Market Commentary on the Q1'2021 Results Season:

Reaching out for the New Inflection Points?

As we are now half-way through the Q1'2021 results season, it is time to take the temperature of the prevailing market sentiment, even more so that a number of issues will be defining the forthcoming half-year results period. One of the key discussion points over the last three weeks has been **to what extent Q1'2021 can really be compared with the same period of last year**, given not only the unprecedented pandemic lockdown in March 2020 – with home office adjustments and state-sponsored furlough schemes only evolving – but also with two more working days in Q1'2021 and a generally more positive business outlook for 2021. Naturally, for those companies claiming to have had a "great start into the new 2021 fiscal year" the challenge was to explain during the analyst Q&A in greater detail how to make a like-for-like comparison and whether they should not have used Q1'2019 as a "base year" to define their future organic growth potential.[i]

This resulted in two other key themes for the debate we have observed so far. One was the feeling of unease the analysts had when companies were trying, in their perception, to **talk up the potential economic recovery over the summer, albeit remaining extremely cautious with their outlook for the full-year 2021**.[ii] The third major theme for market discussion was when and how "positive inflection points" would possibly converge,[iii] with a clear indication that **investors and analysts have become more interested in investment for future growth** and less so in discretionary vs permanent cost cutting in the wake of the Corona crisis. In this context, more questions are being raised a) about the optimal capital structure for future growth;[iv] and/or b) the medium to long-term "efficient balance sheet" to support the future growth investment.[v] There is now a clear shift in market sentiment towards the supply chain and manufacturing footprint required to meet growing demand and also how best to optimise and leverage distribution channels for future growth.[vi]

With cost inflation and component shortages not only leading to excess inventory build-ups but also reducing visibility for new inflection points, we will focus first on the current debate on inflationary pressure and market volatility. We will then highlight some of the recent shareholder activist campaigns and their implications for corporate change. We finally address a broad discussion about the Corona-induced changes in companies' strategy, with examples being vertical integration as recently witnessed in the European car manufacturing industry,[vii] geopolitical pressure in the semiconductor industry or recently announced US government and OECD-led ambitions for corporate tax changes.

One point of caution though when talking about strategy changes as we were vividly reminded about risk management issues at global banks in the wake of the Archegos family office and Greenhill Capital exposure in recent weeks. Having followed both the Credit Suisse and UBS Q1'2021 results call in detail, it was not only striking to what extent analysts and investors were hugely upset about the scope of this negative surprise but also the time they took at the Q&A to enquire about imminent strategy changes and the extent of cultural shift required to make this happen.[viii] More than ten years after the banking crisis, it is not only puzzling that this is still possible given all the regulatory changes, but also evident how psychologically difficult it is for the banks to walk away from highly-leveraged and risky deals.[ix]

INFLATIONARY PRESSURE

After a long period of low inflation and cheap borrowing rates, one of the greatest uncertainties fund managers have faced in recent weeks is that of inflation and an unruly rise in borrowing costs as evidenced by recent money manager surveys.[x] While this is not the place to discuss the sharp rise in yields and the possible response by central banks, suffice it to say that this has come from a repricing of higher growth expectations due to a sustained fiscal stimulus. What is relevant for our analysis here is that investors have already increased their allocation to assets linked to inflation that benefit from stronger growth, as we had recently witnessed not only in the rotation into value stocks and small caps, but also in greater institutional focus on banking, energy and infrastructure.

The other major element of inflationary pressure arises from the ongoing global supply chain disruptions, exacerbated by the Texas storm and Suez Canal blockage, shipping and component shortages – notably semiconductors - and cost inflation for metals such as cobalt and copper which are crucial for the new electrification megatrend.[xi] Hence analysts were asking frequently to what extent companies were able a) to pass on higher costs to customers; and b) to what extent the industry kept price discipline to prevent a competitive price war.[xii] Interestingly, while senior management largely expressed confidence in being able to respond to inflationary pressure, it was less clear how they would behave when faced with competitive price cuts.[xiii] US companies have also started to complain about labour shortages leading to higher personnel expenses.[xiv] This is imminent for the European hospitality and service sector.

