Winners and losers: the gap is widening

By

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Contrary to the hopes of some, the economic and competitive world of tomorrow will be just like the one of yesterday, but with more contrasts and speed in its evolution. The health and economic crisis has sharply accelerated the major dynamics in the development of certain businesses, technologies, customer access methods, geographies... at the expense of others, in particular certain mature businesses and countries. We now see in a few months disruptions and substitutions which would have taken place over five to ten years in other times.

The gap is widening

This acceleration produces increasing gaps between winners and losers. *Between geographies:* China's current economic growth in 2020 is 2%; for the US, it is - 4%, for Europe, it is - 8%[1]. *Between sectors:* airline industry lost 40% of its turnover in the first half of 2020; luxury goods, 25%[2]; on the other hand, digital technology grew by 3% and online distribution by 25% worldwide[3]. Among companies: distributors (excluding food distributors) whose concepts have low differentiation and those which remained focused on physical distribution in mature geographies have been strongly challenged; in the United States, bankruptcies of iconic department stores and chains have multiplied since May: Brooks Brothers, J.C. Penney, Lord and Taylor, Neiman Marcus, J. Crew... On the contrary, Zalando, the German specialist in the shoe sales and online clothing, is expected to grow by almost 20% this year[4]. In the automotive sector, Tesla is expected to grow by about 15% this year while the rest of the sector will decline by - 15%.

For many companies, equity will have decreased significantly by the end of this year. Hence, the European programme of 5 trillion euros poured into the economy[5] will put a significant part of it in a gigantic LBO whose exit will be difficult. In many sectors, EBITDA for the next two years is uncertain. The money available may be mainly in debt and refundable grants. Companies will first have to restore margins and cash flows to pay off some of the debts, then restore capital equity, and finally invest and grow, if there is still time. Many of them will not get out of this cycle if a large part of the debts is not foregone.

Moreover, this monetary creation can only keep rates low. To the extent that household consumption continues to undergo deflationary pressures (growth of emerging countries in international trade, population migration between countries and economic sectors increased given the large growth gaps between them, impacts of new technologies or new business models…), the bulk of the inflationary impact will bear on assets (financial assets, real estate); stock markets multiples are increasing (see Table 1).

Hence, the valuation gaps between companies are increasing. They are due to differences in multiples and not only EBITDA. These multiples are *inversely correlated to the cost of capital*

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[1] OECD forecast as of 16 September 2020. Real GDP (excluding inflation).
[2] First half of 2020 vs. first half of 2019. For luxury, based on LVMH, Kering, Richemont and Hermes.
[3] Estimate based on 25 e-commerce companies.
[4] Analyst consensus as of 18 September 2020 (compared to 24% p.a. on average over 2014-2019).
[5] Estimates based on Germany, the UK, France, Italy, Spain and programmes at European level, taking into account commitments without disbursement (guarantees, moratoriums, etc.), loans and deferrals of payment, recapitalizations by the State, grants and decreases in tax revenues. Subsidies and decreases in tax revenues (disbursements by the State with no compensation) represent 25% of the total (1.2 billion).

and therefore to interest rates, and a direct function of the growth rate (especially as profitability is high) and profitability[6]. They are realistic if one thinks that rates will remain low (this may be true in the short and medium term and certainly false in the long term), that the company is a competitive, profitable and resilient leader in its markets, and that its growth in the medium and long term is strong and sustainable.

Sector by sector and segment by segment, there is often a leader who fulfills these conditions (market share, technology, business model, image...) while 60-80% of competitors have lower profitability, or struggle to grow at the same rate, and do not offer the same resilience in the medium term. So, it's no longer enough to participate. The economic environment and the financial markets discriminate more strongly between the few winners and the myriad of losers, and this *because during periods of low interest rates, the financial markets value profitable companies with long-term growth much more than during periods of high interest rates*.

