Market Commentary on the Q3’2020 Results Season:

Tracking Corporate Earnings in Exceptional Times

Now that we are two weeks into the Q3’2020 reporting season and have followed more than a dozen companies from very different sectors so far, it is worthwhile to step back for a moment and reflect on the key developments and major themes of current investor interest. As most companies are still in the process of preparing their reporting documents, they are all aware that this will be an extraordinary and a very challenging results season - through the combination of intensifying corona pandemic across the globe, the ongoing economic recession and the upcoming US-Presidential elections on November 3. The latter will increasingly distract investor attention from the nitty-gritty details of quarterly results, as they need to prepare their investment strategies and portfolio adjustments regardless of the outcome of the US elections.[i]

However, from all we have heard in the Q3’2020 analyst calls so far, going forward the companies are more likely to be pressed hard on some of the bigger themes, which have been accelerated due to the pandemic (automation, digitalisation, the future of the workplace), and to what extent this will impact not only their business strategy and investment proposition, but will also influence their financial framework and priorities for capital allocation including shareholder return. It is this key institutional focus on how companies adapt to and accelerate the pace of change, which we will highlight in our market commentary, as this will define investor debates well into 2021 and beyond.

INVESTOR SENTIMENT & OUTLOOK

To start with, we should first look at the evolving investor sentiment and market expectations as we enter the third week of the Q3’2020 reporting season, given that the VIX volatility index has not only remained at historically high levels, but has also increasingly decoupled from equity indices. The latter had a record run in August before going through more „rough waters“ afterwards.

There is no doubt that the V-shaped recovery implied in equity indices is less underpinned by the corporate and economic fundamentals, but more by investors’ strong faith in a „consistently favourable and predictable liquidity environment“, which is supported by stimulus from central banks and governments’ fiscal packages.[ii] While the US Presidential elections have triggered a wide range of defensive short-term investment strategies, it is the longer view investors have applied in recent weeks, which is of relevance for our discussion here.

First, there was a clear rotation out of the so-called „winners of the pandemic“ (technology, pharmaceuticals, grocery retail, etc.), as investors increasingly felt that this had probably been the best time they could ever have had.[iii] Having closely followed earnings calls in the semiconductor and pharmaceutical industries during the first week of Q3’2020, it was striking that share prices for most had underperformed local and pan-European indices by some margin on the day of results release, i.e. earnings expectations had originally been much higher.

Secondly, Joe Biden’s extended polling lead after the first presidential candidates’ debate on 29 September had shifted investor sentiment, rotating from growth into value stocks and – in anticipation of a big fiscal package under a potential Biden administration – more into small caps.[iv] Currently, markets are pricing in a „blue wave“ - with Democrats not just winning the White House but both houses of Congress - as not just being the better option for reducing election uncertainty but as the most likely „new reality" going forward.

Thirdly, and this is the fascinating part of observing the Q3'2020 reporting season, the fact that US executives have sold a record-breaking $6.7bn of shares in their own companies in August, according to the figures compiled by the data provider Smart Insider, is the evidence for chief executives being much more downbeat in their outlooks than investors. The data on this kind of „insider sales" are based on filings with the US securities regulator and exclude shares purchased in the March and April lows as executives must hold on to profitable shares for at least six months.[v] Clearly, corporate directors have a much more detailed insight into their business and this will now be closely watched in terms of guidance and dividend policy provided in the Q3'2020 results.

FINANCIAL FRAMEWORK

One key investor focus since the outbreak of the pandemic has been the strength (or lack of) of companies' balance sheets and the balance between equity and debt finance. Long-term statistics has shown that corporate creditworthiness had been eroded over the last few decades, as companies were able to load up on debt, mostly to take advantage of lower interest rates as well as to respond to growing investor demand for higher dividends and share buy-backs.[vi]

As the pandemic led to better share performance of higher-rated companies, at least until late summer, this implied a paradigm shift from previously „efficient" to „resilient" balance sheets, implying less debt and supported by greater cash reserves. During the Q3'2020 results calls we have followed so far, companies were frequently asked what efforts they made to reduce net debt, to what extent they have spoken to rating agencies during the corona crisis and how they possibly optimise their refinancing schedule. In the current situation, companies will need to review their financial framework and to further conceptualise their capital requirements, as has recently transpired in frequent discussions about working capital management and investment priorities.[vii]

