J. STERN & CO.

The Value of Long-Term investing

Insight

RISK, RESILIENCE AND OPPORTUNITY: COVID-19 AND ITS IMPACT ON KEY INDUSTRIES AND COMPANIES

The Covid-19 pandemic has had a devastating impact on the societies and economies we live in. It is the first pandemic in our globalized world. We discussed the pandemic and possible outcomes in our Insight last month, which you can find on our website or by clicking here.

Now several weeks on, we have found that thankfully physical distancing works to flatten the curve and that even though healthcare systems in many countries have been stressed they have generally been able to cope in terms of hospital capacity and other resources.

Infections, hospitalizations and fatalities are decreasing. A number of reliable tests have been approved, including by Roche and Abbott, long-term holdings of ours. Tracking is unproven although European governments have decided that a private sector solution provided by Alphabet and Apple is likely to provide greater data protection and privacy than solutions, they could provide themselves. Vaccines will remain elusive for 12-18 months if they can be found at all despite the good news we hear. However, therapeutics like the drug cocktails that have been developed in different places offer hope that the course of the disease can be improved and allow more effective treatment and better outcomes.

The next months will be a tight rope walk as devastating economic numbers are reported by governments and companies but as measures to reopen economies and incremental improvement in corporate results and outlooks give rise to hope that the global economy could be back to levels similar to where it was just at the end of last year within 12-18 months.

What is clear from an investment perspective is that the Covid-19 pandemic has greatly accelerated many of the changes and disruptive forces that have been occurring.

That is why it is more important than ever to invest in companies that offer the stringent quality we look for, with strong and sustainable competitive positions in good and growing industries, with managements with a track record of value creation and balance sheets so strong the can weather any kind of adversity.

Whether it is the inexorable shift from offline to online in so many businesses, the need for greater investment in healthcare capacity and capability, the required investment in fixed and communication infrastructure, or the increased importance of ESG issues, corporate responsibility and sustainability for companies and their customers, clients and consumers, the Covid-19 pandemic is a catalyst for profound changes that offer great opportunities for some industries and companies and terrible risks for others.

Our investment has provided an overview of some of these impacts and a discussion of the risk, resilience and opportunities we see in key industries and companies we invest in.

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Big is beautiful again in Consumer Staples

The covid-19 pandemic has touched all aspects of our lives. Some of the most memorable scenes from the crisis have been the queues outside supermarkets as people tried to fill up their pantry ahead of the expected lockdowns amidst concerns over food supplies.

In recent years, the death of big brands has been heralded as innovative new start-ups have infringed on their historic dominance, capturing the consumer's imagination and taking advantage of the share of voice advantage that social media has offered.

But in these times of crisis, the pendulum has swung rapidly in the other way. Large food & beverage players, including our own long-term holding *Nestlé*, have stepped up to secure supermarket shelves remain filled. The challenges have been immense: maintaining access to raw materials, having the ability to secure supply chain routes for procurement and distribution, keeping production lines running whilst complying with new safety rules, have all required a depth of operational expertise and access to resources that mean these global players stand on a league of their own.

At the same time, recognising the social imperative of maintaining the commitment to long-term customers and suppliers has meant stepping up and providing a lifeline to badly hit groups, like dairy farmers and out of home food service providers, taking deliveries of fresh dairy products converting it to milk powder and providing where needed free products and extended payment terms.

Similarly pivoting to alternative distribution channels has been critical in maintaining access to consumers. Nestlé has over 700 Nespresso boutiques globally, yet as 98% were forced to shut down as a result of lockdowns, the company was able to keep its direct online platforms open, meaning lost volumes were offset as online sales shot up 60%.

Of course, maintaining innovation efforts and having the ability to fund those remains critical. Perhaps counterintuitively premium categories continued to do well, perhaps as consumer offset bulk buying in some categories with more indulgent purchases in others. In Nestlé's case, the recently launched Starbucks coffee products booked another CHF 150m in incremental sales during the first quarter, making it an over CHF 450m business since launch. This combined ability to invest in new distribution channels and maintain a rich innovation pipeline will be critical in this battle for market share as the world emerges from the lockdowns.

