Butterfield

Global strategy
Technological change claims another victim

Fixed income
Another round of Quantitative Easing (QE)?

Equities
Market says no to a Unicorn IPO

Global asset allocation

Investment Views
October 2019

Global strategy

Technological change claims another victim

To adapt a well-known Hemingway quote, the impact of changing consumer habits and technological disruption on businesses often happens gradually, then suddenly. In September, Thomas Cook, one of the world's largest travel services businesses went into compulsory liquidation. The collapse of the 178-year old company and inventor of the package holiday has left 21,000 jobs at risk, along with a net debt pile of £1.2bn. Commentators have attributed the failure to a host of factors, including poor management, excessive leverage, online competition, Brexit, and budget airlines. While these may all be true to varying degrees, the overriding story is one of a business that struggled to evolve and compete within an industry facing significant disruption.

Thomas Cook was well known as a tour operator, but around 50% of the business was an airline. The rise of the budget airlines has disrupted the industry, but airlines are commodity type businesses and tend to make profits when economic growth is good and oil prices are low, while struggling when the converse is true. The Thomas Cook airline business was profitable and the company had explored selling the division to help shore up the struggling tour operator business.

The tour operator business is where the real industry disruption has taken place. The internet is by no means a recent phenomenon, but the impact has been gradual, then sudden. In previous decades, the specialist knowledge of travel agents was a valuable resource when booking a holiday. You could go into a local high street branch and speak to someone—often well-travelled—who could provide guidance on where in the world to go on holiday and also provide hotel and tour excursion recommendations. However, the internet and websites such as Expedia and TripAdvisor have provided a competing platform for searching holidays, combining flight and hotel bookings, while also sharing experiences and reviews.

To keep up with this evolution, Thomas Cook did have a strategic alliance with Expedia, where they looked to benefit from leveraging Expedia's technology to broaden distribution, while also lowering their costs. Meanwhile however, the expansion of Airbnb proved to be increasingly disruptive. The sharing economy

Global strategy

Technological change claims another victim

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has opened up a much wider range of options for those travelling abroad and also at a lower price point due to the smaller cost base of the platform model; Airbnb doesn't need to maintain hotels. In response, Thomas Cook focused on consolidating their own range of hotels and delivering more bespoke packages such as sport travel. But ultimately, the combination of an expensive business transition and weight of debt proved too much to overcome.

We do not own either the bonds or the equity of Thomas Cook, and far more comprehensive pieces will be written about what went wrong, but in a broad sense it does provide an excellent case study touching on many aspects of industry disruption and economics more generally. Technology creates winners and losers and in this case the losers are the staff, suppliers and investors, while the winners are concentrated in Silicon Valley and other metropolitan areas where technology staff are often based. This also has implications for the property market, with high street retail properties suffering and data centres and prime office and residential locations seeing strong demand.

From an economic perspective, the impact of technology has fallen disproportionally on white collar workers in developed markets. The proliferation of information and global platform companies has seen an increase in the demand for software developers at the expense of more traditional middle-class office roles. We do not subscribe to the view that technological disruption should be resisted, but the distribution of the winners and losers in an age of globalisation is going to be an ongoing political challenge.

Identifying themes is a key pillar of our process and these themes can be cut two ways; where is the disruption and is there an investment opportunity in the disrupters? We are generally cautious with any industry seeing significant disruption and spend time trying to avoid stocks which might look superficially cheap but have structural issues. It is certainly not the case that disruptive businesses always make for good investment opportunities and an example of this is discussed below. Overall, Thomas Cook is a reminder that it's better to be investing in companies or industries with tailwinds rather than headwinds.

Fixed income

Another round of Quantitative Easing (QE)?

