TD Asset Management

Market Perspectives + 10 Minutes
= Confident Investing

Part 2 of a 2-part
TD Asset Management series

Investing in a post-pandemic world

Observing the investment landscape through a new lens

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At a glance

- The COVID-19 pandemic has the potential to structurally change the attractiveness of a variety of industries— both positively and negatively
- We believe that coming out of the pandemic, quality and secular growth companies will be the winners
- We feel that Technology, Health Care and the Automation industries stand to thrive while we expect greater bifurcation between the winners and losers across the Real Estate and Energy landscape

In the first of our 2-part series, the Fundamental Equity team at TD Asset Management (TDAM) discussed what the investing world may look like when the pandemic is behind us. The article focused on some of the industries that stand to gain, and lose, when society and business return to "normal", which included Technology, Health Care and the Automation industry.

In part 2, we will again shed light on more of the industries we believe will benefit moving forward but will also focus on some of the sectors that may be challenged in the future.

Survive and thrive, or fizzle and fade?

Industries we expect to prosper post-pandemic— and those which may face existential crisis.

Commercial real estate

While quality is a theme that underscores our investment process across all sectors of the equity market, nowhere does quality matter more today than in real estate. This pandemic is driving a meaningful shift in the value of assets, both positively and negatively, across the commercial real estate landscape. Against this backdrop, we will explore the segments of the commercial real estate market whose cash flow profile has weakened as well as those categories that have been bolstered by the pandemic.

Office

Companies have already begun to alter their thinking around the long-term feasibility of remote work arrangements, like working from home (WFH), as they've witnessed productivity increases over the past several months. However, there are two major factors which should still support the value of prime office real estate over the longer term:

- **Office culture and networking**— Collaboration-intensive and creativity-oriented segments of the business community stand to experience some of the most negative consequences of mandated WFH environments. Businesses understand the deep value of these intangibles and will ultimately find ways to ensure the corporate culture continues to exist and grow in a physical office environment. The truth is virtual water cooler sessions can't quite replicate the impromptu brainstorming and innovative ideas that tend to emerge from collaborative workspaces.
- **A change in building codes**— A gradual change in building codes and health standards to protect employee well-being will serve to reduce workplace density. This may offset the ultimate end-state of more hoteling and lower overall office space demand given the success of the current WFH experiment.

The pandemic's impact on various real estate segments

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Communications Infrastructure (Data centres, towers)

Industrial (Warehouses, distribution centres)

Apartments (AKA Multi-Family or Residential)

Office – Prime (Class A, Urban)

Retail – Necessity Based (Grocery anchored)

Office – Secondary (Suburban or Class B)

Retail – Secondary (Suburban)

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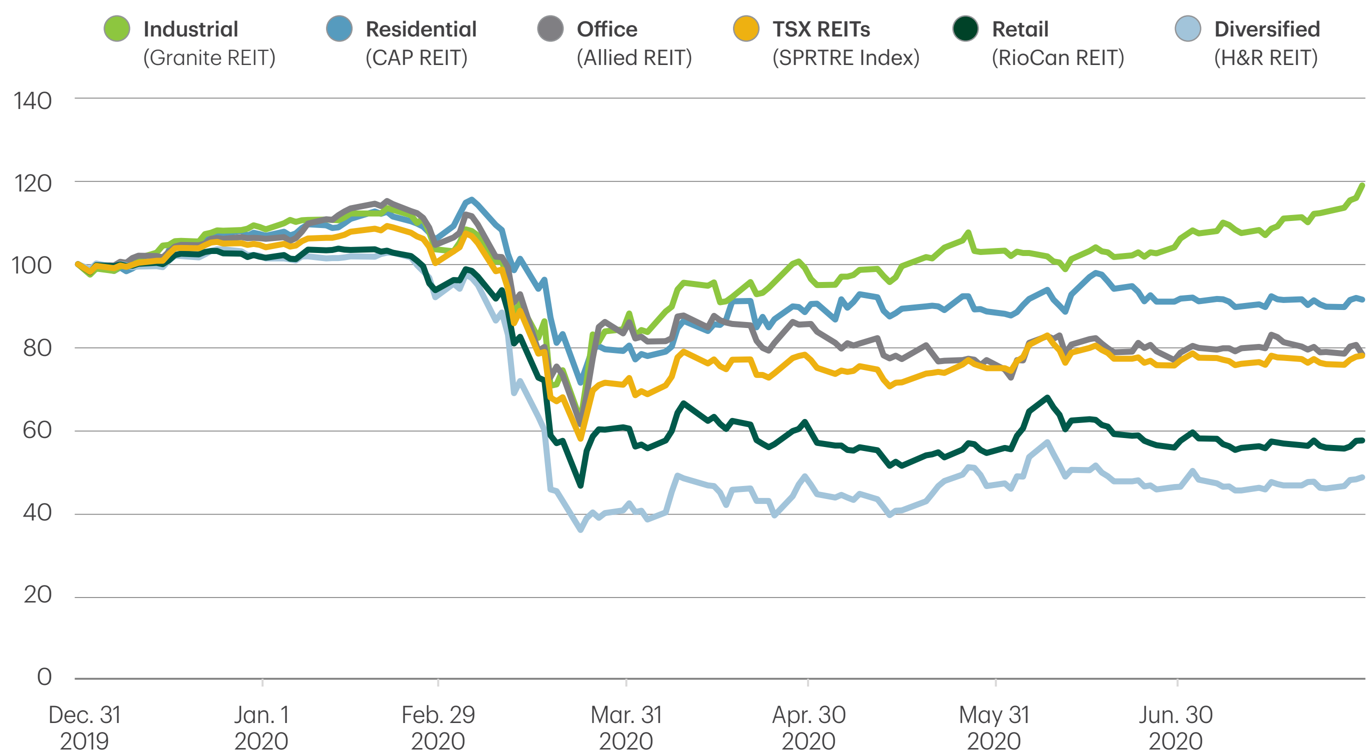
It's important to differentiate between higher quality **prime office real estate**, which is positioned to attract and retain talent and facilitate networking and creative clusters, and **lower tier office real estate** in less desirable locations that simply can't offer the same types of benefits. Against this backdrop, rents in the lower tier office category will be less resilient than those in the prime office space category.

