“THE NEXT NORMAL” EMERGING FROM THE COVID-19 CRISIS

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The enclosed observations have been prepared through the Research Committee at The Investment Management Corporation of Ontario (IMCO). The Research Committee’s mandate is to inform IMCO’s investment process with critical insight into key global issues and trends.

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INTRODUCTION

The COVID-19 crisis is, first and foremost, one of the worst health emergencies the world has ever witnessed. At time of writing, the world has experienced more than 170 million cases, and more than 3.5 million people have died. The global economy contracted by 3% in 2020 due to the pandemic, the deepest recession since World War II. Governments' economic response to the crisis has also been unprecedented with US$10T announced in stimulus in the first two months – three times greater than the response to the 2008-2009 financial crisis. The total stimulus announced since the start of the pandemic has now exceeded US$14T. While the final impact remains to be seen, the crisis will likely lead to sustained secular changes impacting individuals and companies across the globe. As we seek to understand what the "next normal" could look like, several themes are emerging.

FIGURE 1: Emerging themes for the "Next Normal"

Several themes are emerging to shape the "Next Normal"

CATEGORY	THEME
Global growth shifts	**Globalization in transition and reshaping of supply chains** as firms and governments place renewed emphasis on resiliency
	Uneven recovery, as highly developed countries with early access to vaccines and countries like China who managed the pandemic well look set to drive future global growth and recover relatively faster from the crisis
	Reshaping of global travel flows as economies recover and reopen, but business and leisure travel patterns are reshaped
A new societal deal	**Elevated role of remote working**, albeit at lower level than during peak shelter-in-place periods
	Increase in government activism to achieve broad goals during the recovery from the crisis (e.g., trade policy, stimulus packages)
	Need for intensified reskilling as the benefits of globalization have been unevenly distributed and people are facing growing job threats
Accelerating industry disruption	**Rise of ecommerce and shifting preferences** as consumers build new habits during lockdown and businesses accelerate their investments in digital
	The era of the purpose driven organization as investors, employees, customers, & other stakeholders prioritize meaning in the Next Normal
	Ecosystem revolution as horizontal platforms and ecosystems have disrupted markets and have become increasingly dominant

As the COVID-19 crisis continues to evolve, more themes that will shape the Next Normal are likely to emerge

This document contains research on three of these key trends that are likely to shape the post-COVID world:

- Globalization and reshaping of supply chains as firms and governments place renewed emphasis on resiliency
- Elevated role of remote working, albeit at lower level than during peak shelter-in- place periods
- Rise of ecommerce and shifting preferences as consumers build new habits during lockdown and businesses accelerate their investments in digital

By proactively defining its perspectives on these themes and the nuances within them, IMCO can explore the investment implications at the asset-class level to protect and grow value for its clients.

GLOBALIZATION AND THE RESHAPING OF SUPPLY CHAINS

CONTEXT

Over the past century, the world has progressively grown more globalized. Business and technological innovations, supported by policy reforms (e.g., lower trade barriers), have been driving this growth. However, in the last decade, trade in goods – while still increasing – decelerated. Global goods exports grew at 2% per annum from 2007-2017, due in large part to a significant drop in trade during the Great Recession. In comparison, goods trade grew at 10% per annum in the previous decade (from 1997-2007)[1].

Recently, trade tensions have adversely impacted global exports. For example, in July 2018, the US imposed a new set of tariffs on China, which was met by commercial retaliation. The subsequent US-China trade rift led to a decline in yearly trade of 15% between the two superpowers[2]. Elsewhere, some countries have pursued nationalistic policies (the UK and Brexit) while others forged new international trade agreements (TPP – a comprehensive free trade agreement between Canada and 10 nations in the Asia Pacific region).

COVID-19 has put additional pressures on global supply chains. Across the world, governments took an active role in securing supply chains during the crisis. In March 2020, India put export restrictions on 26 key active pharmaceutical ingredients (APIs), causing global shortages. In April 2020, former President Trump invoked the Defense Production Act to support production of ventilators. More generally, labor shortages caused by shutdowns exposed supply risk (e.g., supplier concentration) across industries and sudden changes in demand due to lockdowns highlighted the need for more responsive supply chains.

In response, many governments signalled their intention to build domestic supply chains. For example, in Ontario, Premier Doug Ford stated that "[He's] not going to rely on any prime minister of any country ever again. Our manufacturing, we're gearing up and once they start, we're never going to stop them" (April 2020)[3].

In this context, IMCO sought to understand and contextualize the changing nature of trade (e.g., deglobalization vs regionalization) and the potential impact that the crisis would have on globalization and supply chains.

