries, with some having even to backtrack on their revenue outlook during the actual results call.[xxii]

Naturally, the reinstatement (or lack) of companies' dividend policy – given political and regulatory interference in 2020 – and commitment to more shareholder return through share buy-backs has been taken as an indication of corporate executives' "feel-good factor" about their business outlook in 2021 and beyond. Therefore, it is no surprise that the discussion about the size of the dividend – as well as the metrics and details of guidance – consumed a great deal of the Q&As during the FY2020 results calls, with companies being pressed hard on how they actually arrived at those numbers and what the thinking at Board level was like. While the proposed timeframe for guidance was typically short-term (2021) and mid-term (2023), this raised the question how sustainable both the guidance and shareholder return are given all the uncertainties of an ongoing pandemic and economic recession.

Given the sharp share price reaction for most companies on reporting day in recent weeks, we would think that best fared those who had taken the time to explain and offered granularity of metrics to underpin their new guidance and dividend policy.

Peter Kirkow
8 February 2021

ENDNOTES

[i] Craig Arnold, Chairman and CEO of Eaton, explaining at the Q4'2020 results call on 2 February 2021.

[ii] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

[iii] For the so-called Group of 30, see Financial Times, 26 January 2021, and for hedge fund manager, Christopher Hohn, taking on various S&P 500 companies, see The Wall Street Journal, 29 January 2021.

[iv] Barclays' analyst at Shell Q4'2020 results Q&A, 4 February 2021

[v] Merrill Lynch analyst at Eaton Q4'2020 results Q&A, 2 February 2021

[vi] We feel vividly reminded of the time when we had worked as young sell-side analysts in London during the internet bubble in 2000-01, particularly with all the additional hype coming from retail investors, with the difference that interest rates had been at much higher levels back then and Central Banks seem to be the last resort today.

[vii] KPN Q4'2020 results call, 27 January 2021

[viii] See, for example, UBS Q4'2020 results call, 26 January 2021

[ix] See, for example, Parker Hannifin Q2'2021 results presentation, slide 16

[x] Wells Fargo analyst at Shell Q4'2020 results Q&A, 4 February 2021. In this case, management tried to play down the impact of inflationary pressure, referring to their integrated business model, trading skills and hedging policy.

[xi] For a good overview of this discussion, see: Andrew Edgecliffe-Johnson, *Corporate America experiences „K-shaped" recovery*, Financial Times, 29 December 2020

[xii] See for an extensive discussion, Parker Hannifin Q4'2020 results call, 4 February 2021, labelling themselves as „consolidator of choice", and also Eaton Q4'2020 results call, 2 February 2021.

[xiii] See numerous questions on this topic so far both for BP and Shell at their respective Q4'2020 results Q&As.

[xiv] In pharma, Lonza was perhaps one extreme, producing a special slide on their „refreshed focus on sustainability", see Lonza FY2020 results presentation, page 22. There is no doubt that the current investment rotation into value stocks and small caps has benefited a lot of companies in less liquid markets, and when combined with a recent ESG rating by the likes of CDP, this has dramatically boosted trading volumes and company valuation of previously less favourable and more cyclical stocks in chemicals, energy and banking, to mention a few.

[xv] In this respect, one good example was the BP Q4'2020 results Q&A when analysts frequently requested more specific information on sustainability reporting and carbon emission but, in this case, where referred to the planned ESG analyst call in early March in conjunction with the publication of the BP 2020 Sustainability Report.

[xvi] Back in summer 2019, we were already surprised to see that more than 90% of the 170 largest long-only and high-quality institutions in our European targeting model had a clearly defined ESG investment framework, i.e. companies which would not comply with those requirements would simply fall below their radar screen. See for the discussion on the new ESG bubble, Gillian Tett, *Wall Street's new mantra: green is good*, Financial Times, 29 January 2021.

[xvii] Michael Mackenzie, *„Blue Wave" trade back on after Georgia Senate poll*, Financial Times, 7 January 2021

[xviii] These were expressions used by both CEOs of Eaton and Parker Hannifin at their Q4'2020 and Q2'2021 results calls on 2 and 4 February, respectively.

[xix] While there is much discussion about the reflationary impact on the US economy, there is broad agreement that Treasury bondholders will have to pay for the unprecedented fiscal and monetary stimulus in 2020-21, see among others, Jeremy Siegel, *Higher inflation is coming and it will hit bondholders*, Financial Times, 19 January 2021.

[xx] Mohamed El-Erian, *New Covid variant will increase stress on global economy and widen inequality*, Financial Times, 5 January 2021

[xxi] Both topics were eloquently discussed by the Chairman and CEO of Parker Hannifin, Thomas L. Williams, at the Q2'2021 results call on 4 February 2021.

[xxii] See, among others, ABB FY2020 results call, 4 February 2021, for their revenue guidance in 2021, and OMV Q4'2020 results call, 4 February 2021, for the outlook on production volumes.