

Coronavirus: A Huge Leap Towards the Future

In this issue of the Thinking Man, we continue to look at the consequences of the COVID-19 outbreak. We now center our analysis on the global secular trends that had started to emerge over the previous cycle, and on the long-lasting winners and losers that will likely emerge from the pandemic.

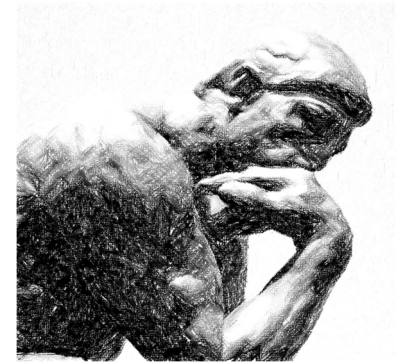
Crises are inevitable, but they always come to an end. We believe that this health-rooted crisis will not change the world as many analysts seem to argue; rather, we believe this *Great Global Virus Crisis* (GVC) or as the IMF calls it, the *Great Global Lockdown Crisis*, will super-accelerate the global secular trends that were already in place.

COVID-19 will also change the nature of the relationship between the state and the market, and what is known by “public goods”, mainly healthcare and education. Some of the main trends being accelerated, as well as the potential winners and losers, which we will expand on, include:

1. Private sector: big business takeover of small business
2. Big government takeover
3. Slowdown of Globalization
4. Credit deterioration accelerated – It’s all about the “balance sheet”
5. Some clear winners:
 - a. Personal & healthcare & medical supplies, equipment and services
 - b. E-commerce
 - c. Information and communications technology (ICT)¹
 - d. Telehealth
 - e. On-Line Education
6. Some clear losers:
 - a. Expensive higher-priced colleges, especially in the U.S. losing their luster

¹ An extensional term for information technology (IT) that stresses the role of unified communications and the integration of telecommunications and computers, as well as necessary enterprise software, middleware, storage, and audiovisual systems, that enable users to access, store, transmit, and manipulate information).

The Thinking Man’s Approach



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- The COVID-19 crisis is super-accelerating some global secular trends already in place.
- From a business perspective, these trends include the triumph of big businesses with strong balance sheets and profitability over smaller businesses.
- Companies’ survival will depend primarily on their balance sheets; the industry and the access to government aid are also relevant.
- From a macro perspective we will possibly undergo a big government takeover with increased regulation and intervention, as well as a slowdown in globalization.
- We identify and explain a variety of “winners” and “losers” defined by these trends.
- The big “winners” include sectors that have benefited from the pandemic, such as: healthcare and medical supplies & equipment, e-commerce, telehealth and on-line education.
- The big “losers” include higher education, commercial real estate, retail, travel, tourism, leisure and VC.

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- b. Commercial Real Estate (especially offices)
- c. Retail (especially small businesses with limited to no online/web activity and weak balance sheets)
- d. Aviation, cruise lines, tourism & leisure
- e. Agriculture & food processing
- f. Venture Capital (VC)

1. Private sector: big business takeover of small business

The strong companies will emerge stronger, as robust balance sheets and positioning allow them to take market share and improve profitability, while smaller and weaker rival companies will exit or are too cash-strapped to innovate. Globally, we are creating a further increase in corporate concentration and a new oligarchy of well-connected firms.

So far, the monetary and fiscal stimulus (aka “bazookas”) in the U.S. are equal to more than a quarter of the country’s Gross Domestic Product (GDP). In the U.S., where we had a 5% fiscal deficit before the start of the health-rooted crisis, the public and politicians consider this spending crucial to avert a deep recession. This spending will be financed through extremely cheap debt, and most will be handed directly to the public as unconventional monetary policy in what is commonly referred to as “helicopter money”. Coronavirus has rapidly brought the U.S. into a Japanification process. Specifically, U.S. Treasury rates in the range of 3 months to 20 year maturity have fallen between 0% and 1%. As the world slowly gets back to its feet, big firms are being helped by the Fed and are having better access to capital markets, giving them an additional competitive advantage over smaller firms.