At the same time, the collapse in equity markets has opened up opportunities for strong companies with solid balance sheets. Smaller, local or regional players are facing immense challenges in meeting the higher costs that the pandemic has given rise to, whilst losing precious shelf space at retailers, who have focused on their biggest suppliers that can guarantee product availability. Inevitably this will push some of them in the hands of bigger competitors. For those companies, with the balance sheet flexibility, this will be a time of rich pickings.

Agility and a pivot to new opportunities for Industrial leaders

In the Industrial space, Covid-19 has led to huge dislocations. Key production hubs like China went abruptly into lockdown only to be followed by the rest of the world. Factories and construction sites across the world came to a standstill, logistic chains were severely disrupted, and planes were grounded.

This has placed significant challenges for industrial companies. The disruption in supply chains has required swift action. One of our holdings, *Honeywell*, the leading industrial technology and software provider, has over 18,000 suppliers globally. The company moved rapidly to set up a task force to monitor input disruption and keep access to raw materials and logistical chains open. And despite disruptions and staffing constraints, it is a testament to the company's operational excellence that over 90% of its facilities are fully functional, providing customers with access to what is deemed to be "essential and critical" services across jurisdictions. At the same time, as demand for key markets like aerospace and oil & gas has been severely affected, our companies moved fast to take discretionary costs out of the system, whilst maintaining growth investments, leveraging their well-honed playbooks in that regard. This is one of the cornerstones of our approach when we invest in industrial companies: structural growth opportunities balanced with proven operational track records to manage the business through the cycle.

At the same time, new opportunities are emerging. As the leading provider of PPE equipment, Honeywell moved quickly to add manufacturing capacity for N95 masks taking production capacity to 20 million per month and creating 1,000 jobs in the process. At the same time, the company has rapidly pivoted to capture new areas of demand, including healthcare, PPE, cybersecurity, healthy buildings, supply chain analytics and in airline passenger safety. This reflects Honeywell's deeply embedded proactive and entrepreneurial culture.

In fact, as we look forward in how the world emerges from this crisis higher demand for industrial verticals like factory and warehouse automation, network communications amidst increased bandwidth requirements, new ways of travelling, and medical applications will all provide opportunities for names in the industrial space. This is one of the reasons, we added *Amphenol*, a leading player in connectors and sensors during the month and a structural play in the "electrification of everything". A consolidator in its industry, with a flexible operating model based on over 100 operating units targeting specific market segments, the company is a hidden gem in the industrial space, providing high specification bespoke solutions to its customers across the industrial, IT, medical, military, broadband and mobile networks markets.

And like in other sectors, balance sheet strength and scale provide not only a cushion but also an opportunity in times of crisis. It is no coincidence that our holdings mentioned M&A as an area of focus in the current environment. As smaller competitors come under pressure amidst both supply and demand challenges, players with financial flexibility will move in to take advantage of depressed valuations to strengthen their competitive position and broaden their competitive moat.

Katerina Kosmopoulou, CFA

Resilience and Resurgence in Healthcare

Source: Author's private collection

Last weekend, on my daily exercise trip to a local park I saw a tree growing horizontally living on less than 20% of its roots. Presumably, the tree was hit hard by a storm some years ago, but it managed to re-root itself and grew to its current monumental beauty.

As the SARS-CoV-2 has spread across the world with the lockdown imposed by various governments trying to contain the virus, the situation may have seemed desperate at times. Like this amazing tree, our healthcare companies in the World Stars portfolio are adapting to this new environment and are facing up to this enormous challenge.

Source: Abbott -ID Now Point of Care Instrument

From very early on in the outbreak of COVID-19, companies like *Roche* and *Abbott*, who both belong to the big four diagnostics companies in the world, started to work on diagnostics tests for SARS-CoV-2. Abbott assembled four R&D teams, each going after one of the four different tests, with four shots on the goal.

All four tests are needed, each targeting a different proposition. The laboratory-based test runs on Abbott's m2000 RealTime System, is high throughput, but the turnaround time is longer as samples need to be collected, sent to the lab to be tested and results disseminated. The second test is done at the point of care which runs on Abbott's ID Now instrument. The instrument is the size of a toaster, allows portability and is better suited in doctors' offices and emergency care units. A positive result can be delivered in just five minutes.