The gap in multiples between sectors and within the same sector has increased over the past five or ten years (see Tables 2 and 3). In banks, the average multiple of this sector (PER[7]) was by 10 in 2015, 11 in 2019. It is 8 times in 2020. However, for fintech leaders (Adyen, FIS, Square, Worldline), it was by 29 in 2015, 42 in 2019. It is 63 times in 2020. The same phenomenon is observed in other sectors (automotive, energy, health...) and, in general, segment by segment.

The current concentration of industries is therefore no longer only strategic. It is financial, with the power and leeway that comes with it. Today, 17 years after its creation, Tesla accounts for 15% of the global market capitalization of the entire automotive industry. The 7 American and Chinese digital leaders (excluding e-commerce) account for 25% of the total capitalization of the sector. The 3 leaders of e-commerce (Amazon, Alibaba and Meituan) represent 50% of the global capitalization of all distribution - physical and online - (excluding luxury).

Financial valuations incorporate not only the (supposed) accuracy of the strategy but also the speed of its execution.

What are the implications for business?

For number twos or threes being outpaced by a more competitive, or more agile, or simply more ambitious leaders, the issue is to pick up quickly with the right growth rate and the right level of profitability. Speed is critical as the gaps will continue to increase in the short to medium term.

For leaders with high multiples, financial value provides outstanding flexibility. It is both a (transitory?) opportunity to invest, acquire competitors and concentrate its industry, expand its playing field, and an opportunity to continue at the same pace, with growing results and value, for many more years to come.

It is also a risk. *When money costs nothing, investments are often dilutive*. The "strategic visions" and investment & acquisition opportunities must be strongly challenged with rational analyses.

Decisions taken in the next 18 months will be critical. They will structure the economic landscape and competitive structures for the next ten years.

Multiples and cash flows

The extraordinarily high multiples will not last forever. They will fall again when interest rates rise, i.e. when savings flows on the one hand, and investment or consumption needs on the other hand, will reverse, given the demographic dynamics or the evolution of some major emerging countries in their development cycle.

However, the competitive positions and cash flows created by companies which have been able to use these multiples intelligently in the meantime will remain.

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[6] According to Gordon's formula, at constant parameters, PER = 1 / ROE x (ROE-G)/(K_e-G), where PER is the Price Earnings Ratio, ROE the return on equity, G growth and K_e the equity cost of capital.

[7] Price Earnings Ratio

And these companies will emerge even stronger in the next crisis, when rates will rise and both the cost of debt and the cost of bad investments will have to be paid.

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Estin and Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists the branches of major European, North American and Asian groups in their growth strategies, as well as private equity funds in the analysis and valuation of their investments.

