COMMENTARY

February 28, 2020

Dear Clients and Colleagues:

The real impact of the coronavirus disease outbreak is difficult to assess at this time. Since last week, we are seeing growing concerns about regional contagion after South Korea, Italy and Iran reported a spike in number of cases. In the coming weeks, a broader demand slowdown is at risk. Further, the global economic impact of coronavirus is likely to be higher than during the severe acute respiratory syndrome (SARS) outbreak in 2003. Back then, China's proportion of global exports was only 5%, as opposed to 10% today.

Located in the Hubei province, Wuhan is an important hub for automotive, semiconductors and medical devices. In recent weeks, supply chains were disrupted due to Chinese New Year, the extra week closure and the virus outbreak. Manufacturing companies are gradually increasing production but their level of activity could remain below average in the short term. Capital goods companies exposed via both their direct sales exposures to China or their production footprints are affected. Additionally, freight volume is expected to decline. In short, manufacturing could be facing few weeks of disruption before things return to normal.

Airlines and tourism-related businesses have been impacted by the travel bans imposed on Chinese visitors. Major European airlines have about 2% to 5% of their available seats on Chinese routes. In term of airport spending, Chinese consumers generate about 14% of retail revenue at the Paris and Frankfurt airports. The Asia-Pacific region, which is more dependent on Chinese travelers, could suffer more than other regions. Countries like Thailand, South Korea and Japan have among the highest share of outbound Chinese tourism.

With consumers staying home and avoiding nonessential shopping as a health precaution, retailers are not immune. Companies such as Nike and Burberry have reported a sharp decline in customer traffic and purchasing activity. On a sector basis, this year the energy, the materials and consumer staples sectors have been among the worst performing to-date. However, sectors that are more domestic focused like Banks, Real Estate and Utilities have outperformed.

It is still too early to assess the full impact on our holdings. We believe that our consumer-related companies like Autogrill, Melia or L'Occitane are the ones most exposed. Autogrill is a concession business offering food and beverage to travelers around the world. Their European and American operations are performing well so far this year but their sales exposure to Vietnam and China has been impacted. These two countries represent only 1.2% of Autogrill's revenue. More worrisome is their Italian operations which represent 19% of their revenue. The coronavirus outbreak in Italy over the past weekend has contributed to a notable drop in traffic on their motorways. L'Occitane is a cosmetics and well-being products manufacturer and retails globally. Their Hong Kong and Chinese exposure accounts for 20% of their total sales. Like any other retailers, L'Occitane could face an important drop in footfall in Q1 2020.

Melia is one of the leading European hotel groups; it owns and manages more than 326 hotels and resorts in 33 countries, mainly in America and Europe. Compared to its peers, Melia is less dependent on China. Chinese tourists represent 1.6% of the group's clientele, mainly concentrated in hotels operating in China and Southeast Asia. Spain received 600k Chinese tourists in 2018 from nearly 83 million. The only hope in the short term is that certain geographical areas may benefit from the closure of many Asian destinations.

Depending on the duration of the outbreak, we could see a V-shape recovery somewhere between the second and third quarters of 2020. That also depends if the coronavirus follows the same path as SARS in 2003. Now that coronavirus has expanded elsewhere, other countries could face similar challenges.

Our portfolio strategy has not changed; we continue to maintain a well-diversified portfolio minimizing industry and currency risk while adding value through security selection in both up and down markets. We believe the current market environment will create investment opportunities.

Have a great weekend.

The Global Alpha team