Abbott also launched a serology test to detect the presence of antibodies (IgG) in the blood for people who have already been infected by the virus. These tests run on Abbott's laboratory-based immunoassay instruments ARCHITECT i1000SR and i2000SR with a speed up to 100-200 tests an hour. The fourth test is also a serology test and is expected to be on the market shortly. The test measures a different type of antibody, IgM, which is the first antibody the body makes to fight infections. The combination of the two serology tests should give us an idea who has already had COVID-19 and thus has potential immunity to the coronavirus.

Roche's approach to combat SARS-Cov-2 has two elements. On the diagnostics side, similar to Abbott, the company has developed high throughput COVID-19 tests as well as serology tests. Both run on Roche's existing installed instruments, cobas 6800 and cobas 8800. In pharmaceuticals, repurposing existing drugs already on the market to fight COVID-19 is another approach to leapfrog the lengthy drug development process. Roche's Actemra, an IL-6 rheumatoid arthritis drug, has been used off-label to fight COVID-19 in both China and Italy and it is believed to dampen the cytokine storm (an over-reaction of the body's immune system) in COVID-19 patients. The company is conducting a randomised, double-blind, placebo-controlled Phase III clinical trial to test its safety and efficacy in patients with severe COVID-19 pneumonia. The clinical trial is expected to readout in early June. Roche has been working 24/7 to ramp up production of Actemra. Millions of doses have been produced and shipped across the world to whoever requested it.

Source: Medtronic PH980 Ventilator

There has been a huge supply shortage of ventilators across the world. *Medtronic* is one of the major suppliers of ventilators. Since the COVID-19 outbreak, Medtronic has increased its ventilator production by five-fold at its manufacturing site which produces a very sophisticated model Puritan BennettTM 980 (PB980) and a much simpler model NEWPORT™ 70 (HT70). In addition, the company has publicly posted design specifications such as hardware, manufacturing instructions and ventilator-design documents for an earlier version of ventilator Puritan BennettTM 560 (PB560). This allows innovators, inventors, start-ups, and academic institutions to leverage their own expertise and resources to evaluate options for rapid ventilator manufacturing. To date, the company has received more than 90,000 requests.

Whilst the healthcare industry is developing solutions to combat COVID-19, the outbreak has also posed certain challenges. Some are significant for our companies in the short term. Elective surgeries, treatments for many health conditions that are non-life threatening or do not require urgent treatment, have been postponed as hospitals and healthcare systems focus on fighting COVID-19. Operating rooms and regular post-surgery recovery wards have temporarily been converted to COVID-19 intensive care units. Surgeons from various disciplines have been re-directed to treat COVID-19 patients. Surgeries, unless they are absolutely essential, such as heart failures, have been delayed.

Source: Medtronic HT70 Ventilator

Several of our medical devices companies have been impacted to varying degrees as a result of this. In addition, routine check-ups and non-essential doctor/hospital visits have been cancelled either by healthcare providers as resources are re-directed to COVID-19 or by patients who fear of catching the virus from such a visit. All of our World Star companies in the medical devices space have withdrawn their 2020 full year guidance as they wait for more clarity on the duration of the lockdown and speed of the recovery in non-essential and elective surgeries.

Our recent conversations with many doctors in the US revealed that elective surgeries are the most profitable part of the operations for US hospitals. Delays and cancellations of non-essential and elective surgeries have put a huge dent in the budgets of all hospitals. As the peak of the outbreak passes and the economy re-opens, hospitals will need to rebuild their balance sheets and surgeons will need to earn a living. Both the hospital management and surgeons are highly motivated to bring surgeries back to the operating theatre. The US government is also acutely aware of the urgent need to bring back elective surgeries for the hospitals. The Centres for Medicare & Medicaid Services (CMS) and American College of Surgeons have both issued roadmaps on the resumption of elective surgeries after COVID-19 pandemic. Elective surgeries need to be carried out in a safe environment to prevent infections to surgical staff as well as to patients. However, a certain slack in the hospital system, such as ICU beds and PPE supplies, needs to be maintained for COVID-19 in case of a sudden outbreak. Some suggest a dual track system, a 'clean' track (non-COVID-19) and a 'dirty' track (COVID-19) built within hospitals or designating certain hospitals as 'clean' and others as 'dirty'. Every hospital is drawing up its own plans and strategies to resume surgeries. Some hospitals have already contacted patients and are conducting virtual consultations in preparations for the re-opening. We anticipate the speed of resumption of surgeries depends on the nature of diseases and the urgency of the treatment as well as the severity of COVID-19 outbreak at each locality. A heart condition may tolerate a few weeks but not months of wait. On the other hand, a hip replacement could be delayed for a much longer period. Our medical devices companies tend to be positioned in the middle to more urgent part of the spectrum, and therefore are likely to recover a bit sooner in varying degrees.

