

Disruption and the case for Value

Paul Brunker | 23 July 2021

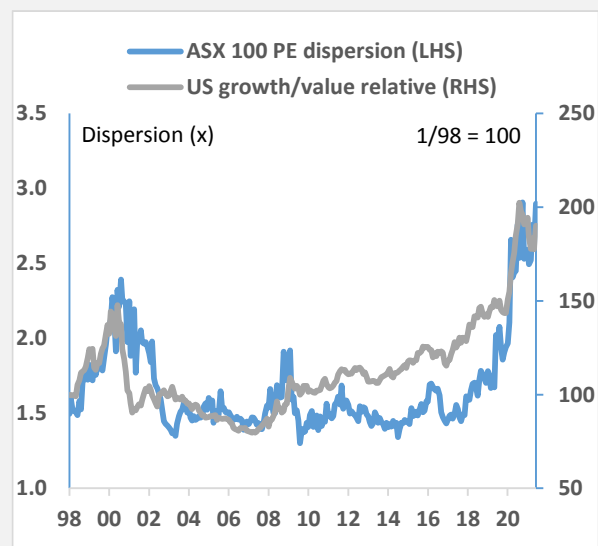
Key Points

- Industry disruption through technology is cited as a reason to steer clear of value stocks.
- Much of the ASX is in industries that are hard to disrupt. The key debates centre on Financials: even here the barriers to disruptive new entrants are often under-estimated.
- Investing in 'disruption' carries its own risks – and faces a limited pool of opportunities in Australia.

Does disruption disrupt Value?

The outperformance of growth stocks reached extreme levels during 2020. **Figure 1** shows growth/value measures for the US and Australia. From 2017 markets were strongly favouring companies less exposed to economic cycles, particularly ones with strong potential growth; COVID-19 propelling these metrics to record highs.

Figure 1: ASX PE dispersion and S&P500 Growth/Value



Source: FactSet, UBS

A lot has been said about macroeconomic triggers for a rotation between these two groups. A bond sell-off did spark a sharp spell of outperformance by value in late 2020. An easing of yields has reversed some of this, though we think macro drivers still favour the value end of the market (see [here](#) for example).

Some argue that this is a sideshow. This view sees growth's outperformance as driven by major technological shifts which will disrupt the industries that dominate the 'value' end of stock markets. 'Cheap' stocks are not really cheap, because they are underpinned by engendered earnings and assets; and the disruptors, which are pushing the growth leg of the pair, are not expensive because they have so much runway.

This is not a debate that can be clinched by a set of numbers or charts, but we can make a number of observations about it. The most important is that the disruption argument moves us from **macro to micro**. We cannot throw a blanket over all 'old economy' sectors as if they were all equally vulnerable to challenges by new entrants and new technology. Even within sectors, some players or business segments may be more exposed or better protected.

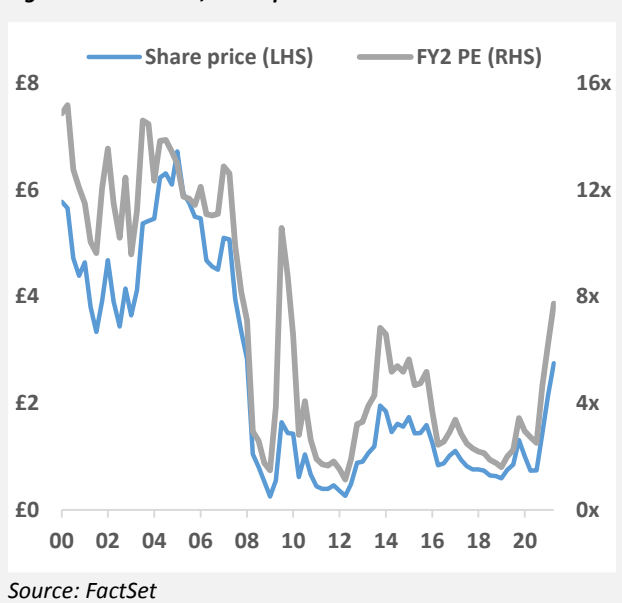
The same can be said for the challengers. Exposure to an emerging technology is no guarantee of high returns on capital, strong growth or even survival.

Is it disruption, or just competition?

The word 'disruption' is over-used, particularly by companies seeking to burnish their high-growth credentials. Sometimes they are just competitors.