PERSPECTIVES

The death of globalization is greatly exaggerated – the crisis has instead accelerated an evolution towards Globalization 2.0

While trade intensity[4] is expected to continue to decline, absolute trade flows are projected to recover from the COVID-19 crisis within the year[5]. Furthermore, trade intensity decline has been largely driven by increased wealth of emerging economies, with China leading the pack (i.e., increase in domestic consumption, lower need for intermediate inputs to manufacture finished goods) – not a wholesale rejection of global supply chains as a lever to create economic value.

Though geopolitical uncertainty (especially US-China) and targeted diversification of supply chains may lead to some reduction in inter-regional flows, overall economics and supply chain resiliency are expected to continue to spur regional optimization of trade. One source estimates that ~15-25% of trade could shift country of origin over the next 5 years, highlighting a continued optimization over a reduction in international trade.

All sectors are not created equal – the impact in some sectors will be up to 5x what they are in others

In some sectors, only 5-10% of trade could shift in the next 5 years (e.g., chemicals, basic materials), while in others this is as high as 60% (e.g., pharma, apparel)[6]. Four factors will drive the level and speed of shift at the sector level: i) Investments in resiliency to reduce impact of disruptions, ii) Adoption of digital technologies (e.g., reducing benefits from labor- cost arbitrage), iii) Government interventions (e.g., tariffs and subsidies), and iv) Focus on sustainability by stakeholders.

There will be many winners and losers at the company level – investments in supply chain resiliency can help firms mitigate risk and build competitive advantage

In the next normal, leaders will go beyond "efficiency" and focus on digital, responsible, and resilient supply chains. A survey of global supply chain professionals found that 87% were planning to increase resilience of supply chains (February 2021)[7]. However, country-level dynamics remain challenging to predict, and executives must consider the risk-reward profile of their supply chain changes they envision (e.g., weighing the risk of additional costs that may not be passed on vs a more exposed supply chain).

Companies that have invested in supply chain resiliency are outperforming in the crisis. For example, Nike's Q1 2020 sales declined only 5% -- compared to 45% vs major foreign competitors in China. Nike was able to react in real-time to disruptions due to its superior visibility in its supply chain (e.g., RFID tagging allows E2E tracking of products). Investments in predictive demand analytics and an integrated digital ecosystem enabled the company to minimize the demand impacts of store closures in China amid COVID-19.

1 UNCTAD Trade Flows of Goods and Services
2 US Census Bureau
3 As reported by the CBC
4 Defined as global gross exports over global gross output
5 World Trade Organization
6 McKinsey Global Institute
7 2020 Gartner Future of Supply Chain Survey (February 2021), n=1300

ELEVATED ROLE OF REMOTE WORKING

CONTEXT

Pre COVID-19, there was limited – but accelerating - adoption of remote work in the United States. Only ~5% of workdays were completed outside of the office or work site and only ~2% of workers were fully remote. Despite ~30% of workers being able to work remotely, only half of the individuals that had the ability to work from home took advantage of this modality at least occasionally (~15% of all workers). Occupations including professional and business services, information, and financial activities had the highest rate of remote work[8].

The main barriers to broader adoption of remote work included proximity requirements both physical (e.g., manual labor) and psychological (e.g., enjoying the social aspect of being with other people, a belief that being seen by one's supervisor was necessary for promotion). Additionally, lack of availability of digital tools like laptops, internet bandwidth, and collaboration software like Slack and Zoom also held back adoption of remote work. Due to the pandemic, these barriers have been at least partly removed as companies adapt to physical distancing requirements. According to a NBER report, by May 2020, about half of US employees were working from home[9].

Firms are observing the benefits of remote work. Productivity has been sustained during periods of work from home, and in some cases has even improved. Talent can be sourced more broadly, lifting current geographical constraints on recruiting. In the future, real estate savings could be realized. Employees are also enjoying working from home. Over 80% of US office workers would prefer to work from home at least one day a week after the pandemic[10]. Technology companies have been leading the adoption of remote work. For example, Twitter, Shopify, and Spotify employees can now work remotely indefinitely.

Nonetheless, certain activities still benefit from in-person connection. For example, onboarding and job training, especially for new hires or more junior roles, poses unsolved challenges in a remote environment. More broadly, certain activities requiring high levels of communication are more difficult remotely (e.g., team building, cross-function collaboration). Finally, many people are missing the social interaction they had at the office and hope to return to that in the not-too-distant future.

