Principal Global Equities

Structural change implications of the Coronavirus experience

May 2020

"The times they are a changing"

-Bob Dylan

As we sit here in the spring of 2020, looking out on our respective neighborhoods from our home offices, we're well underway into another seasonal change. But unlike any previous spring season, 2020 has swamped us with unthinkable change. For far too many, this spring has brought dire economic and employment conditions. For others, the pandemic has resulted in greater appreciation of those essential workers on the front lines. Without a doubt, this season of change has resulted in the emergence of a new definition of "hero" - our healthcare workers and those in public service, who have exhibited extraordinary acts of compassion and bravery while battling the COVID-19 public health crisis.

A reasonable definition of change is: "The end result is very different or completely different from what we started with." Given our current experience with the pandemic, this notion has probably crept into everyone's minds recently. The inspiration of change has been a hallmark of Principal Global Equities' investment approach for nearly two decades. Change has been the driving force behind our philosophy of seeking out businesses that are becoming better. Even during these unsettling times of the pandemic, our investment research efforts remain disciplined as we evaluate how the pandemic-driven change will result in longer-term "new normal" trends and changes to business models.

We believe the next couple of years will mark an environment where active, fundamental stock pickers will have the opportunity to add substantial value to client portfolios. We're looking beyond the headlines and asking ourselves not only what is changing near-term, but what the longer-term result of change will be and how that can translate into sustainable investment opportunities.

Potential legacies of the pandemic

As a team, our research analysts dissected each industry to identify where investment opportunities exist and will evolve in the future. In some cases, changes which were already underway, such as increasing ecommerce, will accelerate. Elsewhere, we will see some trends slow, or even reverse. Undoubtedly, technological advances and expansion of communication services such as 5G will continue to have a dramatic impact across all industries. We'll save the topic of the impact of technology for another discussion and today focus on recapping a few of the trends across sectors our team has been discussing since the emergence of COVID-19. Of course, the following is just the tip of the iceberg. Throughout the rest of 2020, we'll dive deeper and share our views on the potentially unintended consequences of actions taken to combat COVID-19 and the resulting investment opportunities across the globe.

New or emerging trends	Accelerating trends	Slow or reversing trends
-Healthcare -Work from home -Supply chain management	-Consumption and ecommerce -Manufacturing automation -Renewable energy capital spending	-Globalization -Travel

New or emerging trends

Healthcare

- Overall, healthcare spending is likely to increase – more emphasis on diagnostic testing capacity, disease prevention, and investments in hospital infrastructure.
- Telemedicine – the pandemic has shifted many non-emergency healthcare visits to digital visits. We expect adoption to continue with high rates of patient retention on telehealth platforms.
- Shift in procedures to outpatient settings – data suggests similar outcomes for certain procedures in an inpatient or outpatient setting with lower cost of care in outpatient facilities. We expect the pandemic to accelerate that shift as patients avoid seeking care in healthcare settings that present potential COVID-19 infection risk, if possible.
- Home health – patients and payers are likely to push for healthcare to be delivered in the home. An already ongoing trend, we expect this to be accentuated by patients in need of care but wanting to avoid healthcare settings that may be treating COVID-19 patients as well.
- Clinical trials will contain increased reliance on data, digital technologies, and virtual/remote patient monitoring. Pharmaceutical companies have historically been risk-averse, but regulators will increase protocol flexibility to allow new, innovative approaches to trial conduct that should benefit patients, physicians, and pharmaceutical companies in general.

Work from home (WFH)

- Working from home will become less the exception. The pandemic has shown how productivity in many cases is no lower than working in the office. We have access to technologies which make working from home as effective as from an office. We expect WFH will become part of many office workers' new normal.
- More focus on the home in general as people spend more time there - there will be a greater need for high quality, fast broadband, higher quality electronics and in-home entertainment. We expect a greater emphasis on home renovations.
- Online education – with the unknown of future virus flare ups, online educational providers will continue to experience stronger demand.