- Competition is almost universal. Disruption is rare: it is a profound negative change in industry economics driven by new technology which potentially renders incumbent models valueless in the long term.
- Competition is usually incremental and leaves leading players with strategic options to respond. Disruption is a step change, and incumbents find it difficult or impossible to respond without abandoning legacy assets and cost structures.
- Competition can be factored into the valuation of a company. It is very hard to say that disruption is 'in the price': low multiples of assets or earnings are misleading if the company's economics are changing radically. **Figure 2** shows an example. Reach PLC (formerly Trinity Mirror) is a UK newspaper publisher: its stock has traded at less than 8x FY2 earnings for a decade, and the consensus FY22 EPS estimate is lower than the FY05 actual.

Figure 2: Reach PLC, share price and PE ratio



Source: FactSet

Finally, **technological change does not always mean disruption**. New technology can hurt incumbent business models by lowering barriers, it can help them by lowering costs, or both at the same time. It only becomes truly disruptive when it transforms the structure of the industry, and incumbents either cannot use it or are held back by trying to protect legacy returns.

With all that in mind we have broken the ASX100 along a spectrum of exposure to disruptive change (Figure 3). There is some judgement involved here, which is the point. Each sector and sub-sector has to be argued on its merits.

Where’s the disruption risk?

We put 52% of the ASX100 in the ‘**Disruption Difficult**’ group. Mostly, these industries make or move tangible outputs – manufacturing, mining, logistics and so on. They tend to involve larger commitments to physical capital. They of course experience innovation, but generally as users rather than potential victims. Some could move up the risk curve over time (food retail for example), others are less likely to. Candidates for value investment are often in this box.

‘**Disruption Visible**’ industries are facing a live threat from new technologies. For **hydrocarbons**, the impact is slow because the energy transition will take time and upstream assets decline naturally. Companies have more options to adjust investment priorities. **Generators** are further down this path with renewable assets lowering the marginal cost curve. **Mall REITs** and **traditional media** are already feeling the impact of online competition.

We put 39% of the index in the ‘**Disruption Debate**’ category: this is where, in our view, the interesting cases are. With the exception of discretionary retail (which in other economies would be in the ‘Visible’ box thanks to online competition), these are all financials.

This makes sense. Industries underpinned by physical capital are harder to disrupt through digitisation. Financial intermediaries meanwhile are in one sense data companies: they keep track of the numbers that allow us to know what we owe, own or are owed. This makes them potential targets for technology-led disruption. But unlike online advertising or online shopping these sectors have significant entry barriers, which has kept them – for now – in the middle of the risk spectrum.

Figure 3: industries categorised by exposure to disruptive change, and % of ASX100 by weight

Disruption Difficult 52%		Disruption Debate 39%		Disruption Visible 6%		Disruptor 3%	
Metals & mining	17.2%	Banks	24.1%	Hydrocarbons	3.6%	Fintech	1.7%
Health care	10.6%	Capital markets	4.0%	Retail REIT	1.1%	Online ad	1.4%
Consumer staples retail	4.8%	Discretionary retail	4.0%	Electricity generator	0.7%		
Airlines/airports/toll roads	3.8%	Diversified REIT	2.8%	Traditional media	0.2%		
Logistics	3.5%	Insurance	2.8%				
Chems, building mats, packaging	3.4%	Diversified financial	1.0%				
Gaming	2.5%						
Telco	2.3%						
Software, data centres	1.7%						
Contractors	1.0%						
Food/bev manufacturing	0.7%						
Property development	0.4%						
Electricity grid	0.4%						

Source: Optar Capital, FactSet

Banks: how big a disruption threat?

The **Bank sector** is more than half of our Disruption Debate group, so it is worth focusing on it to illustrate this point.

Banks perform a privileged credit creation role in the economy. They transform liquid, safe liabilities (deposits) into illiquid, risk assets (loans) – which also create new deposits. Because of this circular nature of credit creation and the regulation needed to operate, banks run enormous gearing levels (assets to equity often 20x or more, levels which would make an industrial company weep). Banks can sustain high gearing thanks to close prudential supervision, central bank liquidity support and, more recently, Government guarantees for depositors.

So, to be a bank, you need a pool of risk capital, loan and deposit origination capacity, credit assessment capability, diversification of credit exposures (which tends to reward scale) and a banking licence so that the whole thing stays within acceptable boundaries. You also need transaction processing ability and interconnection with other institutions and participants, and useful customer interfaces (physical and/or digital).