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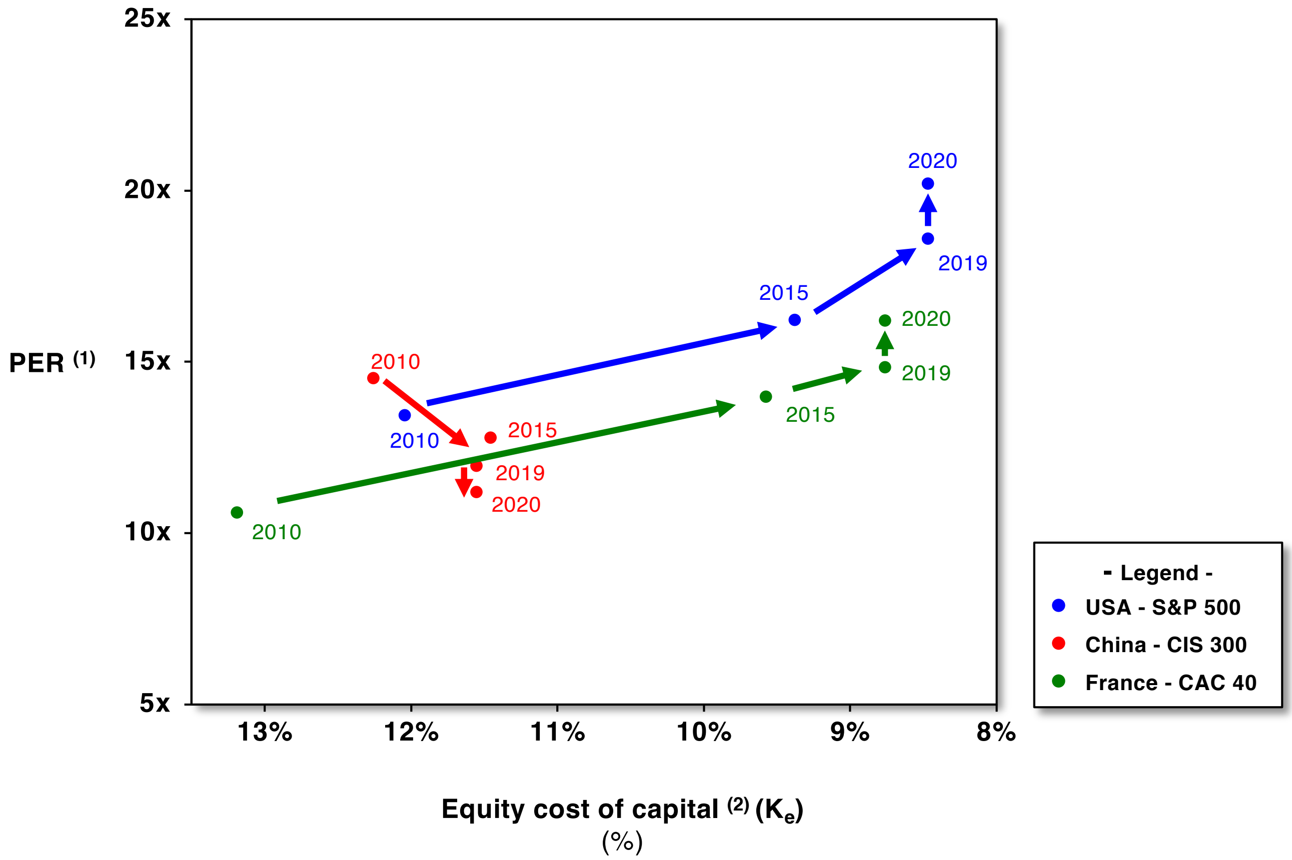
- Table 1 -

Average cost of capital and PER 2010-2020 (1)