PERSPECTIVES

While remote work is here to stay, it will largely co-exist in a hybrid model with in-person work

By some analysis, after the pandemic, about 15-25% of workdays could be performed remotely, a significant increase from the pre-COVID baseline (~5%)[11]. Importantly, this does not mean that workers will shift to fully remote work. It is likely that many workers will shift to a hybrid model – performing work requiring being in-person at the office or work site and shifting work that can be done remotely to home. More specifically, people are less likely in the future to come into an office building to sit in a closed office with no human contact to write reports or build models. This work can just as easily be performed at home. And many employees report they prefer to do this kind of work at home.

About 30% of workers are projected to spend at least 1 day a week working from home. The biggest change in work modalities is expected in sectors where the pandemic caused a cultural shift – for employers and/or customers – in perspective on remote work. For example, in the health and education sector only about 10% of workers worked from home at least one day a week before the pandemic. As the population has adopted remote learning and telehealth, the share of workers working from home at least one day a week is expected to grow to about 30% of the workforce. Even more surprisingly, about 30% of workers in the construction, real estate, mining, and utilities sectors are also expected to spend at least one day working from home post-pandemic – a significant increase from a baseline of about 2% pre-crisis[12].

Remote work adoption will vary significantly based on the characteristics of the industry, company, and individual as well as the city in which they live

The level of remote work adoption will vary based on several factors including sector, type of city, age and experience of worker, and company culture. We expect higher rates of remote work for workers in knowledge industries, especially where the work output is primarily digital and their home environment (i.e., good broadband, a quiet place to work, consistent electricity, etc.) enables remote work. For example, more than half of workers in professional and business services, information, and financial activities can work remotely today.

8 U.S. Bureau of Labor and Statistics
9 NBER Working Paper 27344
10 PWC US Remote Work Survey, January 2020, (n=1200)
11 Author's analysis, based on U.S. Bureau of Labor and Statistics, Dingel & Nemain (2020), McKinsey Consumer survey, Survey of Business Uncertainty from the Federal Reserve Bank of Atlanta (May 2020), Gartner CFO survey (April 2020)
12 Survey of Business Uncertainty from the Federal Reserve Bank of Atlanta

Larger metropolitan cities will also have more remote work in the future – while only ~30% of workers in non-metro cities can work remotely, more than half of workers in large metro cities could do so[13]. Millennials and other younger workers are also a cohort worth watching: On one hand, these workers are increasingly incentivized by flexibility making remote work appealing; on the other hand, this desire for flexibility could be at least partly mitigated by the importance of in-person training, mentorship, and networking earlier in an individual's career.

Finally, company culture will ultimately make or break the long-term sustainability of remote work. For example, firms that have more expertise with technology and where workers have more autonomy (e.g., creative fields like programming) or where remote monitoring is facilitated by clear KPIs (e.g., customer care centers), we expect to see a higher share of workers embracing more remote work permanently.

Remote work will not lead to the downfall of all office real estate, but demand for the asset class will be lower and different than it was pre-COVID

While likely not catastrophic, the most direct impact of the projected increase in remote work will be on office real estate (e.g., potential reduction of 10%+ in footprint; lower than the increase in remote work). Unsurprisingly, the impact will be more significant where tenants have higher rates of remote work adoption (e.g., in large cities, with workers in high-risk industries like professional and business services, information). The shift to hybrid models – versus fully remote – will mitigate some potential decline in office real estate, as footprint requirements will be based on peak capacity, albeit reduced.

The desire for flexibility around work will lead some companies to actively consider and use hub and spoke models and flex spaces. Hub and spoke models also make it possible to occupy shorter buildings – with limited need for elevators and shared lobbies – more suited for physical distancing. While some believe that de-densification will be the saving grace for the sector, it appears that it may be an expensive solution to social distancing that could be time limited. It is therefore less likely to mitigate headwinds for the office real estate sector.

More broadly, a rise in remote work – and the accompanying shift in where people decide to live, work, and travel – will have implications for residential real estate, infrastructure and urban transit, and business travel.

13 U.S. Bureau of Labor and Statistics

RISE OF E-COMMERCE AND SHIFTING CHANNEL PREFERENCES

CONTEXT

Pre-crisis, the retail industry was already facing major disruption. Patterns in personal consumption were shifting (e.g., growth of online and omnichannel, decreasing brand loyalty) and advances in technology were challenging the status quo (e.g., advanced analytics, automation). The COVID-19 pandemic is set to accelerate this disruption, further driving the rise of e-commerce and the decline of brick and mortar.