Challenger banks or ‘neobanks’ still need all those things. The question is whether they have a competitive advantage in them. They have two potential sources of edge: they avoid the cost of physical branches, and their technology stack may be significantly cheaper and/or better thanks to a ‘clean slate’ with no legacy systems. They also have some disadvantages.

- **Higher funding costs.** New entrants usually pay a premium to attract deposits and their non-deposit funding will also cost more, not least because the deposits are less sticky than a mainstream bank’s.
- **Pricing power.** Because of their market position, challengers typically need to undercut the lending rates of major banks to get traction, or are confined to niche, potentially unscalable applications.
- **Risk origination.** Lacking an established customer network, neobanks may struggle to deploy the deposits they attract, and/or may end up with higher-risk assets. Because they are smaller, they may also have higher concentrations of credit risk.
- **Overheads.** Regulatory requirements are mostly as stringent for challengers as for incumbents, so they weight more heavily on a smaller revenue base, and attracting customers incurs high marketing costs.

Whilst most OECD countries have policies to encourage neobanks, those policies often come with a stated premise of hoping that the regime at least sees one viable new entrant succeed. In other words, governments fostering neobank start-ups expect a high failure rate.

UK neobank Monzo was considered one of a success in terms of customer and media buzz. In March 2020 it had 4 million customers (from 590,000 two years earlier). This is nearly 8% of the UK adult population, though for most customers Monzo was a second bank. However it had yet to turn a profit. As Figure 4 shows, its user-friendly app had attracted plenty of deposits but it had just £144m of loans. Income was swamped by marketing and other overheads. In July 2020 Monzo flagged “significant doubt” about its ability to continue as a going concern due to the COVID-19 pandemic. Locally, the now-defunct challenger Xinja Bank was a similar story.

Figure 4: Monzo, summary financials year ended Feb 2020

	£ million
Net interest income	24
Fees, commission and other income	32
Expected credit losses	-20
Net operating income	36
Personnel expenses	-78
Other opex incl depreciation	-44
Total expenses	-121
P/L before tax	-85
Cash and balances at bank	1374
Loans and advances	124
Other assets	223
Total assets	1721
Customer deposits	1393
Other liabilities	200
Equity	129

Source: Annual Report

Setbacks for banking disruptors are not new. Internet banking was one of the hot topics in the tech boom of the late 1990’s, and its failure to make much headway was one of the themes of the subsequent post mortem: These examples show that crossing the incumbents’ moat is a costly and long process. Meanwhile, the old guard have time to reduce branch costs, improve technology and emulate some of the appealing features of the newcomers.

These dynamics explain why many challenger financial businesses adopt market ‘skimming’ strategies: focusing on areas of the industry in which there are possible inefficiencies or contestable economics. These can be high-margin niches such as small-scale forex transactions (OFX Group for example). Challengers may target payment processes (e.g. Square) or price discovery (e.g.. online mortgage broking): In principle though the incumbents can also use these technologies to cut costs and processing time. The ASX’s venture in blockchain may prove to be a case of this.

Some of these challengers can chip away at the economics of traditional banks. Even so, the investor must be able to distinguish genuine innovation from old-school risk-taking. Greensill Capital claimed to be disrupting the niche of trade financing, making much of its technology credentials, but it was in essence an originate-syndicate business with narrow channels of funding and lending.

Perhaps the challenger banks will prove to be the fallen vanguard of a more profound shift. One picture of this is decentralised finance, supported by distributed ledger technologies. But there will still be a need for an intermediary to create liquidity and certainty of return for depositors and other creditors. A possible endgame is that the incumbent banks adopt transaction processing innovations rather than being killed off by them.

A top-down disruption narrative is too simplistic if it fails to engage with the specific economies of each industry. What is the value proposition, can technology undermine existing models of delivering it, and can incumbent players adopt that technology without a radical reduction in their earnings power?

The risks of investing in disruptors

The same holds true on the long side of the disruption trade. Investors might be tempted to say that exposure to the challengers is a better bet than navigating the risks to incumbents. This ‘right side of history’ approach can be tripped up by the specific dynamics of companies and industries in a number of ways.

