

CORPORATE EXCELLENCE INSIGHTS

We are a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: STRONG CORPORATE RESULTS PUSHING INDICES HIGHER

World equity indices are still moving upwards as they are pushed e.g. especially in the USA by strong corporate earnings.

32

RECORD HIGHS THIS YEAR POSTED BY THE S&P

How far can it go? Given historic low volatility, markets are expecting calm conditions and no disruption is foreseen. Low interest rates still favor equities.

6%

RISE OF THE EUR AGAINST CHF IN ONE MONTH

The EURCHF reached the highest level in 2 ½ years. As a result, the SNB might move back to interest rate normalization - this is positive news for Swiss stocks

3

HOURS ON JULY 27 THAT J. BEZOS WAS THE RICHEST MAN ON EARTH

The recent surge in Amazon was short-lived, but it shows how powerful the change in the business environment due to technological shifts can be.

MONTHLY TOPIC: RISE OF THE MACHINES

Automation and big data are changing the world – the vote on basic income in Switzerland and Bill Gates' proposed tax on robots are the zeitgeist of modern times and show that people are worried. On the other hand, numerous advancements in the field of machine learning and artificial intelligence are creating huge productivity gains and making life more comfortable. But the tech revolution has just started in some sectors and opens opportunities for labor-intensive businesses. So who stand to win from another mega-trend?

An estimated 47% of employees in USA are at risk, indicating automation of whole occupations is progressing quickly. Ca. 50% of the world's job positions are subject to automation, according to McKinsey, leading to a revolutionary trend in the services sector, the effects of which will be comparable to the industrial revolution of the 18-19th century.

The activities most susceptible to automation are the ones which involve physical activity in predictable and organized environments as well as data collection and processing.

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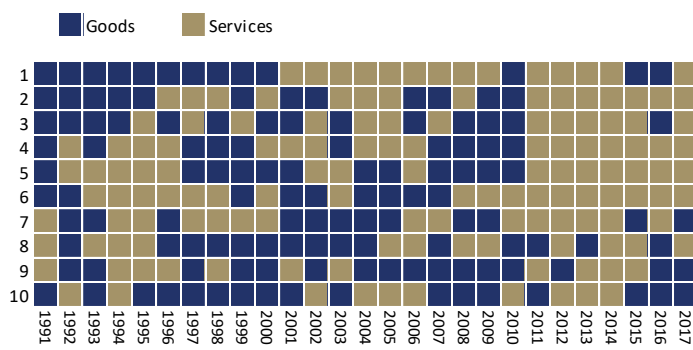
UNEXPECTED WINNERS OF THE TECH REVOLUTION

The future is now

Have you seen the latest Amazon Go ad ([link to video](#))? That is essentially how the retail industry will look like in the nearest future. Driverless trucks delivering products to warehouses, pre-ordered by a computer system based on the automated monitoring of void shelf spaces. Afterwards, robots fill the shelves with the required products following algorithm-based advice on proper positioning. Customers use self-service checkouts or even just walk out without standing in line for the cash register, enjoy a personalized brand experience, advised by the devices and getting reviews of products immediately via image recognition and logo detection. And Amazon is pretty serious – in June they bought Whole Foods to gain the physical store presence and to bring their concept to reality.

What studies suggest

Frey and Osborne estimated 47% of employment in USA is at risk¹, indicating automation of whole occupations is progressing quickly. Ca. 50% of the world's job positions are subject to automation according to McKinsey² leading to a revolutionary trend in the services sector, the effects of which will be comparable to the industrial revolution of the 18-19th century. Trends in job reduction in the services sector are already evident in the US today: starting in 2011 (see Figure 1) job losses in the services sector became the majority, and this will continue to an even larger extent in the near future.



Source: Bureau of Labour Statistics

Fig 1. Top 10 job losing sub-sectors: services vs. manufacturing

Massive advances in technology are also to blame for the sluggish job growth in US manufacturing in the last 15-20 years. It is noteworthy that weak employment decouples with productivity growth in the US that remains robust in the US after 2000³, indicating new opportunities used by companies to improve efficiency.