2. Big government takeover

There is clearly a tug of war between the global economic pause and the unprecedented amount of policymakers’ stimuli. Global policymakers have opened their purses and pumped trillions of dollars into the economy — with more under consideration. Total stimuli year to date amounts to nearly \$8 trillion in the big western economies alone. The view on regulation is also changing. After a deregulation spree that bolstered the market in recent years, the pandemic could usher in a wave of regulation. That could include increasing safety measures at nursing homes after the spate of COVID-19 deaths at long-term care facilities, measures to better prepare the healthcare system, and efforts to further reduce dependence on China and other countries for strategic goods.

3. Slowdown of globalization

The pandemic has brought significant operational challenges, with companies unable to get crucial parts because of widespread disruption of global supply chains. Rising labor costs in China and the trade war, had already pushed companies to redesign supply chains towards a more regional or local source, and now, that will accelerate. Executives are now talking about regionalization and hubs to produce goods in



one area rather than globalization. As companies move more production back to North America, where the labor pool is older, we see a positive impact for companies in the automation, robotics, and digital-tool industries, which can make manufacturers more cost-efficient. In many ways, the pandemic could reverse globalization more than the trade war, if countries retreat inward and engage in a blame game, rather than collaborate to tackle an outbreak that doesn't abide by borders and affects their interlinked economies.

4. Credit deterioration accelerated – It's all about “balance sheet risk”

Today, we have companies that will eventually have significantly lower to no revenues. This will likely be the case for 2Q and 3Q of 2020. The English weekly magazine, The Economist, calls it the business of survival. Which companies survive will depend on their industry, their balance sheets and how easily they can tap government loans, guarantees and aid. Also, their capacity to tap into the capital markets is key. Thus, the importance of the strength of the balance sheet and their cash at hand.

Even our views on the shape of the recovery are seen through the lens of credit quality. While we believe the economy will have a U-shaped recovery, we expect “high grade” financial assets will have a V-shaped recovery, and “high yield” financial assets (especially the lower tiers) will have an L-shaped recovery. Where does this leave the stock market? As 90% of the S&P 500 market cap is “investment grade” (meaning bond ratings at BBB- or above), we think we'll see a V-shaped recovery.² The “unlimited” Quantitative Easing from the Fed has historically proven to be effective in the past. While we will certainly see market volatility for the next few months, we would not recommend going against the Fed this time either.

5.a. Personal healthcare & Medical supplies, equipment and services

The most immediate impact of this crisis will be felt by healthcare companies in our view. Investments will not only be made to come up with a COVID-19 vaccination, but also for antibody testing, as well as the need to increase the capacity of intensive care units with sufficient medical equipment. Funds will also be spent to ensure safety stocks of supplies, to research novel antibiotics, and to develop rapid response testing systems and kits that allow a better future outbreak response. We believe companies such as Regeneron, Gilead, Abbot Labs, Roche, Thermo Fisher and Danaher are all set to benefit from these inflows, as should biotechnology firms. Organizations that increase the efficiency of healthcare, like UnitedHealth, will also benefit from the increased spending and size in our opinion.

5.b. E-commerce

² A security has an investment grade rating if it has a rating that falls within the range of Aaa to Baa3 from rating agency, Moody's or AAA to BBB- for rating agency, Standard & Poor's. The company's securities have investment grade ratings if it has a strong capacity to meet its financial commitments.



The planet is having a crash course in e-commerce, digital payments and remote working. Now that many of us are confined to our homes, online shopping will continue to accelerate. People that prefer to shop for groceries in brick & mortar supermarkets, are now forced to consider online as an alternative. More retail shopping will transition to the virtual world, benefiting players such as Amazon (which hired 175,000 staff in the last month to cope with the virus rush) and Alibaba. Both stocks are outperforming the market and Amazon was trading at an all-time high as of the time of this writing. Both “kings” of e-commerce will come out of the GVC with more momentum than ever and with increased revenue streams thanks to their digital platforms. This should also further accelerate the shift from cash to electronic payments – even in physical retail, given the awareness of cash being a potential germ vector. Companies such as Visa and PayPal are well positioned to profit from this trend.