With money managers back at their desks, financial markets returned to a sense of normalcy in September as government bonds declined and risk assets caught a bid. The 10-year US Treasury fell to a low of 1.46%, before rebounding to 1.90% and finally closing the month at 1.67%. Volatility within, what is supposed to be the boring segment of a balanced portfolio, is extreme and this is likely to continue as the main drivers of the sharp market movements in August remain in place. Markets remain captured by the risks and impact of the trade war and no matter how dovish global central banks become, it would take a truly out-of-the-box change of monetary policy to drive growth higher from this point. This leaves a deal on trade or a large dose of fiscal stimulus as the only games in town to prevent potential stagnation.

Whilst the focus remains on the daily movements within the broad liquid markets such as the S&P 500 and G7 government bonds, during September we witnessed two key developments in US Fixed Income markets. First, there were some signs of funding stress, which could signal that further problems may lie ahead. The repo market, which all global banks use as a tool for their funding arrangements, temporarily froze and overnight interest rates spiked as the demand for US dollars outweighed the level of supply. Second, QE appears to be back on the table, but without the bang and certainly not much of a buck to be gained. It should be a temporary fix, but more concerning is that no one really noticed anyway.

Although global growth continues to remain sluggish and manufacturing (including in the US) is in freefall, one of the last bright sparks in the economy, the US consumer, continues to spend, with retail sales and housing in particular showing very strong gains in September and beating most analysts' expectations. Given the US consumer is such a large component of not only the US economy, but the global economy, such

Fixed income

Another round of Quantitative Easing (QE)?

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resilience in the face of weakening indicators elsewhere is encouraging, but also make our job in predicting a recession much more difficult. For now we remain in the camp that the US avoids a recession; however, the world is at risk of talking ourselves into a more dramatic slowdown as main street takes more notice of what the bond market and financial media is "telling them".

On the geopolitical front, in what could have been a major confrontation, a suspected Iranian drone strike on one of Saudi Arabia's oil facilities took out 5% of the entire global supply of oil overnight. In normal times this should have led to a sustained increase in the price of crude. In this case, the price of a barrel rose from $55 to $64, one of the largest daily moves ever, but quickly resumed its down trend closing the month at $54. This is a good outcome for the global economy, not only has a military response been averted, but a sharp increase in energy prices, with global growth in its fragile state, would have likely have tipped the economy into recession. We continue to hold some inflation protection primarily because inflation break evens are relatively cheap. While the growth outlook is not seen as a driver of excess inflation at present, an event such as an oil price shock or increased concerns over Federal Reserve actions could push inflation above current expectations.

We remain bearish on the longer-term outlook for yields, as long as the US can avoid a recession, and thus will continue to look for opportunities to shorten up duration as we close the year. Conversely, we continue to own credit risk within portfolios. Due to the current market obsession with the risk of BBB credit, we see some value in this space and versus the less attractive AAA-AA corporate credit, so continue to add exposure to companies in this space that maintain pristine balance sheets and show leverage discipline.

Equities

Market says no to a Unicorn IPO

Global equity markets produced a small, but positive, total return during the third quarter of 2019, returning 0.5%. The headline figure has masked some divergent moves, both at sector and regional levels. Trade tensions, yet again, have seemingly been a driver of return during the quarter, with news coming as recently as last week pointing to a further escalation. The Trump administration admitted that discussions have been held about potentially limiting US investor portfolio flows into China, despite the reality that any such decision could ultimately backfire on the President and actually hurt US investors more than anyone else. Unsurprisingly, shares of Chinese companies listed on US exchanges fell on the news; Alibaba and JD.com fell over 5%. We believe that President Trump will most likely use this threat as a negotiating tactic, rather than seek implementation of these restrictions, which could force billions of dollars of US pension fund monies, insurance company assets, and retail savings to reallocate out of China.

One topic we wrote about earlier in the year, the Unicorn company IPO market, has been in the news recently. High flying start up Beyond Meat has fallen 40% since its late July peak despite signing several accretive partnerships with various restaurant chains. Most IPOs this year have not fared as well as Beyond Meat's, even with the recent retracement of shares. Uber, Lyft, Peloton, and Smile Direct Club are all Unicorns whose shares are trading well below the IPO price. That backdrop leads onto a review of perhaps the most discussed start-up of recent time: shared workspace company WeWork.