Retail

With consumers forced to shop online because of closed shopping centers, buying habits for certain categories may have changed for good. Prior to the pandemic, many consumers were already shifting their spending away from traditional brick and mortar stores with many retail names feeling the negative effects. Pressure has been seen across retail for years and the pandemic only serves to accelerate that trend.

It should be noted however, that it may not be negative for all retail. Necessity-based retailers like grocery and pharmacy will find their traffic remains very high. What's more, smaller street-front retailers may find their foot traffic is not significantly reduced, as the perception of safety is higher within this type of real estate. Ultimately, not every retail property will suffer, but pressure on rents will likely be broader in the retail space than in office space.

Canadian Real Estate Investment Trust (REIT) Performance in 2020



Source: TDAM. Price return only. As of July 30, 2020.

Industrial

The industrial real estate market entered 2020 on very solid footing, and the pandemic has the potential to increase the fundamental attractiveness of this segment. Specifically, demand for logistics and warehousing space.

Warehouses— The shift to e-commerce and online spending may increase an already high demand for industrial space. Due to the increasing ways in which consumers can shop and receive online purchases, e-commerce supply chain operations require more warehouse and logistics space, which by extension, has driven demand for industrial real estate.

Digging a bit deeper, when it comes to supply-chain disruptions, we expect that the concept of "just-in-time" inventory will continue but that the shift to ultra-lean inventory levels may reverse slightly and an overall re-evaluation of corporate supply chains is inevitable (more on this in the next section). With that, we would expect overall demand for warehouses, general storage, cold-storage etc. to rise. This can lead to rising cash flows for asset owners in this category.

Data/Communications— The pandemic is accelerating corporate adoption of the public cloud as companies expedite the migration of computing workloads to a more flexible and robust environment. WFH is the primary driver, but rising streaming activity is also contributing to this. While Microsoft (via Azure) and Amazon (via AWS) – both of which are held broadly across portfolios – are clear beneficiaries of this trend, there is another segment that stands to profit - data center REITs. We have had long-standing exposure to this sector and are very comfortable that the secular growth tailwinds that have propelled robust free cash flow generation in recent years remain intact.

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The energy industry

COVID -19 impacts to the oil & gas sector have been severe with stay-at-home mandates eliminating 20-30% of global oil demand at the peak of the pandemic in April*. The sector is now in recovery with the U.S. Energy Information Administration (EIA) forecasting demand to return to about 4% below pre-COVID-19 levels by the end of the year and back to pre-COVID-19 levels by the end of 2021. This is expected to align with the removal of lockdowns and reopening of global economies.

While value destruction has certainly occurred within segments of the energy value chain, such as niche energy service companies who were already facing secular demand pressures, we believe this recovery presents attractive investment opportunities for certain industry players. A recent example is Chevron, who has one of the healthiest balance sheets in the sector and was able to acquire Noble Energy at an attractive price. We continue to favour the highest quality companies with sound balance sheets that can provide competitive rates of return.