MARKET VOLATILITY

While market psychology has been ruled by ample and predictable liquidity for a while, since the beginning of 2021 we have observed a heightened market volatility with no clear indication yet whether the elevated asset prices will eventually be supported by high and durable growth.[xv] Again, this is not the place to discuss the "top-down" view of central banks, but we seem to get greater clarity on "bottom-up" factors that impact institutional investments and portfolio restructuring. The following key points of investor interest when making their asset allocation became evident during the Q1'2021 season: a) the focus on faster growing parts of the global landscape; b) new technologies revolutionising the post-pandemic world (electrification, blockchain);[xvi] c) the strength of balance sheets; and d) visionary and solid management teams.

Another reason for increased market volatility is the prevalence of passive investment and leverage enabled by low interest rates, causing distortions of prices and feeding frenzied retail speculation as recently witnessed with the likes of GameStop and Tesla.[xvii] Though active investment has performed much better during the most recent market dislocation, from a company's perspective the growing ownership of their shares by passive funds not only makes it unpredictable how institutional shareholders would react in case of new strategic announcements, but also increasingly reduces the scope for proactive investor relations.

SHAREHOLDER ACTIVISM

At times of major paradigm changes, it is perhaps not surprising that we have seen a number of new activist campaigns in recent months, although there is not always a common denominator. One major theme has been that excess capital needs to be either returned to shareholders through buy-backs and dividends or invested in future growth through M&A.[xviii] While we might not agree with the label of "liquidity premium", we have certainly seen a number of calls for a new review of capital allocation principles, even in case of mainstream companies currently not facing shareholder activism, as witnessed during the Q1'2021 season for the European energy and banking industries.

In other cases, small hedge fund boutiques have pushed for change in large companies by teaming up with main investors in the shareholder register and becoming a public face in expressing growing shareholder frustration with poor operational performance and unresolved governance issues.[xix] Among European-grown activists, Petrus Advisers, which reportedly manages about $700 million in assets, teamed up with Swiss activist Teleios Capital to launch a proxy fight at Germany's Aareal Bank AGM on 18 May.[xx] Apart from presenting a long list of demands for change, including strategy, portfolio streamlining and the composition of the Supervisory Board, one of the prominent themes and a public sentiment that Petrus was trying to rally support on is that senior management had received huge compensation during the pandemic.[xxi]

STRATEGY CHANGES

Despite being at an early stage, three major themes for Corona-induced strategy changes are already on the radar screen of professional analysts and investors, though one clearly goes beyond a new post-pandemic world with a more precise focus on climate change and social equality: a) higher vertical integration as a result of supply-chain disruptions and component shortages;[xxii] b) geopolitical pressure in the semiconductor industry, notably to take sides in the US-China trade friction and military rivalry;[xxiii] and c) US government and OECD-led ambitions for corporate tax changes, given not only European resentment of US technology groups not paying a fair share of taxes, but also the attempt to close down on offshore tax havens for multinationals.[xxiv] The latter has become an interesting topic in the broader ESG discussion, with an increasing number of companies publishing their annual global tax contribution.[xxv]

Looking ahead and trying to reach out for the new inflection points, some of the above-mentioned strategy changes will most certainly gain more prominence when coming closer to the half-year results season. However, the issues of like-for-like comparison with Q2'2020 are more likely to intensify, given the more stringent lockdown conditions last year, while, at the same time, analysts will be less likely to accept vague and unsubstantiated outlook statements for 2021.

Peter Kirkow
3 May 2021

ENDNOTES

[i] So far notably industrial companies were faced with this kind of discussion, see Trelleborg Q1'2021 results call on 22 April, where almost every second question focused on this specific issue, but also ABB Q1'2021 results call on 27 April, where the discussion on comparables even culminated into a sequential month-by-month analysis. Interestingly, Volkswagen had already applied the "base year 2019" when reporting FY 2020 results on 16 March and explaining their new cost cutting target, which in percentage terms would have been very different if 2020 had been the benchmark. Within the broader discussion about the "new normal" going forward, this is probably the more sensible approach and we would expect more companies to follow this example.

