How to stop It's the pace of Disruption that matters

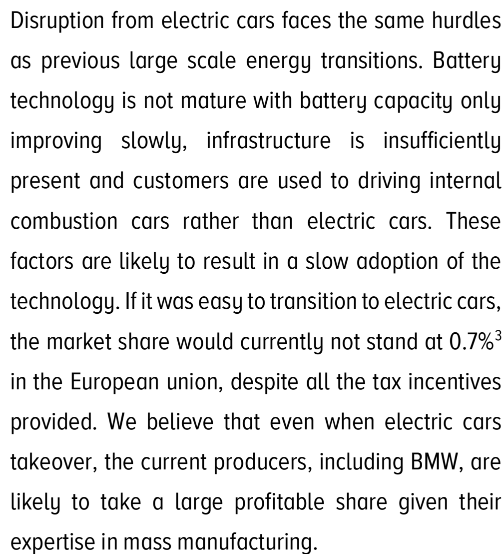
Disruption has once again become the central theme in capital markets. The focus on disruption has led to rising valuations for technology companies and depressed multiples for traditional sectors including Automotive, Healthcare and Energy. Disruption is real and it will impact the profitability of many industries. Capitalism thrives on disruption, and changes in technology have brought the high standard of living we currently enjoy. What has not changed, in our view, is the speed of disruption, which remains much more stable over time. Transitions in technology often span decades, not years, yet the market prices in immediate disruption. This overreaction creates opportunities to find attractive investments in businesses where change is likely to be slower than the market currently expects.

During the dotcom bubble, investors believed e-commerce would radically change the landscape of the economy. With the benefit of hindsight, we can conclude that their prediction was largely right. Where the stock market went wrong is in expecting this change to occur overnight. Instead, it has been a much more gradual process. Even in the current age of Amazon, e-commerce only makes up 9.5% of total US retail sales[1], a full 18 years after the dotcom bubble ended. Retail customers are creatures of habit, infrastructure is unavailable to support instantaneous change and new companies need to time to scale. Similarly diesel, a radical new technology introduced commercially in 1911, offered 50% more efficient engines but had not completely replaced the steam engine in ships more than thirty years later. In fact the ships that freed Europe during World War II were powered by steam engines and not diesel[2]. The slow uptake of diesel was due to a limited ecosystem of diesel infrastructure, an immature technology, and inertia among engineers used to working with steam technology. A similar transition debate is currently underway in the automotive industry with the shift towards electric cars and autonomous driving.

We do not doubt that electric autonomous cars will achieve a high market share in the future. A complete displacement of all self-driven internal combustion engine cars is a likely scenario. Electric cars offer a superior driving experience, use energy more efficiently and emit no direct greenhouse gases. Autonomous driving promises increased safety, higher utilization of the current car fleet and more productive use of the time spent in the car. If you combine these two trends, then the outlook for traditional automotive producers looks bleak. While we do not disagree with the market on the likelihood of these trends, we do disagree on the timing of this change and its impact.

An example of the current pessimism surrounding the traditional automotive industry is BMW, the luxury automotive car manufacturer. Based on its 2017 net income, shares in the company can be bought for close to six times earnings, and at 5.3x times earnings (plus a dividend yield of 5.8%) if one is willing to purchase the non-voting preference shares. At 5 times earnings, or a 20% earnings yield, not much has to go right for it to be an attractive investment. This low valuation is largely due to fear surrounding potential disruption by electrified autonomous cars.

[1] https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf
[2] http://vaclavsmil.com/wp-content/uploads/docs/smil-article-20070000-jgh-2007.pdf



Disruption from electric cars faces the same hurdles as previous large scale energy transitions. Battery technology is not mature with battery capacity only improving slowly, infrastructure is insufficiently present and customers are used to driving internal combustion cars rather than electric cars. These factors are likely to result in a slow adoption of the technology. If it was easy to transition to electric cars, the market share would currently not stand at 0.7%[3] in the European union, despite all the tax incentives provided. We believe that even when electric cars takeover, the current producers, including BMW, are likely to take a large profitable share given their expertise in mass manufacturing.

The change towards autonomous cars is potentially more devastating than a change in drivetrain, given lower dependence on ownership. While companies including Waymo (owned by Alphabet) are making strong technological progress, it is not ready for market entry. We believe this technology will face a long ramp towards widespread adoption. People are hesitant to hand over control to other people, let alone computers. Control creates an illusion of safety. This is the reason why flying is feared more than driving, despite being much safer. Autonomous cars also face regulatory hurdles, delaying the onset of mass adoption. Finally, autonomous cars may result in wider car sharing, but not cause meaningful change in ownership rates. Most cars are needed for daily commutes. In this case, a disruption may only have a muted impact on profitability.

Major transitions, especially energy related transitions, span decades, not years. When faced with new technology investors price in immediate disruption when instead they should be more careful in assessing the timeline of disruption. We believe this creates opportunity to buy businesses where investors misprice the speed at which the industry changes.

[3] http://www.eafo.eu/europe

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