PRIORITIES OF CAPITAL ALLOCATION

Following from the above, the second bigger topic companies were pressed on when presenting their Q3'2020 results so far was that of priorities for capital allocation, notably on their efforts to reduce net debt, as well as about their appetite for M&A, whether bolt-on or transformative. Senior executives naturally tried to talk down the M&A interest, typically referring to travel restrictions undermining proper due diligence and/or asset prices still being excessively high, but consolidation is gathering pace with some companies explaining their strategic rationale in greater detail.[viii]

As we are approaching the close of 2020, and despite the fact that by the end of the Q2'2020 results season half of European companies had either cut or had fully withdrawn guidance on their outlook,[ix] this time around companies will need to be much more specific on their business expectations for 2020 and beyond. Even if corporates are trying to avoid quantifying their outlook in absolute or percentage numbers, one strong indication will be the amount of cash they are planning to put aside for shareholder return.[x] Despite all the regulatory and political interference after the outbreak of the corona pandemic, the proposed dividend is an important signal about the business outlook and investors will watch very closely what companies have to say in this respect.

BUSINESS STRATEGY & INVESTMENT PROPOSITION

The corona pandemic has not only turned the world upside down in recent months, but also has forced companies – as each of us personally – to get to terms with the new reality of heightened risk, volatility and unpredictability. This implies a huge element of uncertainty, either when running a company or when simply investing in company shares, but most have probably realised that this will stay for longer and, hence, will have a lasting impact on the future business strategy.

And this is the third and probably most complex investor enquiry we have observed in the Q3'2020 results season so far, as fund managers and professional analysts have not been easily convinced by general claims for „adaptibility“ and/or „resilience,“ and would want to see specific action to keep up with the accelerated pace of change, either in terms of automation and digitalisation, new supply chains and logistics, or in terms of companies' infrastructure footprint (including office space) and the future of the workplace.

The latter has an immense social element and the potential to further speed up the ESG factor within companies' investment proposition. From an investor's perspective, it is not sufficient any more for the company to claim care for the health and safety of employees (and other stakeholders); it is also important to be absolutely clear about what does a company do for its workforce - in terms of education and higher qualification, diversity and flexibility at the workplace and, most importantly, in terms of motivation and incentivisation. This kind of investor debate is gathering pace and – the better a company can articulate its respective ambition and future outlook – the stronger its investment case will become.

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ENDNOTES

[i] UBS referred in their Q3'2020 results call to their recent Investor Sentiment Survey, saying that 72% of institutional interviewees considered reallocations before the US elections and 62% reallocations based on the actual results, with both presumably overlapping each other, see slide 10 of the UBS Q3'2020 results presentation.

[ii] Mohamed El-Erian, *Retail Stock Market Investors Should Note Professionals' Caution*, Financial Times, 1 September 2020

[iii] See, *Hedge Fund Short Sellers Target Pandemic Winners*, Financial Times, 14 October 2020

[iv] See, *US Investors Pivot to ‚Blue Wave' as Odds Favour Biden*, Financial Times, 13 October 2020

[v] See, *‚Downbeat' US Executives Dump Most Stock in a Month Since 2015*, Financial Times, 4 September 2020

[vi] See, *How Covid-19 Sparked a Dividend Drought for Investors*, Financial Times, 10 September

[vii] In this respect, one good example for a smaller company is the way A1 Telekom Austria presented the impact of Covid-19 on key financial and operational KPIs and to what extent this has influenced their thinking on the 2020 guidance, see slides 14 and 16 of their Q3'2020 presentation.

[viii] See for example, the discussion at the AkzoNobel Q3'2020 call, to what extent consolidation among the peer group has spurred their appetite for M&A and why AkzoNobel is not preserving firepower for more M&A instead of re-starting their share buy-back programme.

[ix] Nick Nelson, *European Corporates Signal Earnings Have Bottomed Out*, Financial Times, 21 October 2020

[x] While a few companies have announced the renewal of their annual share buy-back programmes in recent weeks, this remains a contentious issue in the investor debate. For some investors this is more of a signal that management is running out of investment ideas, while others see in it more of the value in enhancing EPS growth by reducing the number of shares and, at the same time, not paying taxes as would be the case for dividends.