WeWork filed paperwork with the SEC to go public in mid-August, giving prospective investors detailed information on the background of the company, as well as financial statements, in order for the company to gauge demand for the IPO. This was the first instance that the majority of investors were able to learn in great depth the inner-workings of The We Company (the filing showed a new name for the corporate entity). Taking a step back, the company was founded in 2010 by Adam Neumann, with its first location in New York's SoHo district. By 2014, investments in the company had been made by many prominent global investment banks and investment firms including JP

Equities

Market says no to a Unicorn IPO

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Morgan, Goldman Sachs, and Benchmark Capital at various valuations. Many venture capital and private equity firms were flush with cash, and buoyed by low interest rates, invested in private companies that remained private much longer than in past cycles in order to avoid the quarterly scrutiny of public markets. In early 2017, Softbank made a $1.7B initial investment in WeWork, through Softbank's $100B Vision Fund. The Vision Fund has subsequently invested an additional $9B into WeWork, at valuations as high as $47B. WeWork is now valued between $10B-$20B and is considering selling assets and laying off employees.

The filing of WeWork's intentions to take the company public in August has set off a discussion regarding the IPO and the merits of an investment in the company. The majority of the discussion is centered on Corporate Governance, which we will focus on, as well as the company's questionable financial position. Corporate Governance sets forth the rules and guidelines for managing a corporation, balancing the interests of all stakeholders (employees, customers, shareholders, and management). It appears as though the major investors in WeWork ignored the governance red flags and focused solely on the growth prospects, putting too much faith in founder and CEO Adam Neumann. The most glaring red flag at WeWork is the intertwined nature of Neumann's personal relationships and personal finances, with the company's executive team and cash burn rate. Neumann appeared to run the company for the betterment of himself and his family with a series of decisions and events that ultimately led to the company's current depressed valuation. Neumann appointed his wife as Chief of Brand and Impact Officer, while his brother in law serves as Head Of Wellness. In 2016, Neumann borrowed $7M from WeWork at an egregiously low annual interest rate of 0.64%; this was not the only time loans had been made directly to Neumann. In 2019, WeWork sought to acquire the rights to the "we" trademark which was owned by an entity controlled by Neumann, and paid the CEO $5.9M for the rights; the company stated the valuation was determined by a third-party appraisal.

The company signed leases in four properties that are owned by Neumann, and entered into the lease agreement on three of the four the same day that Neumann acquired the asset. Neumann travelled around the globe as he ran the company, and did so on the company's own Gulfstream G650 jet. WeWork paid $60M for