The power generation world post-Covid-19

Our view remains unchanged in that traditional fossil fuels will continue to play a role in the energy transition during the post-Covid-19 world. Consider for example the dynamics taking place within the power generation industry. While most of the power generation today is fueled by a combination of coal and natural gas, we know that the combustion of natural gas emits about half as much carbon as coal.

In that context, there remains a huge opportunity for natural gas to serve as a bridge between economies that run mostly on coal and those that run entirely on renewables. China is a prime example of this 'coal-to-gas' transition and the country is expected to be the world's largest liquefied natural gas (LNG) importer by 2022. This presents a strong opportunity for our investing strategies to capitalize on this massive shift in energy consumption.

Less commuting, business travel and re-shoring

Significant impact to oil and gas or just a rounding error?

While it is still early to quantify the longer-term impacts of less traveling for business and leisure in the next two years, passenger vehicles, public transit and aviation accounts for a significant portion of oil demand, and the possibility of a prolonged recovery remains, or even worse, a structurally changed dynamic. This could impair oil demand from returning to pre-COVID-19 level growth figures.

One implication coming from the drastic drop in demand is an accelerated mergers and acquisition (M&A) cycle in the oil patch. Even before the current down-cycle, M&A was necessary as the industry was too fragmented and facing a different growth model than in the past, and COVID-19 only exacerbated the problem.

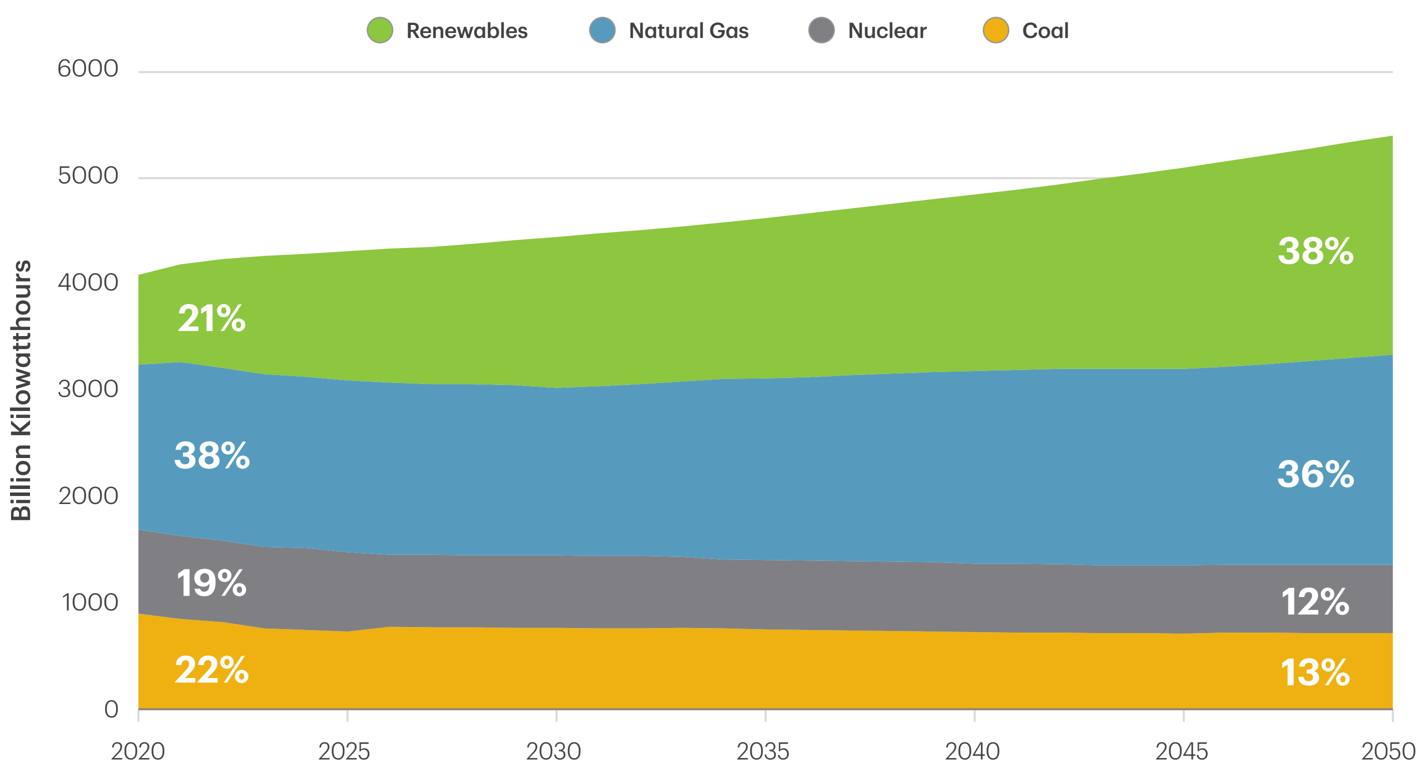
The recent announcement of Chevron acquiring Noble is a great example of this. In terms of companies that will be able to recovery more quickly than others, since the supply side has already responded (curtailments and OPEC+ cuts), the remainder of the recovery will be demand driven and therefore downstream dynamics should lead the recovery.

