

# CAMmunique

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE



JUNE 2020

## The investment road ahead looks promising but is likely to be bumpy as economies exit lockdown

The investment landscape has certainly changed since the beginning of the year. The global economy was growing at-trend-growth and corporate profits were expected to grow between 6% and 10%. That all changed when governments around the world decided to shut down their economies by restricting people's movements to curb the spread of the highly infectious and deadly SARS-CoV-2 virus. A 1-in-100-year event, a black swan. Even in wartimes, economic activity was not shut, but redirected. It is estimated that economic activity fell to between 20% and 40% of normal activity. This exogenous shock caused the global economy to come to a sudden halt in March and April.

The policy response to the crisis from governments and central banks has been unprecedented

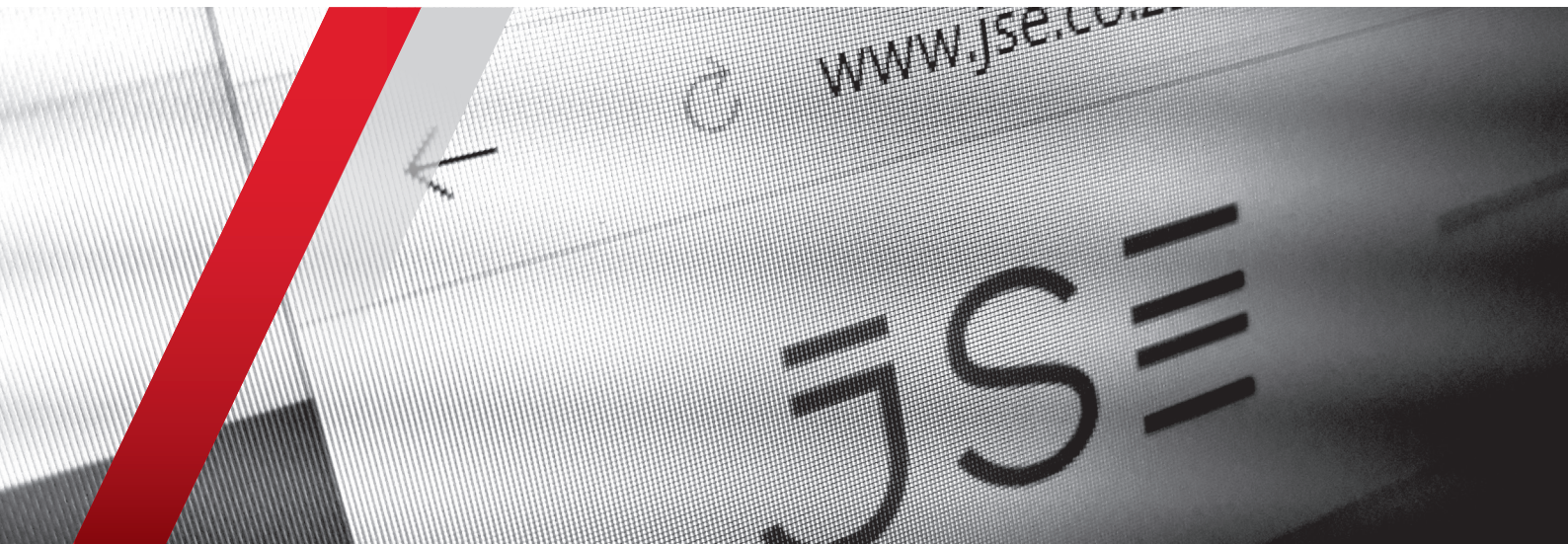
- Governments around the world have increased their fiscal spend and relief measures by as much as 10% of GDP to help households and businesses overcome this crisis. This has come in the form of social grant handouts, tax payment holidays, loans, and other relief measures. They have also directed funds to the healthcare sector to provide necessary support and protection for patients and healthcare professionals.
- Central banks have relaxed financial regulations, dramatically cut their interest rates, and provided liquidity to financial institutions and corporates. This has provided debt relief and payment holidays to corporates so that they can pay employees and fund their businesses.

### WE EXPECT THE US AND CHINA TO LEAD THE GLOBAL ECONOMIC RECOVERY

Lockdown measures have certainly been effective in controlling the spread of the pandemic; however, the economic cost has been severe, and much is still unknown. The US Federal Reserve (US Fed) Governor Jerome Powell is concerned that permanent damage has happened in many sectors of the economy and many jobs will be permanently lost. These concerns are shared by other countries too.

As economies exit lockdown and the global economy normalizes, the level of GDP output experienced before the crisis is only expected to be achieved in late 2021-2022. Countries that can provide more policy support are likely to recover faster than others.

