

The COVID-19 American's Hierarchy of Needs

A Framework for SMid Cap Investing in and After COVID-19

COVID-19 has impacted the U.S. consumer, the largest part of our economy, in countless ways. Lock-down disruption and massive government stimulus programs have been like dueling banjos, evoking a series of emotions and behavior changes from the U.S. consumer, many of which have been surprising.

For example, witness a red-hot housing market in the face of 14% unemployment! The resulting noise has also masked (sorry) fundamental shifts in future supply and demand behaviors that persist beyond this crisis. At 150,000 U.S. deaths as of this writing, we expect the COVID-19 experience to be more generationally scarring than the Global Financial Crisis of 2008, and likely more comparable to the WWII experience or the Great Depression of the 1930s. In a war-like footing, our government has brought out the big guns of stimulus — as much as \$6 *trillion* committed as of this writing, or roughly three times the total cost of the Iraq War (2003–2011).

But we do think it is appropriate to look beyond 2020 results as we consider underlying earnings power of a business. Corporate earnings guidance is of little help

right now, as management teams have prudently withdrawn the annual outlook that is the traditional grist for the Wall Street “consensus” mill. So, what is an investor to do?

The small-mid market cap arena, traditionally less efficient than large cap, offers particular opportunity for stock picking today. As our analysts evaluate companies serving the U.S. consumer, this means understanding both competitor supply and customer demand today, as well as in a post-vaccine world. While human history is full of cautionary tales of viral woe, we believe that progress to date by leading pharmaceutical firms like **Pfizer**, **Moderna**, **AstraZeneca**, **JNJ**, **Merck** and **Gilead** make it much more likely than not that we will have both an effective therapeutic (think Tamiflu) and a vaccine (more likely several competing versions) within a year. Within this strange current reality, and a likely altered future state of consumer attitudes and behaviors, we continue our search for quality businesses that are underappreciated.

To borrow from psychologist Abraham Maslow, we might consider the “hierarchy of needs” of a *hypothetical* U.S. consumer in these changing times. **Call it the COVID-19 American's Hierarchy of Needs, both today and in a post-vaccine world:**

COVID-19 American Hierarchy of Needs

Meal Delivery

Stocked Pantry

Protection and Cleaning, e.g., Masks and Lysol Wipes

Alcohol

Investment in New Shelter (Preferably in the Suburbs)

Digital Bandwidth

Nesting: Work From Home, Remote School, Furniture, Lawncare

Gaming: Console and Online

Entertainment Video Content (Including for Children)

Personal Transportation, e.g., Car and Fuel

Home Fitness

~~Elective Health Care Spending, e.g., Dental Cleanings, Wellness Checkups, Joint Replacement~~

~~Dining Out~~

~~Air Travel~~

~~Clothing: Business, Casual, School~~

~~Live Events, e.g., Sports, Movies and Concerts~~

POST Vaccine American Hierarchy of Needs

Dining Out

Personal Transportation, e.g., Car and Fuel

Elective Health Care Spending, e.g., Dental Cleanings, Wellness Checkups, Joint Replacement

Live Events, e.g., Sports, Movies and Concerts

Meal Delivery

Clothing: Business, Casual, School

Fitness, e.g., Gyms and Recreational Sports

Air Travel

Digital Bandwidth

Investment in New Shelter

Gaming: Console and Online

Entertainment Video Content (Including for Children)

Alcohol

Nesting Activities: Work From Home, Furniture, Lawncare

Protection and Cleaning, e.g., Masks and Lysol Wipes

Stocked Pantry

The above table is informed speculation, based on industry analysis and personal experience. Actual results are, of course, uncertain and not likely to be static, but this framework is a decent starting point for stock pickers. Are there undervalued opportunities in areas most likely to recover following a vaccine? As always, we consider both the most likely outcome, as well as a

more negative outcome in the case that we are wrong. **Incorporating all this, our analysis leads us to two major categories of opportunity in the small-mid cap arena at the moment:** 1) Businesses that are benefiting from COVID-19 chaos more than is commonly understood, 2) Businesses that are positioned to win in the post-COVID-19 world and are not valued as such.

Counter-Cyclical COVID-19 Beneficiaries

The market has appreciated the heightened current appeal of stay-at-home entertainment, e.g., video games, and the strong position of prepared food to your doorstep, e.g., pizza delivery franchises. However, we believe much of the economic pain and likely credit cycle deterioration are still in front of us. We are finding opportunities in businesses that will benefit from current and growing business stress, including within non-bank financial services. **Ares Management (ARES)** is a provider of direct lending and distressed credit that provides a liquidity lifeline to solvent businesses facing short-term business pressure. For more severe cases, the restructuring division of investment bank **Houlihan Lokey (HLI)** stands ready to manage the asset divestiture and credit workouts before and during the bankruptcy process. Neither ARES nor HLI equities adequately discount this counter-cyclical benefit, and are therefore attractive holdings.

Post-Vaccine Winners

Restaurant dine-in volume, as reported by Open Table, is down >55% YoY in the United States. The resulting underutilization is punishing small local restaurants, many of which continue to hang on due to stimulus provided by the Payroll Protection Program. When these funds run off, the resulting supply destruction will benefit chains like Outback Steakhouse, part of **Bloomin' Brands (BLMN)**, that are in stronger financial positions and have the ability to leverage their scale and off-premise capabilities to gain market share. BLMN shares look attractive to us at 15x 2021E EPS and a 12% free cash flow yield, with sufficient liquidity to weather the storm. With a vaccine on the horizon, we

can invest with conviction that diner demand will return to find more limited supply; this is good for survivors like BLMN. As miles driven recover, we also see need-based auto sales recovering. Specifically, used auto volumes should improve, benefiting auto wholesale auction leader **Kar Auction Services (KAR)**. KAR enjoys its position in a rational oligopoly that is the used car auction business, and is leading the migration to online auction as a complimentary channel to the large physical markets. The 15x 2021E EPS multiple and 14% FCFY look enticing to us, given these tailwinds.

As students of the market and human nature, we are long-term optimistic. It has been foolish to bet against human ingenuity. However, in these times of generational disruption and change, the need for fundamental analysis and stock picking is apparent. Historic market volatility and limited corporate visibility represent opportunity for profitable insight by active management.

As always, Westwood seeks to invest where the downside is understandable and limited, and the upside is more substantial.



Grant L. Taber, CFA

Senior Vice President

Senior Portfolio Manager, Research Analyst

SMidCap

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Strategy

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