Renewables

While the full impact of COVID-19 on renewables is not yet clear and disruptions to supply chains risk delaying deployments of wind and solar, we believe renewables remain a fundamental component of the energy transition and the share of utility-scale renewable generation in the global power mix will continue growing in the next decade.

According to the World Health Organization (WHO), the number of people without access to electricity declined from 1.2 billion in 2010 to 789 million in 2018**. However, under policies and projects that were in place or planned before COVID-19, an estimated 620 million people would still lack access in 2030. This means progress must continue to accelerate and the $120 billion in capital expenditure commitments to clean energy projects in 2020 is still not enough**. Ultimately, these projects will all move forward but timing is uncertain. The transition in energy use is being driven by governments and policy and this evolution is viewed as a long-term movement towards a more sustainable world. At TDAM, we continue to closely monitor and assess renewable initiatives across the globe and support companies who can accelerate this transition while generating shareholder value.

Electricity Generation from Selected Fuels



Source: U.S Energy information Administration – Annual Energy Outlook 2020, released January 2020.

Renewable

The supply-chain revolution

It became very clear during the early days of this pandemic that global supply chains were ill-prepared to deal with a crisis of this magnitude. Two specific industries felt the brunt of the disruption: Healthcare (worldwide shortage of personal protective equipment and equipment/devices) and the food sector (grocery stores and food producers). During the pandemic, many companies across the industrial, technology, and consumer sectors experienced significant dislocations.

Although the initial stress on the supply chain ecosystem was driven by a surge in demand for critical products, three key factors exacerbated this demand-driven disruption:

- The multi-decade move to just-in-time (JIT) inventory management, driven by demand for lower costs and higher profits
- Inadequate supply chain management infrastructure
- Single-sourcing to the lowest cost producer

Considering the vulnerabilities exposed by the pandemic and given uncertainties related to ongoing U.S -China trade tensions, companies of all sizes are placing a greater focus on diversifying and fortifying their global supply chains.

Not only will firms begin redesigning their logistics network in order to eliminate single source dependencies, we believe many industry leaders will begin to implement regional supply chain hubs. Furthermore, we are beyond the days where comprehensive dashboards providing real-time supply chain analytics are reserved for only the most sophisticated companies. Going forward, these advanced analytical platforms will likely be table stakes.

This unique backdrop presents a distinct opportunity for select companies that provide software and design solutions to these highly complex logistical problems, and our portfolios have direct exposure to this theme.

Mitigating risks and taking advantage of opportunities

Many of our views expressed within this two-part series were influenced by our frequent assessment and analysis of the pandemic' full potential impact on fundamentals, such as corporate earnings, default rates and long-term inflation expectations. There have been encouraging signs of improving financial activity as economies reopen.

At TDAM, we continue to believe that the path of the pandemic may still impact the sustainability of the current equity and credit market recovery. Significant risks remain on the horizon for many companies, sectors and global economies. To mitigate these risks, our investment portfolios continue to be tilted to high-quality companies and assets that can meet our disciplined investment process, best withstand elevated periods of volatility, and deliver strong risk-adjusted returns over the longer term. We strive to ensure that our investment portfolios are weighted to industries and companies that are strategically positioned to capitalize on the potential reversal of current trends.

We believe that active management will continue to play an important role in helping to protect client portfolios through this period and in finding opportunities during the economic recovery.

*U.S Energy information Administration – Annual Energy Outlook 2020. https://www.eia.gov/outlooks/aeo/index.php
**Tracking SDG 7: The Energy Progress Report: International Energy Agency (IEA) the International Renewable Energy Agency (IRENA), the United Nations Statistics Division (UNSD), the World Bank, and the World Health Organization (WHO)

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