5.c. Information and communications technology

The pandemic has shaken people out of their routines and created new habits, as people are being forced to shop online for groceries. Older generations, not just teenagers, have taken to socializing online. People are working from home, and interacting with customers, business partners, and clients on a virtual basis, potentially revolutionizing the workplace. Zoom, an online videoconferencing service was serving 10 million customers a day at the beginning of 2020. Now it serves 200 million customers a day.

This creates more demand for the companies whose technology infrastructure helps create faster and more secure digital networks like 5G, wireless technology, cloud computing and cybersecurity. According to Swiss multinational private bank, Pictet, their portfolio manager on the thematic equities team, Gertjan Van Der Geer states: “Due to social distancing imperatives, an increasing number of staff now works from home. Companies have largely adopted it where possible. This creates demand for services and products that ensure the safety of networks, virtual private networks, network infrastructure, as well as cloud services.” Examples of firms well positioned in this field are Amazon, Microsoft, Cisco, and Alibaba. Cloud computing companies have been a clear beneficiary of the stay-at-home and social distancing measures to help combat the spread of the virus. For example, Forbes magazine reports that Microsoft has seen a 7 times increase in the use of its cloud services in areas with social distancing or shelter in place orders. Microsoft Teams now has more than 44 million daily users, and they generated over 900 million meeting and calling minutes.

5.d. Telehealth

People are not going to want to go to the Doctor or the hospital for a while, rather preferring a trend already in place: Telemedicine. In the healthcare industry, video chat and remote monitoring devices are being integrated with electronic medical records, cloud-based analytics platforms, and clinical workflow processes. According to PlushCare (a concierge online doctor service), in 2019, of the 600 million doctors' visits per year in USA, only 2% were virtual and only 0.2% of all medical claims were telehealth.



The first significant piece of Covid-19 legislation was just passed, greatly expanding telehealth reimbursement for in-home patient care. While it is a fractured industry of private players, Strategas Research Partners, for example, believe companies like Teladoc, UNH and Anthem should all benefit.

5.e. Online Education

Per the National Postsecondary Student Aid Study (NPSAS), the average tuition inflation rate in the U.S. from 1995 to 2018 was 7.4%, double the average CPI of 3.7%. Covid-19 brings a recession and thus less people that can afford off-line expensive private tuitions. Common sense and the experience during the lock-down are making parents think: "Can education be done on-line?" It's cheaper in the tuition, the housing and the food and saves time. It perhaps helps improve the moral fabric of our society and strengthen our family relationships.

6.a. High-Priced College Education

Before the outbreak, we were already experiencing a drop in the number of international applicants to American universities, given how much more expensive or unaffordable they had become. We were also seeing a cannibalization of expensive offline classes for online courses. Online education providers and "boot-camp" specialized courses, that are short and effective, were already prospering. It would appear that online education may just have a better return on investment for the student. However, COVID-19 "black swan" could potentially bring a crisis to educational institutions, revolutionizing traditional universities.

As our professional colleague, Professor Scott Galloway from NYU Stern Business School, states, "we'll see a sustained drop in applications at four-year universities. The myth/magic of campuses and geography is no longer a constraining factor".

According to Professor Scott Galloway, most programs will likely be hybrid soon, dramatically increasing enrollments among the best brands. Similar to other categories, he believes there will be a flight to quality and a concentration of power among a small number of brands. Further, he thinks big tech firms will partner with world-class universities. Galloway predicts that a theoretical MIT/Google program could enroll 100,000 students at \$100,000 in tuition, yielding \$5 billion a year in a two-year program. Partnerships like Bocconi/Apple, Carnegie Mellon/Amazon, UCLA/Netflix, Berkeley/Microsoft, to give some theoretical examples, could potentially occur.

In Galloway's opinion, Universities would dramatically increase their spending on technology and, in many cases, outsource entire programs. Education startups would also attract cheap capital and seize the



opportunity the pandemic has accelerated; the theoretical MIT/Google partnership could offer a two-year degree in STEM.³

6.b. Commercial Real Estate (CRE)

Chairman and CEO of Starwood Capital Group, Barry Sternlicht points out that retail is in the worst shape of all the sectors within CRE. Offices might be the second most problematic segment of this asset class, as companies reassess how much physical square footage they need, while swapping business travel for videoconferencing.