- China was first-in and first-out of this pandemic and is leading the recovery. Industrial activity and exports are close to normal levels, although Chinese consumption is lagging. The demand from the rest-of-the-world for Chinese goods and services is also lagging. This return to normal has been well supported by targeted fiscal spend and increased liquidity and credit to businesses. The Chinese authorities have stated that their focus for 2020 is to see the labour market return to more normal levels.
- The US Fed has already provided more than \$3 trillion dollars of liquidity to financial institutions. They have also guided interest rates to remain at the historical low of 0.25% until 2022. To ensure markets have sufficient liquidity and are well-functioning, the Fed will for the time being continue their asset purchase program. The US government is contemplating additional fiscal stimulus to support the economic recovery. »



## THE SOUTH AFRICAN ECONOMY IS LIKELY TO TAKE A LOT LONGER TO RECOVER TO PRE-CRISIS LEVELS

The South African economy was at stall speed before the COVID-19 crisis, with high debt-to-GDP levels, highly indebted SOEs, unstable electricity supply, high unemployment, and low productivity gains. Business and consumer confidence were low. The COVID-19 pandemic has only made these structural concerns worse.

Minister of Finance Tito Mboweni plans to unveil a new and revised budget for 2020 on 24 June and has indicated that the COVID-19 crisis has forced government to urgently reform and rethink how they go about executing their growth initiatives. Government has indicated their intention for the state to play a central role in leading the economic recovery. However, government's track record of allocating capital to productive use and effectively and efficiently implementing those initiatives has not been exemplary in the past, and our concern is that this persists in the future.

## THE INVESTMENT OPPORTUNITY FOR GREAT GAINS HAS INCREASED, BUT THERE ARE RISKS

The extent of the economic damage is not yet fully known. Certain sectors have been affected more than others. Tourism, entertainment, hospitality, and other discretionary sectors have been hardest hit, while the technology sector has benefitted. Sectors like healthcare and food have been defensive during this crisis. Investing in businesses that can demonstrate their resilience and grow earnings will provide investors with excellent returns.

However, these businesses face several risks to a greater or lesser extent. These include

1. A "second wave" of infections,
2. Permanent damage to the economy and/or the economic recovery takes longer than expected, and
3. Political and geopolitical risks increase, changing the investment landscape.

### **1 The risk of a "second wave" of infection causing the global economy to return to lockdown**

As economies return to normal activity levels, we expect the infection rate to increase. However, we believe the risk of a "second wave" of infection which causes economies to return to severe lockdown measures is low, for the following reasons:

- The global community understands the virus a lot better than it did at the beginning of the year, particularly who are most vulnerable and affected by the virus.
- People's social behaviour has changed, with increased social distancing, wearing of masks, and washing of hands. This should help reduce the spread of the virus.
- Global and local travel restrictions are likely to remain in place for some time. This should reduce the spread of the virus and limit the problem to local regions or cities, allowing other regions or cities to remain economically active.
- Governments have boosted their Healthcare sector to better deal with the virus. If the healthcare system was to come under significant strain that was sustained, then it is possible that governments impose further lockdown measures.
- Many people's livelihoods have been lost, presenting new humanitarian concerns for governments to manage.
- Various economies like Sweden chose not to shut their economies and have not experienced significantly worse infection rates. »

## 2 The risk of permanent damage to the economy and/or the economic recovery takes longer than expected

This risk is real and needs to be carefully monitored as economic data and businesses report. The recession is expected to be worse than the Great Financial Crisis of 2008, and so is expected to take longer to recover, only reaching pre-crisis levels by late 2021-2022. Some areas of the economy are likely to be permanently affected as the coronavirus pandemic has changed people's behaviour. Some of the changes include:

- Accelerated the trend towards on-line business activity. This is a structural headwind for several businesses that rely on people visiting shopping centers, eating out at restaurants, buying in-store. Business travel is likely to be reduced in favour of online meetings, affecting air travel and accommodation. Cloud computing services becomes important as people work from home.
- Working from home as an option for individuals (and companies) causing people to invest in their home environment.
- Increased health consciousness, boosting the health and wellness industry.

These behavioural changes will affect businesses differently either strengthening or weakening their investment case. Businesses that struggle to adapt or innovate are not likely to survive.

## 3 Political and geopolitical risks increase

The way US President Trump has managed the COVID-19 crisis has been questioned by many and could see him and the Republicans lose the US Presidential elections in November. This could cause policy changes such as increased corporate taxes (which Trump had lowered), adversely affecting corporate profits.

