



Digital Payments and Aerospace—Diverse Growth Opportunities

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New-economy digital business models proved resilient and defensive amid the pandemic-induced collapse in economic activity, and this widening performance differential is particularly interesting to us as investors in industry-leading growth companies. We are also interested in some of the more compelling structural growth companies in cyclical industries that have been particularly affected by the economic slowdown.

Recovery Accelerates

Following the peak of the pandemic and related lockdowns, economic activity accelerated strongly in June in China, Europe, and the United States, including both manufacturing and services.

Our preferred supply side indicator—orders in excess of inventories—registered double-digit improvement in the euro area and is already back to positive territory in the United States. Crucially, a rebound in new orders drove the improvement.

Unprecedented fiscal support, combined with healthy corporate and household balance sheets at the start of the pandemic-induced recession, points to a continued strong sequential recovery, although we do not expect either gross domestic product (GDP) or corporate profits to recover to pre-pandemic levels this year.

China, Europe, and the United States followed somewhat different approaches to containing the spread of the virus. These differences may affect the trajectory and speed of the recovery in each of these major global demand

centers, with the United States lagging and likely to continue to fall behind given the resurgence of cases.

From a corporate performance perspective, new-economy digital business models proved more defensive and resilient amid the pandemic-induced collapse in economic activity.

While the majority of S&P 500 Index companies saw year-over-year revenue declines in excess of 10% during the first quarter, the fastest growers clocked up double-digit gains. This widening performance differential is particularly interesting to us as investors in industry leading growth companies.

While valuation multiples appear inflated due to depressed earnings, this is largely consistent with historical recovery environments.

Looking forward, however, successful containment of the virus, combined with improving prospects for an effective vaccine, are likely to pave the way for a broadening of market leadership to include more traditional cyclical companies as their earnings begin to stabilize and reaccelerate.

This will be the ultimate catalyst to see a style reversal in the market, where the valuation differentials of high-growth companies relative to all others will likely be compressed. We are monitoring this closely.

Electronic Payments

Given that backdrop and this period of high uncertainty, we are focused on understanding the durability of the competitive advantage of those digital business model winners, the nature of the acceleration of their growth, and how much of that future success is priced into the stocks. Electronic payments are a key focus area in that context.

The adoption of digital, electronic, and cashless payments is not a new story; it has been a decades-long phenomena, predating e-commerce.

But online shopping has been a massive catalyst, as have mobile penetration, availability of better and easier payment solutions, and evolving consumer habits/preferences—not to mention cleanliness.

All were in place long before COVID-19. Perhaps not surprisingly, we have material exposure to the payments industry, both direct and indirect, in most of our investment strategies.

Before this year, electronic payments growth and penetration had been steadily increasing, growing at about two times GDP in many major economies, including North America. McKinsey calculates that mobile transactions in China grew at a compound annual growth rate (CAGR) of 123% from 2013 to 2018.

During the pandemic-related closures, both consumers and merchants have increasingly adopted digital payments as they adjust to the realities of this new world. Mastercard reported “card-not-present” transactions as a percentage of total volumes in April moving from 40% last year to 50% this year. Visa reported that similar transactions were up 1,200 bps in April as well.

Interestingly, PayPal said there has not been a decline from elevated levels as economies have reopened, and it has also observed new demographics moving online. Worldline believes that COVID-19 is a “true accelerator” of cashless trends.

We have observed an acceleration in lower-penetration categories (such as grocery, pharmacy, and furniture) and an emergence in newer areas of the digital economy (such as education, healthcare, food delivery, gaming, and digital media). And the consumer experience is proving to be a positive one.

Payment practices have historically proved to be sticky, so we believe this step change will create a new baseline. In fact, we believe the electronic payments penetration growth story has accelerated by up to three or four years. Card payments growth could increase by an additional 100 bps per year.

While these stocks have performed well in the face of altered consumer behavior, we think this industry is the beneficiary of accelerating structural growth, and the stocks remain compelling.

Aerospace

In contrast to digital payments, the pandemic has cast a tremendous amount of uncertainty on the aerospace industry. While there may be limited visibility, many of these stocks remain quite depressed and may represent a significant valuation as well as growth opportunity when activity normalizes.

Air travel and aerospace manufacturing companies are good examples. Many of our portfolios have material exposure to the commercial aerospace industry because, in our view, consumer demand, company (and product) quality, and the industry structure have converged to be a very compelling long-term investment opportunity. There is certainly less cyclical to their sales and profits now than in previous decades.

Technological breakthroughs have changed the return profiles for the aerospace component manufacturers materially. The last 20 years have seen an industry transformation: planes now run much more efficiently and longer, not to mention more safely, and consolidation of the industry has also helped profit growth.

Many parts makers have shifted to consumption-based business models, and this combined with lower competition and disruption makes for highly visible cash flows.

On the demand side, growth of air travel has been an inexorable trend for decades. We still see very low penetration of air travel in most of the higher growth parts of the world, and aspirational consumption of travel is very real.

Thus, demand has steadily risen, while the cost per seat mile has declined in similar fashion. There remains a massive total addressable market (TAM) opportunity.

This growth has clearly been disrupted by the pandemic, with global air traffic during the second quarter bottoming at just 10% to 15% of the January 2020 level. We have observed this to be coincident with pandemic-related death rates.

Since then, China domestic travel has now recovered to 80% of prior peak levels, and Europe is likely to be there

by mid-July. The United States probably has more near-term uncertainty, but even Southwest Airlines has been planning for resuming 100% of its capacity by year-end.

There is some visibility into schedules and we believe that during the third quarter, global air traffic will be back to 40% to 50% of pre-existing capacity.

That is the near-term story, and it will not make much of a difference to the industry's financials or likely the stocks. We are focused here on the intermediate to long term.

Importantly, airlines around the world have not experienced many bankruptcies. They are better run, and in many cases have received government support, so we believe the risk to the manufacturers' customer base is low.

Thus, with some volatility expected, we believe the aerospace industry will recover to pre-COVID levels by 2022. Prices of these stocks, however, remain about 40% to 60% below their pre-COVID levels.

Final Thoughts

In this confusing period, visibility of growth is being bid up, while uncertainty is being punished. In reality, the actual stock risk/reward may be better where it is less visible. Twelve months from now, we would expect either the gap in actual growth or the gap in visibility of growth to narrow. This presents a very compelling opportunity.

As growth investors, the critical point of these two examples is that we strive to strike a balance between different types of growth in the portfolios such that we can deliver consistent performance through different economic backdrops and market environments.

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