In residential, the sudden shutdown of vast parts of the U.S. economy is leaving landlords with less rental income, and many may default on their mortgages this month. Hospitality and hotels are suffering, but they should come back slowly, as suggested by trends in China at the moment. Hotels in China are running today at 30% occupancy rates, while factory production is running at 80-90% of capacity.

Commercial real estate prices in the U.S. have more than doubled over the past decade, according to Real Capital Analytics, leading many investors to believe the market offered few buying opportunities. However, many of these assets could soon hit the market as lenders and desperate landlords look to raise cash. Investment firms like Blackstone Group Inc., Brookfield Asset Management and Starwood Capital Group are sitting on billions of dollars in cash and capital commitments, raised in recent years from pension, and sovereign wealth funds, along with other big institutions. These firms see optimal distressed opportunities as the spread of the coronavirus pandemic has closed businesses across the country, in most cases leaving them unable to pay rent, and as a result, limiting their landlords' ability to pay their mortgage bills.

Despite the continuing uncertainty and economic destruction, the current environment presents the sort of circumstances that risk-taking property investors say can make a career. And while investors are in it for the profit, they also say their investments may help the market bounce back, stabilizing property prices. While we will most likely see price markdowns during the next few months, we are also seeing active fundraising. As the public markets are also recovering due to the Fed's speedy and massive intervention, it will be interesting to see the extent of the markdowns in the first half of 2020.

6.c. Retail

Most U.S. states have imposed lockdown measures restricting gathering and social contact, disrupting the lives of hundreds of millions of Americans and the operations of thousands of retail businesses. Retailers have furloughed hundreds of thousands of workers, cut executive pay and stopped paying rent, in an effort to conserve cash. For the most indebted retailers, particularly those already struggling before the start of the crisis, those measures may not be enough. A significant amount of debt will have to be

³ STEM is a curriculum based on the idea of educating students in four specific disciplines: science, technology, engineering and mathematics — in an interdisciplinary and applied approach.



refinanced across these companies, which are focusing on renegotiating loan terms. The retail industry was going through a shakeout before the coronavirus pandemic. As shoppers had migrated away from malls, buying from online retailers, specialty apparel and department stores were among the hardest hit. A record number of chains have filed for bankruptcy protection in recent years, and others have closed hundreds of stores. As the virus keeps American businesses temporarily closed, the struggling companies will only continue to weaken.

Stronger retailers with on and offline presence, strong balance sheets and omnichannel⁴ models will prevail, while mom and pop shops will continue to unfortunately perish. Amazon is in a position to come out stronger than ever, as are other giants like Walmart and Costco. Even a few large non-essential businesses like Nike should prevail. Reason being is that the sportswear giant has seen an early recovery in China, helped by keeping stores clean and contacting customers via its app to educate shoppers about fitness, and not just about selling them sneakers.

While the large and strong retailers are hiring hundreds of thousands of employees, they cannot fully mitigate the destruction of jobs in smaller retailers. Small businesses were the backbone of the U.S. economy, but this dynamic is changing fast.

6. d. Aviation, cruise lines, tourism & leisure

The travel industry will be hurt as companies swap business travel for videoconferencing. Further, hurting the industry is a likely shift in leisure travel, as people—including the Chinese who have recently made up the largest set of international travelers—choose to stay more local to avoid the hassles of travel restrictions or a possible backlash toward foreigners.

Flights are down 70% worldwide since February 2020, and U.S. hotel rooms are sitting at just 20% occupancy rates. It's not clear how much of a recovery there will be when restrictions are eased, but lower demand and the desire for social distancing could force airlines, entertainment venues, and restaurants to reduce capacity.

This crisis and the measures needed to contain it, have also served as a demonstration that in-person interactions can often be replaced by virtual ones. On-site meetings can be replaced by video calls. As we get more and more used to video calls, it can have a long-lasting effect on business travel. Airlines and hotel chains, already aching from the lockdown, may continue to suffer. Airlines have already agreed on a \$25 billion relief bailout. Will the industry go bankrupt again like after the 9/11 attacks or after the Great Financial Crisis of 2008? The carriers are scrambling for liquidity to keep flying amid an unprecedented collapse in air travel. Airlines continue to suspend service, ground planes, and cut costs as they burn

⁴ Omnichannel is a cross-channel content strategy that organizations use to improve their user experience and drive better relationships with their audience across points of contact. Rather than working in parallel, communication channels and their supporting resources are designed and orchestrated to cooperate.



through cash and provide refunds for canceled flights. Alliance Bernstein analyst, David Vernon, estimates that airline ticket sales have crashed by 95% while planes fly nearly empty and refunds to customers continue to drain coffers.