US-China relations have soured over the spread of the COVID-19 pandemic, as various allegations have been leveled at China's handling of the pandemic that originated in China. Tensions were already high over trade and China's ambition to compete in 5G technology, Artificial Intelligence, and biotechnology. These political and trade tensions have increased policy uncertainty, disrupted global supply chains, and increased import duties and costs to businesses. These tensions between the two superpowers of the world are changing the investment landscape for investors.

## THE PATIENT INVESTOR SHOULD BE HANDSOMELY REWARDED

With increased uncertainty, global markets are likely to be volatile near term, however for the patient investor there is an excellent opportunity to be handsomely rewarded over the medium to long-term. Understanding the risk-return tradeoff of each business is crucial in making an informed investment decision. Each business should be carefully monitored to ensure the investment case remains intact. Following this disciplined process and holding a diversified portfolio of quality businesses both locally and offshore, should compound our clients' wealth overtime. •

# Booking Holdings

## An opportunity to own part of the world's leading online travel agency

### **BOOKING HOLDINGS IS AN ONLINE TRAVEL AGENCY WITH A PLATFORM BUSINESS MODEL**

The Group provides online travel & related services to consumers and local partners in over 230 countries through six primary brands: Booking.com, KAYAK, priceline.com, agoda.com, Rentalcars.com, and OpenTable.

The Group operates a platform business model, which tends to be capital light in nature (i.e. they do not own any of the properties, and carry no inventory). Through their platform, Booking Holdings connects consumers (demand) and travel service providers (supply), and earns a commission for facilitating transactions between the two. Through one or more of their brands, consumers can: book a broad array of accommodations (including hotels, motels, resorts, homes, apartments, bed and breakfasts, hostels and other properties); make a car rental reservation or arrange for an airport taxi; make a dinner reservation; or book a cruise, flight, vacation package, tour or activity. Approximately 87% of Booking Holdings revenue is generated by charging commissions for facilitating travel reservations.

Consumers can also use the Group's meta-search services to easily compare travel reservation information, such as airline ticket or hotel reservation, from other online travel platforms. The Group also offers various other services, such as certain insurance products to consumers and restaurant management services to restaurants.

### **BOOKING HOLDINGS IS A GOOD BUSINESS BENEFITING FROM STRONG NETWORK EFFECTS**

As a platform business model, most of the investment will be upfront creating the platform, including high marketing spend to attract both consumers and suppliers, with the goal of creating a strong network effect. A network effect is a very powerful competitive advantage - Booking Holdings has built more partnerships with hotels, motels, and other accommodations etc., compared to their competitors, and therefore offer consumers greater choice. As this greater choice attracts more consumers, so it will attract more travel service providers, which in turn will attract even more consumers, resulting in a positive feedback loop, with every new user increasing the value of the network.

This enables the business to grow earnings and cash flows with very little incremental capital being deployed. This results in a capital light business model that earns very high returns on capital, and generates large amounts of free cash flow (FCF) that can be used for acquisitions or returned to shareholders. The Group has an excellent track record in converting profits to cash with a FCF margin of 31%, while the free cash flow to net income ratio has averaged over 100% over the past decade.

### **WHAT ABOUT THE CORONAVIRUS?**

The travel industry is no doubt feeling the pain from the coronavirus and may take some time until people feel comfortable to travel again. This will obviously impact revenues and cash generation for a company like Booking Holdings in the short term, but the Group had a strong balance sheet heading into the pandemic, and have taken further measures to boost liquidity.

The Group will also be able cut back on expenses during this time, as they benefit from a highly variable cost structure that naturally declines in periods of low travel demand (their largest expense is performance marketing i.e. the advertising costs they pay to the likes of Google).

Over the medium-to-long term, we don't believe that the coronavirus will have changed people's desire to travel, go on family vacations, visit new countries etc., and we think that Booking Holdings, as the industry leader, is best positioned to steal market share as smaller competitors exit the industry. There are already signs that domestic travel is picking up, while international travel is still constrained due to travel restrictions. As with previous recessions, hotels and other accommodation providers will be struggling with low occupancy rates, and will turn to Booking Holdings to drive volumes as demand recovers. »

## VOLATILITY CREATES OPPORTUNITY

During the global market crash in March, the share price dropped as low as \$1 152 per share as investors overreacted to the pandemic. We were able to take advantage of this opportunity and added to our position. The share price has subsequently recovered somewhat, and is now trading around \$1 800 per share. We continue to believe that Booking Holdings has attractive long term prospects, and our clients should benefit from owning this compounder over time. •