United States, France and China



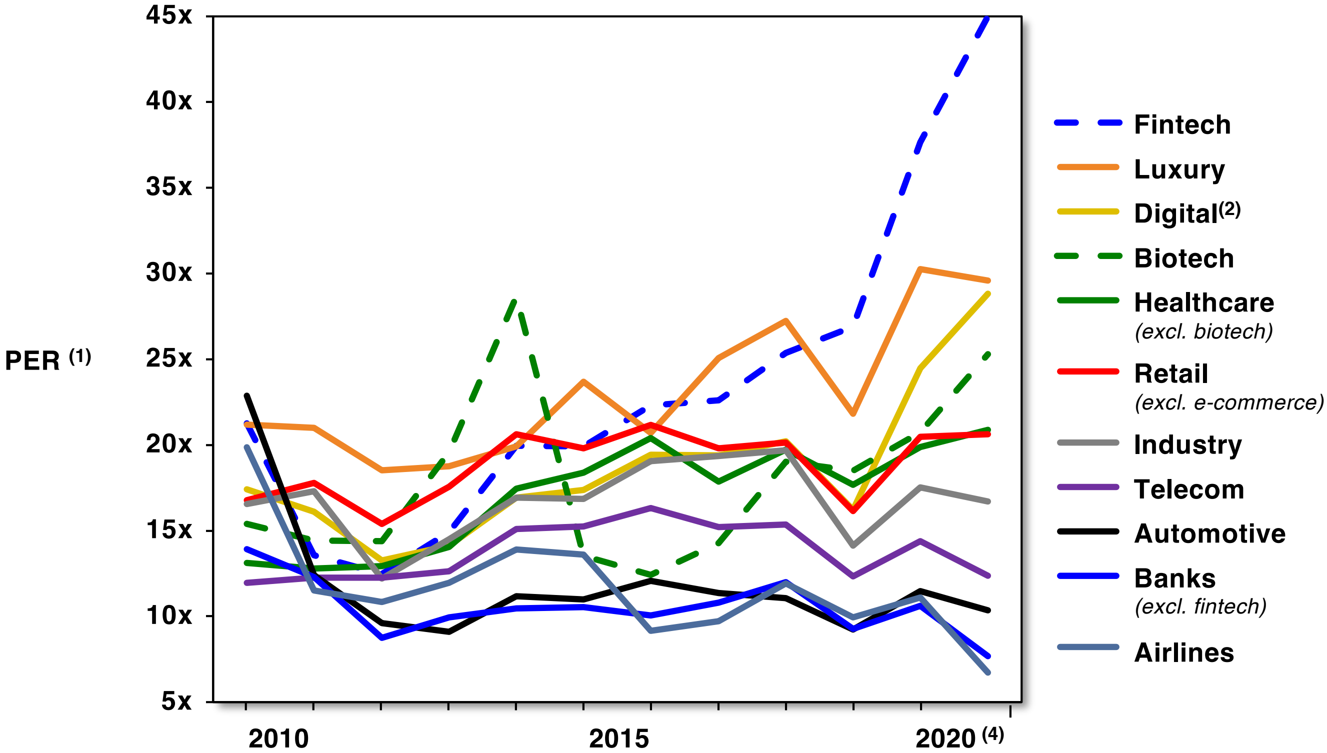
(1) PER: Price Earnings Ratio "next twelve months": market capitalization as of 31 December N divided by the consensus of brokers as of 31 December N for the net profit of year N + 1; for 2020, market capitalization as of 30 September 2020 divided by the consensus of brokers for the year 2021; (2) Cost of equity (K_e) estimated by Bloomberg on the S&P 500 for the U.S., the CSI 300 for China and the CAC 40 for France

Sources: Bloomberg, Estin & Co analysis and estimates

- Table 2 -

Evolution of valuation multiples (PER[1]) by sector

2009-2020 – World



(1) PER: Price Earnings Ratio ; (2) Software & hardware IT; excl. fintech, telecom, media and e-commerce ;
(4) As of 30 September 2020
Sources: Refinitiv, Estin & Co analyses and estimates

- Table 3 -

Evolution of valuation multiples (PER[1]) by sector

2015-2020 – World

	Average of sector			Core market or niche leaders			
	2015	2019	2020	2015	2019	2020	
Retail & e-commerce	26	28	35	76	46	73	*Amazon, Alibaba, Meituan (50% of the sector's market capitalization [2])*
Digital (excl. e-commerce) [3]	21	26	31	20	27	34	*Apple, Facebook, Google, Microsoft, Baidu, Tencent, Xiaomi (25% of the sector's market capitalization)*
Health and biotech	20	20	21	32	32	38	*Vertex, CSL, Thermo Fisher*
Energy and renewables	15	15	11	24	21	44	*Longi Green Energy, Tongwei, Vesta Wind System, Xinyi Solar*
Automotive and components	12	11	10	n.a.	> 100	> 100	*Tesla (15% of the sector's market capitalization)*
Banks and fintech	10	11	8	29	42	63	*Adyen, FIS, Square, Worldline*

(1)PER = Price Earnings Ratio ; (2) Leaders representing > 90% of the market capitalization of global e-commerce; (3) IT software & hardware ; excl. fintech, telecom, media and e-commerce

Sources: Refinitiv, Estin & Co analyses and estimates