Equities

Market says no to a Unicorn IPO

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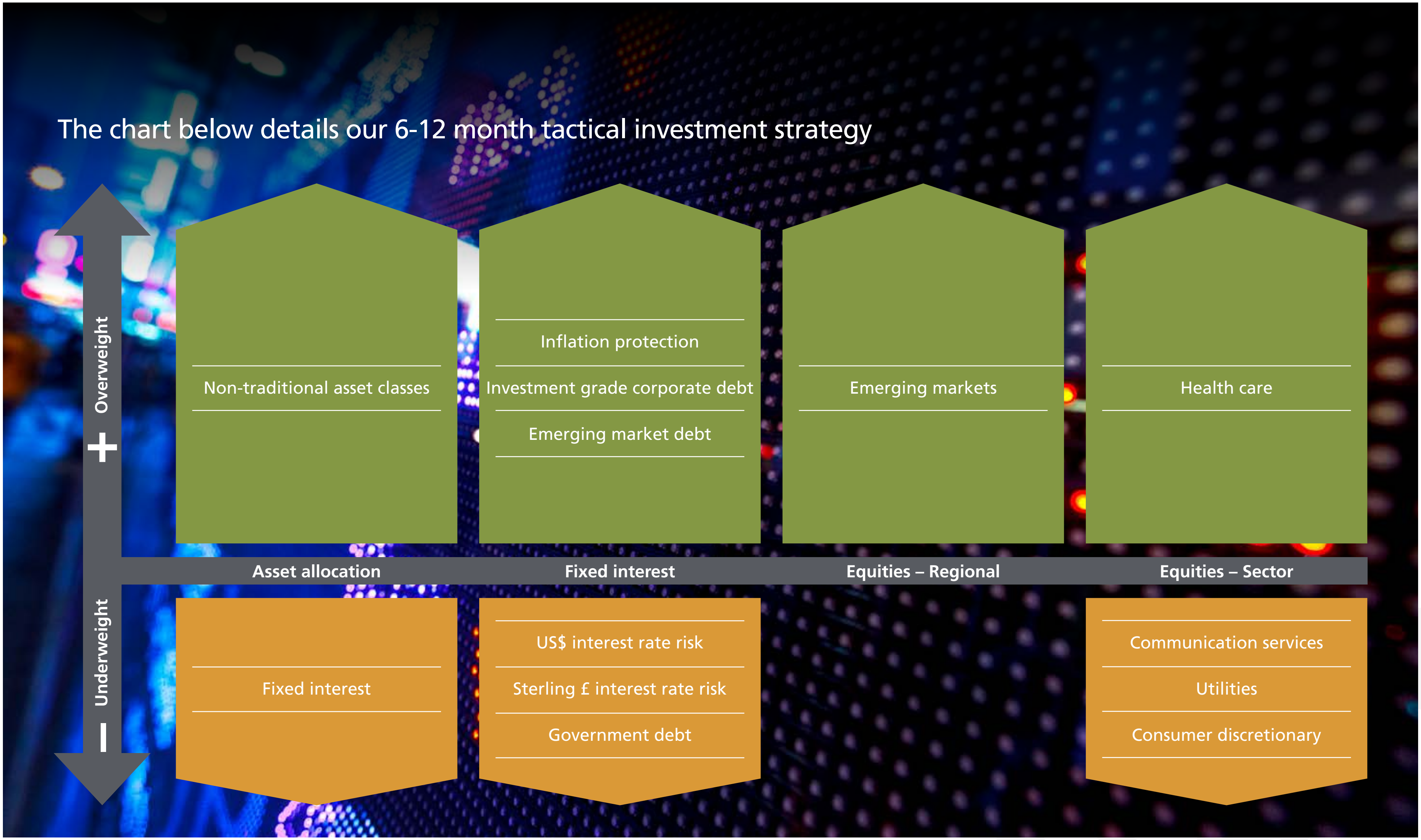
the private jet, while multiple employees had spoken of denied bonuses or raises due to a "lack of resources." Finally, the SEC filing showed a share structure with Neumann owning a large percentage of a super-voting class, giving him full control of corporate decision making.

The aforementioned anecdotes of executives placing their own interests above other stakeholders are extreme examples of poor, or nonexistent, governance. This is a story that isn't necessarily unique to WeWork, however, the lack of oversight at the company is of great concern. WeWork is a truly disruptive company and has the potential to transform how small businesses structure their physical presence around the world. Disruptive companies with no checks and balances in place can quite quickly become the disrupted. There were surely difficult questions asked of WeWork by some of the most influential investors around the globe, but the allure of high returns must have been too strong.

The reaction of much of the investment community after performing some semblance of due diligence recently is exactly how markets should work. Clearly, Environmental, Social, and Governance (ESG) red flags were present in this instance. We believe that the fallout from this saga can have a positive impact on markets in the future and provide a shaking-out period for assets that are potentially built on uneven ground. There will be short term repercussions, potentially in venture capital and private equity valuations, perhaps in the leverage loan space as well. So why write so much on a company we do not own or plan to invest in? Simply, to reiterate a core investment belief: before we underwrite a new investment, whether in equity, fixed income, or alternative classes, we spend the time necessary to understand the bull case, but sometimes more importantly, we examine the bear case, while constantly updating our thesis.

Global asset allocation



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