Pre-crisis Canadian ecommerce penetration was 10% in 2019 and set to reach 13% by 2023 with ecommerce sales growth (~10% p.a.) far outstripping brick and mortar (~3% p.a.)[14]. At the peak of lockdown, ecommerce penetration reached 20-25%[15], with 68% of consumers trying a new shopping behaviour (e.g., new digital purchase)[16].

Coming out of the crisis, consumers are expected to continue to purchase through ecommerce with a penetration of 16% by 2023 and a slower brick and mortar growth of 0.3% p.a. Similar dynamics are expected in the US, albeit reaching a higher level of penetration of 27% by 2024 (ecommerce growth of ~12% p.a. 2019-2024 and -0.3% p.a. for brick and mortar)[17].

Ecommerce acceleration, combined with the recessionary effect of crisis, is expected to amplify existing trend of brick-and-mortar closures.

PERSPECTIVES

COVID-19 has impacted consumer behavior in several ways, many of which are here to stay

Canadians are amongst the most pessimistic consumers in their outlook and approximately 30% expect their household finances to be negatively impacted for greater than one year due to the crisis[18]. In addition to accelerating e-commerce penetration, the crisis is shifting consumer preferences more broadly.

The crisis has been a shock to loyalty – Over 77% of Americans have tried either new brands, places to shop, or shopping methods during the crisis, primarily driven by value and convenience. Most of the consumers who tried new ways of shopping intend to continue using a combination of what they did before COVID-19 and what they tried during the crisis. A similar shock has been observed in Canada.

14 Forrester Analytics
15 Statistics Canada, Forrester Analytics, and author's analysis
16 Statistics Canada, Forrester Analytics, and author's analysis
17 Source: Statistics Canada, Forrester Analytics, author's analysis, McKinsey & Company COVID- 19 Canada Consumer Pulse 8/14 8/19/2020, n = 1,032, sampled and weighted to match Canada's general population 18+ years
18 Forrester Analytics

The crisis also caused a shift to value and essentials – with consumers spending more than usual (positive net spending intent) on essential categories and less than usual on non-essential categories. Most discretionary categories are still at -20 to -40% net intent vs. pre-COVID, but net spending intent on discretionary categories is slowly recovering.

Finally, there has been a trend towards “mission” shopping, as consumers transition away from seeing shopping as a pleasurable activity. Number of shopping trips are down, basket sizes are up (44% reported spending more per visit), and consumers are visiting fewer stores (40% consumers reported shopping at fewer stores)[19].

The crisis will have an uneven impact on ecommerce penetration and total demand by sector

All categories are expected to see an acceleration in ecommerce penetration, with online sales growth ranging from 22% p.a. in the Canadian grocery sector which has traditionally had low penetration (3% of all sales online in 2019), to 7% p.a. in computer hardware, the most prominent online sector (73% of all sales online in 2019).

Discretionary spending will have a slower and more muted revenue recovery (e.g., apparel is forecast to decline by ~2% p.a.) and there may be substantial bankruptcies for retailers in discretionary categories. Non-discretionary spending may recover more quickly, with the Canadian grocery sector set to achieve higher sales relative to pre-crisis estimates ($5Bn higher vs. pre-crisis estimate)[20].

Impact from the acceleration of e-commerce will create winners and losers across the retail value chain

Many traditional retailers have been dramatically negatively impacted by the crisis. Canadian retailers like Groupe Dynamite, Aldo, Reitmans, Le Château and MEC have all filed under CCAA, with some liquidating or selling, and others undergoing restructuring. Despite this, some retailers are facing tailwinds in the crisis. Players in grocery, retailers that are digitally focused, and/or, value players are more likely to emerge as major winners from the crisis. For example, Amazon has been continuing to grow during the crisis, recording ~44% YoY global sales growth in Q1 2021.

Retail real estate is set to face an accelerated decline due to the forecasted decline in brick-and-mortar sales, leading to continued store closures and a struggle to replace the lost demand with similar rents. Increase in work from home could further shift where consumers live and work, potentially impacting even the jewel retail real estate assets that would often be in prime downtown locations.

Technology solutions required to facilitate growing ecommerce sales will benefit from tailwinds in the “next normal” as firms optimize ecommerce operations and move online for the first time. Logistics capabilities associated with meeting growing ecommerce sales will also face increasing demand including B2C last mile delivery, D2C transport, 3PL, and warehouse players.

19 McKinsey & Company COVID-19 Canada Consumer Pulse 8/14 8/19/2020

20 US Department of Commerce, author’s analysis, McKinsey & Company COVID-19 US Consumer Pulse Survey 8/19 8/23/2020, n = 2,026, sampled and weighted to match the US general population 18+ years
Forrester Analytics