[ii] This was very eloquently raised by the BNP Paribas analyst at the Lufthansa Q1'2021 results call on 29 April and, having followed more than a dozen companies across Europe and North America so far, we would agree that this has become a much broader issue analysts are watching out for very carefully now.

[iii] This description was used by the CEO of Parker Hannifin at their Q3'2021 results call on 29 April, though arguably with a very US-specific perspective on industrial momentum, vaccine progress, aerospace recovery and climate investment from the new Biden administration, see slide 6 of the Fiscal 2021 Third Quarter Results Presentation.

[iv] See, among others, the questions posed by the RBC analyst at the Total Q1'2021 results call on 29 April and also the Merrill Lynch analyst at the Shell Q1'2021 results call on 29 April, with a new discussion evolving about the virtue of issuing hybrid bonds.

[v] See Goldman Sachs analyst at the KPN Q1'2021 results call on 30 April.

[vi] See, for example, Merrill Lynch analyst at the Parker Hannifin Q3'2021 results call on 29 April and also Credit Suisse analyst at the Lufthansa Q1'2021 results call on 29 April.

[vii] See, UBS analyst on higher vertical integration and the ambition for own battery manufacturing and the Exane analyst on the electrification strategy at the Daimler Q1'2021 results call on 23 April.

[viii] See, among others, JPM Morgan analyst at the Credit Suisse Q1'2021 results call on 22 April and also Societe Generale and Barclays analysts at the UBS Q1'2021 results call on 27 April.

[ix] See the extensive discussion on the role of proprietary trading desks during the banking crisis in 2007-08 in: Suzanne McGee, *Chasing Goldman Sachs. How the Masters of the Universe Melted Wall Street Down … And Why They'll Take Us to the Brink Again*, Crown Business, New York, 2010. What had infuriated analysts most at both the Credit Suisse and UBS Q1'2021 results call was the claim that these were merely "idiosyncratic" cases against the broader market understanding of this being rather systematic.

[x] See, for example, the reference to a Bank of America poll in Joshua Oliver, *"Taper tantrum" and inflation replace Covid as top investor worry*, Financial Times, 16 March 2021 and, for bond investors in Thushka Maharaj, *Bond sell-off is a foretaste for things to come*, Financial Times, 9 March 2021.

[xi] On cobalt for new electric car batteries, see Henry Sanderson, *Cobalt price jump underscores reliance on metal for electric vehicle batteries*, Financial Times, 30 April 2021, and the overwhelming demand for copper used, among others, for household appliances, electric vehicles and wind turbines, see Neil Hume, *Copper hits 10-year high above $10,000 a tonne*, Financial Times, 29 April 2021. For the latter, there is discussion of a copper super-cycle given the current overwhelming demand, reflecting a cyclical rebound not only in China but also the US and Europe.

[xii] On both topics, see Deutsche Bank analyst at Daimler Q1'2021 results call on 23 April and the Barclays analyst at Parker Hannifin Q3'2021 results call on 29 April. On the issue of European manufacturers passing on higher input costs to their customers, implicitly increasing eurozone inflation, see also Martin Arnold and Valentina Romei, *Europe's factories raise goods prices as supply bottlenecks bite*, Financial Times, 24 March 2021.

[xiii] In this respect, see for extensive discussion in the European telecoms industry, the A1 Telekom Austria Q1'2021 results call on 28 April and KPN Q1'2021 results call on 30 April, as well as in the European and North American industrials sector, the ABB Q1'2021 results call on 29 April and Parker Hannifin Q3'2021 results call on 29 April.