In pharmaceuticals, clinical trials starts and regulatory reviews may be delayed from the difficulties of recruiting patients in the former and of making site visits and inspections by the regulators in the latter from the lockdown, travel ban and social distancing measures. In chronic therapy settings, the recruitment of new patients into newly launched therapy may also be slowed as patients avoid doctors' visits and stick to the existing therapy. Where the administration of a drug is done by a doctor/nurse at a medical centre, patients may choose to miss or delay a dose for non-life-threatening conditions, again in fear of getting the virus. Some ongoing clinical trials for chronic conditions may also have the same issue of patients missing doses. The industry is working closely with the regulators to protect the integrity of these trials. However, the impact on our World Star holdings, in particular Roche, is relatively limited. Indeed, at the first quarter results, the company has reconfirmed its 2020 full year outlook published in January before the COVID-19 outbreak.

In conclusion, the impact on our healthcare holdings, largely medical devices companies, in the World Star portfolio will result in a decline in sales and profits in the short term. However, we believe the demand, though delayed, by and large, has not been lost. Just like that amazing tree, our companies are resilient, have strong balance sheets to weather this storm and are well-positioned to come through this crisis even stronger than before

Zhixin Shu, CFA

Acceleration of Technological Disruption

One of our pithier observations during the COVID-19 pandemic was that 2020 was meant to be the year of self-driving cars, and instead we are all stuck indoors washing our hands.

Indeed, we wrote last year about the prospect of self-driving cars and whilst this may take a little while longer to come to fruition, other technology trends have seen accelerated adoption during the pandemic, and we believe will continue afterwards.

There has been a marked increase in communication through video calls with Zoom, Houseparty, WhatsApp and FaceTime all becoming much more popular. *Facebook* has noted that their platform has had a significant increase in usage during the pandemic and we believe that this reinforces Facebook's user proposition. In these unprecedented times, communicating with loved ones is especially important and being able to do so for free even more so. Additionally, it was rare to hold business meetings on Zoom, but we believe that after the pandemic ends it will be much more commonplace. There could be a marked reduction in global business travel expense but a consequent increase in cloud infrastructure spend as remote working becomes more common. As such, the large cloud infrastructure companies enabling this, Amazon AWS, Microsoft Azure and Google Cloud Platform should all see an increase in usage and spend.

The lockdown has also meant that people have had to find their entertainment from indoors. Especially with no professional sports being played, streaming entertainment such as Netflix or Disney+ or playing video games has increased greatly. *Activision Blizzard's* Call of Duty Warzone reached 50 million players in its first month of launch from mid-March. As video games are interactive and are a low-cost form of entertainment, we believe that they will continue to increase in popularity to the detriment of cinema and linear TV. Particularly, as cinemas are closed and will need to introduce social distancing measures, film studios will most likely launch their latest blockbusters straight to streaming and so accelerate the decline.

Lastly, with shops shut it has meant that e-commerce has surged in usage. It was almost impossible to have an online supermarket delivery slot in London at the start of the lockdown as everyone flooded online. Amazon has also had to prioritise essential items for delivery too as it is overwhelmed by the demand. The company has hired an extra 175,000 workers as it deals with a holiday season type of surge. We forecast that the demand for e-commerce will grow significantly as people recognise the utility of being able to order online rather than visiting shops. It will place greater importance on the logistics network which incidentally, Amazon invested greatly into last year for their 1-day Prime service. We forecast that e-commerce penetration will grow further from the current 12% of retail sales in USA

Giles Tulloch

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