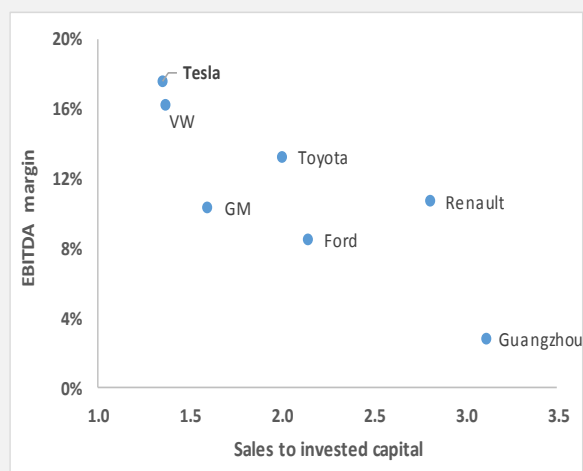
Land grabs. New industries and technologies attract investment because they promise growth. Players see share, not returns on capital, as the priority. But unless the industry becomes a winner-take-all structure, all that capacity will keep returns low. Some aspects of the renewable energy business look like this.

Known unknowns. Disruptors appear most attractive early on, when growth prospects are large. But at that point investors do not know where the industry’s economics will settle, or which technologies and players will survive. Managements and business models are untested so there is more risk of failure, not to mention outright fraud. Investing in a multiple players may not work: if the industry remains competitive, the winners may not be valuable enough to pay for the casualties.

New tech, old economics. Many of the most successful disruptors are capital-light businesses, have significant brand or scale moats, or both. What has made these businesses good investments is an old-fashioned interplay of low capital intensity and high margins. Other would-be disruptors look familiar in a different way: they are capital intensive players in contested markets. Electric vehicles

may prove to be a case of this, unless one player can develop a killer app that cannot be replicated. Tesla’s margin - capital intensity relationship sits around the normal trade-off for an auto company.

Figure 5: EBITDA margin and capital turn, auto companies



Source: FactSet

Valuation risk. Buying a stock because it is exposed to an attractive thematic is a ‘true at any price’ argument. Rapid-growth companies can of course be undervalued, even when short-term metrics like PE look very stretched. The problem is getting a degree of confidence that this is the case. The forecast boundaries for both the industry and the specific player are too wide to be meaningful. Buying an asset that is so hard to value is a bet that the attractive theme will validate any entry price.

One approach to this valuation problem is to work backwards. Rather than building a single central estimate for earnings, ask instead what would be needed for the share price to be right. If that starts to stretch the boundaries of plausibility, the investment is probably too risky.

This approach is illuminating for one of the ASX’s high-growth large caps, Afterpay (APT):

- APT’s fully diluted market cap is around \$35b. Let’s assume that it takes ten years to become a mature company and it would then pay a 4% dividend yield. In the meantime it reinvests all its cash in growth, so if the investor needs a 9% return the market cap will need to be \$83b in 10 years and APT will need \$3.3b free cash to pay the dividend.
- APT’s revenue averages 4% of Gross Merchant Value (GMV, underlying consumer spend via the platform). After operating costs, its EBITDA has not exceeded 2% of GMV. After capex, interest and tax, an optimistic outcome would be perhaps a free cash margin of 1% of GMV (to date, APT has not generated a profit).
- Using that 1% assumption, APT needs to get to \$330bn in GMV in 10 years to pay a 4% yield.

- It is on track to do about \$20b in GMV in FY21. So the share price needs a 16x rise in revenue over the coming decade, or a sustained 32% p.a.
- This is to simply reach *fair value*, with upside requiring even loftier growth, and it assumes nothing goes wrong. Regulation and competition could significantly lower both revenue and margins.

The case of APT is also a reminder that the ASX has a limited pool of genuine disruptors. The only other ones that we put in our ASX100 breakdown (above) were the online advertising models (Seek, Carsales and REA).

Cautionary remarks on high-multiple 'disruptors' may apply more forcefully when candidates are in limited supply in a market with a strong domestic investor base, heightening the risk that valuations become stretched.

It's never that simple

Saying that the threat of technological disruption is always overplayed by markets, and that all potential disruptors are overvalued and their potential victims oversold, would clearly be wrong. It is directly contradicted by the experience of sectors such as advertising.

It is also possible to make the opposite mistake: assuming that technological innovation always equals disruption, that companies exposed to the right technology trends are by definition good investments, and that the incumbents are condemned to go into decline.

Themes (let alone memes) are no substitute for analysing each industry and company on its merits.

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