[xiv] See on rising personnel expenses in the US, Aziza Kazumov, Colby Smith and Eric Platt, *US companies sound inflation alarm*, Financial Times, 29 April 2021 and planned price rises, Aziza Kazumov and Andrew Edgecliffe-Johnson, *US companies plan price rises as inflation pressure builds*, Financial Times, 26 April 2021. Parker Hannifin confirmed both developments in their key North American market at their Q3'2021 results call on 29 April.

[xv] This flow of arguments follows the economic analysis in, Mohamed El-Erian, *How to overcome the uncertainties of the Fed and market psychology*, Financial Times, 16 March 2021.

[xvi] On new blockchain technologies potentially changing stock clearing, see: Philip Stafford, *Stock clearing stalwarts face increasing threat from blockchain*, Financial Times, 6 April 2021, and on equity trading, see: Gillian Tett, *Blockchain may change equities trading for good*, Financial Times, 9 April 2021.

[xvii] This critique came from one of the most outspoken short sellers, Carson Block of Muddy Waters, see: *The 'stonk' bubble poses significant global risks*, Financial Times, 11 February 2021, while also referring to more academic research: Michael Green, *Policy in a World of Pandemics, Social Media and Passive Investing*, www.logicafunds.com, 2021, though the latter also refers to "yield enhancement strategies" by selling volatility across asset classes, see p.5.

[xviii] See for the conceptual analysis, Ethan Klingsberg, *End of 'liquidity premium' to unleash shareholder activism*, Financial Times, 3 March 2021, and for one of Elliott's specific campaigns in Europe, *Elliott believes the time is now for NN Group*, 12 June 2021, pushing in their words for "both sustainable cash-generation measures and extraordinary capital release events". What was new to that campaign was that previous industry executives – in this case, Dieter Wemmer, the former CFO of Allianz – provided their expertise and industry insight by partnering with Elliott, something one might want to question for both professional and ethical reasons.

[xix] One good example is that of London-based Bluebell Capital calling for the replacement of Danone's CEO, Emmanuel Faber, which they eventually achieved in March 2021. Bluebell has reportedly only EUR 70 million of assets under management but owned just about EUR 20 million of Danone, see: Laurence Fletcher and Leila Abboud, *The little-known activist fund that helped topple Danone's CEO*, Financial Times, 24 March 2021.

[xx] See, Laurence Fletcher, *Activist fund Petrus starts proxy fight at German bank Aareal*, Financial Times, 14 April 2021.

[xxi] For the relevant letter to Aareal's Supervisory Board on 30 March 2021, see:
https://petrusadvisers.com/media/letter_to_aareal_s_supervisory_board_-_30_march_2021.pdf

[xxii] For Volkswagen announcing new plans to build six battery factories in Europe by 2030, see: Henry Sanderson, Peter Campbell and Richard Milne, *VW plans six European battery factories by 2030 as it bets on electric future*, Financial Times, 15 March 2021. This was highly rewarded by the stock market, as the Volkswagen shares surged by almost 20% within two days since the announcement and still trade well above the original price level. In turn, other German peers were frequently asked at Q&A during the recent results calls why they would not follow that example, see: the UBS analyst at the Daimler Q1'2021 results call on 23 April 2021 and the Deutsche Bank analyst at the BMW FY2020 results call on 17 March 2021.

[xxiii] On Intel's new strategy and its commitment to build the majority of its own chips, see: Patrick McGee, *Intel to step up chip manufacturing with $20bn plants*, Financial Times, 24 March 2021, and for Taiwan's TSMC being drawn into the geopolitical tug-of-war between the US and China, see: Eleanor Olcott, *TSMC faces pressure to choose a side in US-China tech war*, Financial Times, 16 April 2021.

[xxiv] For more details on the Biden administration proposing a new model for taxing multinational companies, see: James Politi, Aime Williams and Chris Giles, *US offers new plan in global corporate tax talks*, Financial Times, 8 April 2021.

[xxv] For a good example, see NN Group publishing their total tax contribution since 2018, which was well before the Elliott activist campaign in June 2020: https://www.nn-group.com/sustainability/our-approach-to-tax.htm