Supply chain management

- On-shoring – companies will look to secure supply chains and rely less heavily on just-in-time manufacturing.
- Less reliance on specific countries for manufacturing and supply chain needs - we expect to see increased diversification in the number of suppliers across industries.

Potential investment opportunities: WFH software and hardware providers, cloud computing, and home entertainment. European leaders in pharmaceuticals infectious disease research and development, healthcare med/tech equipment manufacturers. Telemedicine providers and home healthcare providers will continue to emerge.

Accelerating trends

Consumption and ecommerce

- Retailing – COVID-19 has pushed many into online transactions and they like it. SARS in 2002/2003 resulted in a much faster adoption in ecommerce in Asia than elsewhere. Online transactions account for approximately 23% of retail in China, 20% in the UK, 12% in the U.S., and only 6% in Germany.
- E-payments will gradually replace a greater percentage of cash payments as consumers will want to utilize no-touch transactions and less hard cash.
- Home improvement and renovation – both home improvement retailers and service providers tend to weather economic downturns better than discretionary retail or new home construction. With more people spending more time within their homes, including work from home, previously neglected projects take on added urgency while wear and tear increases as well.

Manufacturing automation

- Less dependence on working together and lowering labor costs - robot and cobot penetration will rise. Robot density per 10,000 manufacturing workers: China 140, U.S. 217, Japan 337, Germany 338, South Korea 774.
- Warehouse automation will rise. Only 10% of warehouses currently have a high degree of automation. Sources believe this will increase to 65% as a result of increasing growth in the ecommerce industry.
- Further acceleration of digitalization and 5G implementation, which has may benefits, including: tracking elements in a supply chain, predicting maintenance needs, and advancement in keeping the workforce safe.
- Factories may be just as economical to run if fully automated, due to less expensive labor.
- Automation not only lowers labor costs but contributes to safer workplaces.

Renewable energy capital spending

- The pandemic, coupled with geo-political issues, has resulted in extreme depression and volatility of oil prices. If a lower for longer mentality develops, it may disrupt capital spending plans for large integrated oil companies which could accelerate green initiatives.
- Renewable energy and power project returns will be more competitive with fossil fuel projects.
- Energy companies will see a significant reduction in total cash flow available for projects. So, while renewables may increase their slice of the pie within large integrated oil companies, the pie may shrink.

Potential investment opportunities: Global, Latin American, and Chinese digital storefront enablers, global payment processors, suppliers of manufacturing equipment to build out new supply chain, German automation equipment manufacturers, semi-conductors focused on data center providers, Japanese gaming console providers, and U.S. and European home improvement retailers.

Slowing or reversing trends

Globalization

- We expect reliance on global supply chains to diminish, impacting manufacturing, healthcare, and food supply management.
- The re-emergence of trade war conflicts could accelerate and deepen de-globalization trends.

Travel

- Pre COVID-19, the number of air travelers was forecasted to grow by 4.6% annually over the next 20 years according to Statista. This growth will slow as social distancing becomes more prevalent; IATA survey says 12% of people will take more than one year to travel.
- Business travel has undoubtedly hit a lull as Zoom and Microsoft Teams comes of age and are accepted as the norm. We expect less business travel as workers determine they can be just as productive attending some meetings virtually.

Summary

We've touched on just a few of the significant trends that COVID-19 has introduced this spring. We've all discovered the COVID-19 virus has effected massive change, some of which will structurally alter companies and entire industries. The challenge our team continues to embrace is determining which businesses will look different than they did at the start of the year as we move through 2020 and into 2021. We'll continue to focus our fundamental research and stock picking on businesses that are becoming better over time. We believe this focus will allow us to deliver strong, durable results for our clients. We look forward to the day where we can sit down with our clients and business partners face to face to discuss our research views. Until that time, we're happy to visit with you via Zoom or Microsoft Teams to share our insights.

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