6.e. Agriculture & Food Processing

Farmers and food companies across the country are cutting back production as the virus creates chaos in agricultural supply chains, erasing sales to restaurants, hotels and cafeterias despite grocery stores rushing to restock shelves. Supermarkets are an exception as they have done well during the coronavirus economy, but this is not a structural situation but rather a transitory situation. The stocking by consumers is behind us, as the virus curve starts to flatten. Few in the agricultural industry expect grocery store demand to offset the restaurant market's steep decline. In fact, demand coming from restaurants was already higher than that coming from supermarkets before the crisis. According to the United States Department of Agriculture (USDA), in 2018, Americans spent approximately \$678 billion in restaurants, versus, \$627 billion in grocery stores and warehouse clubs. The segment of the restaurants that is doing very well during the crisis and represents a new high-growth sector is the cloud-kitchen.

American producers stuck with vast quantities of food that they cannot sell are dumping milk and eggs, and rendering pork bellies into lard instead of bacon. Bread and butter farms and food companies have become increasingly dependent on restaurants. In part, this is because they can't easily adjust products bound for restaurants into the sizes, packages and labels necessary for sale at supermarkets. Chicken companies are shrinking their flocks, to curb supplies that could weigh on prices for months to come.

In the dairy industry, restaurant closures and other disruptions have left producers with a glut that could grow as supplies increase to a seasonal peak in the spring, and shelter-in-place orders stretch on across the country. Because milk is perishable—and cows produce more each day—dairy farmers have few alternatives.

6.f. Venture Capital (VC)

We are underweighting and are recommending clients to stay away from VC, within our Private Investments portfolio. We have been already alerted of extremely high valuations and a herd mentality within this space. No better example of this than the Softbank/ WeWork debacle. Through the lens of the balance sheet, the sector looks vulnerable in our view. Valuations are likely to be challenged in the coming quarters. Some deals have been renegotiated given the new investing climate and public market volatility. Late-stage valuations will see the biggest impact in our opinion (after reaching record highs in 2019) and will come down over the next few months as they're more apt to be valued based on publicly traded peers.

The shelter-in-place orders across the country have forced most employees to work from home, disrupted sales and marketing, and affected operations and product and project timelines. All companies are looking to extend their cash runway, examining their burn rates and cutting costs during this period of deep



uncertainty. Many have experienced major hits to revenue and significant layoffs or furloughs of their workforce. Some VC-backed startups have had to shut down operations altogether, while others are maintaining their operations without too much disruption.

Excessive dry-powder in the industry does not bode well with a slowdown in deal flow; we predict that deployment will be very hard. An exception within the VC space would be Life Sciences. These startups are receiving additional attention during this time, especially those working on vaccines, antibacterial medications and other life-saving cures.

Conclusion

“After COVID-19, nothing will be the same..... On the contrary, things will never be more the same, just accelerated.” The author of the previous sentence is NYU Stern Professor, Scott Galloway, who is also a firm believer of the acceleration of pre-existing trends. Others like Justin Leverenz, portfolio manager of Invesco Developing Markets fund, says: “Black swans determine history because it is the only time when states, societies, and individuals are so up against the wall that they have to fundamentally change...”. The coronavirus pandemic is forcing the fastest reallocation of labor since World War II, with companies and governments mobilizing an army of idle workers into new activities that are urgently needed. Around the world, former hotel, restaurant and airline staff are applying for jobs and positions with grocers like Kroger or Costco, online retailers like Amazon, and hospitals, as significant parts of the economy continued to be shuttered to prevent the spread of the disease—and essential goods and services are strained. It's a race against time, and our ability to win as a society will depend on our leadership and our capacity to quickly adapt to the new dynamics.



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