The activities most susceptible to automation are the ones which involve physical activity in predictable and organized environments as well as data collection and processing. That's why we will see applications of artificial intelligence primarily in administrative work, transportation, retail, and manufacturing, which is already experiencing the fourth wave of production automation - Industry 4.0.

Fig 2. Occupations with highest automation potential

Occupations with highest automation potential	Automation potential
Production workers	99%
Cashiers	97%
Tractor Operators	92%
Food preparation workers	91%
Order filling clerks	86%
Accounting/ auditing clerks	86%
Truck Drivers	81%
Waiters	77%

Source: McKinsey Global Institute, Bloomberg

Some unexpected winners

Jeff Bezos is surely a star and Amazon is the poster child of the retail revolution – the company has automated everything (pricing, shipping, storage, etc.) relying on more than 15,000 robots in its warehouses. That's why it can put 316 mn products on sale (vs. 17 mn products sold by Walmart) and serve more than 20 mn customers daily while still posting high and increasing gross margin. But that is also the reason why it enjoys a hefty valuation – Price/Sales ratio of 3 (it is meaningless to look at PE, because profits are non-existent as the company spends heavily to finance its expansion).

Who would be the others? Companies with significant employee base and personnel cost share to operating profit might be less obvious winners of the overall automation, but their productivity and profitability growth potential can be enormous. Take Wal-Mart, which employs more than 2 million people worldwide and spending roughly 70 bn USD on personnel costs. If the company can reduce its workforce by 20% (which is realistic) – it would get a 60% boost to its operating profit. Or Deutsche Post – employing almost 0.5 million people and enjoying additional tailwind from online retail – a 20% cut in workforce would double their operating profit. Of course, you should factor in the implementation and technology costs, but the potential savings could still be enormous.

Here is the list of selected companies in sectors where, in our opinion, potential benefits of automation are the highest:

Company	Industry	Number of employees	Estimated employee comp./Oper Profit
Wal-Mart Stores Inc	Food & Staples Retailing	2,300,000	3.0
G4S Plc	Commercial Services &	592,897	33.7
Deutsche Post AG	Air Freight & Logistics	459,262	3.6
Kroger Co	Food & Staples Retailing	443,000	4.7
United Parcel	Air Freight & Logistics	434,000	2.3
Aeon Co Ltd	Food & Staples Retailing	406,146	7.2
Home Depot Inc	Specialty Retail	406,000	0.9
Carrefour SA	Food & Staples Retailing	384,151	5.3
McDonald's Corp	Hotels, Restaurants &	375,000	1.3
Securitas AB	Commercial Services &	335,945	20.8
Target Corp	Multiline Retail	323,000	2.0

Source: Hérans Quality Asset Management

An interesting case are security companies – G4S and Securitas – that pay huge portions of their revenue to employees, however the question here is whether they can really reduce the staff as physical presence is the service clients are paying for. Also, the quality of their financials is questionable.

Conclusion

There are titles you hear a lot about – the mighty five: Facebook, Apple, Amazon, Netflix and Google – which is well deserved, as these companies are undoubtedly the leaders of innovation and have created tremendous value for shareholders over recent years. But sometimes it makes sense to systematically look at the numbers and think beyond the obvious to identify companies and market opportunities, which the general market is ignoring.

Sources:

1. Frey C.B., Osborne M.A. (2013). *The future of employment: how susceptible are jobs to computerisation*. Oxford Martin School, University of Oxford.
2. *Wheremachines can replace humans*. McKinsey Global Institute, <https://public.tableau.com/profile/mckinsey.analytics#!/vizhome/InternationalAutomation/WhereMachinesCanReplaceHumans>
3. Rotman D., Brynjolfsson E., McAfee A. (2013). *How technology is destroying jobs*. MIT technology Review.