



# SCANNING THE **HORIZON**

**SCENARIOS FOR 2023**



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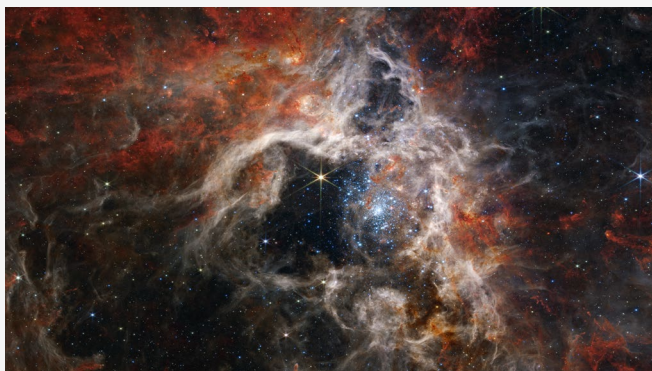
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# BEING READY FOR ANYTHING IS TOP PRIORITY FOR 2023

**INTRODUCTION BY PETER THAL LARSEN, GLOBAL EDITOR**

## **SCENARIO SCANNING**

There was a time when forecasting was a relatively simple pursuit. The most reliable approach was to assume that the coming year would turn out much like the previous one. Many corporate chieftains and money managers owed their glittering reputations to this simple rule of thumb. No longer. In the past three years, the world has been rocked by a string of unexpected and epoch-defining events. Little wonder that executives, policymakers and financiers are anxiously scanning the horizon to work out what is coming next.

At the start of 2020, many world leaders identified climate change and the shift from fossil fuels to renewable energy as the planet's most pressing challenge. Within a few weeks, they were confronting a deadly pandemic. Twelve months ago, the debate shifted to how quickly the world would recover from Covid-19. Then Russian President Vladimir Putin invaded Ukraine, upending geopolitical relations and disrupting global markets for energy and food.

**WHAT HAPPENS IF CHINESE PRESIDENT XI JINPING ORDERS AN INVASION OF TAIWAN?**

Anyone trying to think about what 2023 will bring is confronted by a staggering array of possibilities. This is why many chief executives and investors have dispensed with forecasts, preferring to plan for a range of scenarios. Some of these are specific: What happens if Chinese President Xi Jinping orders an invasion of Taiwan? What if Putin unleashes tactical nuclear weapons in Ukraine? What if a cyberattack cripples critical infrastructure? In many cases, just envisaging possibilities requires a leap of imagination.

**WHAT IF PUTIN UNLEASHES TACTICAL NUCLEAR WEAPONS IN UKRAINE?**

It is in this spirit that Breakingviews once again embarks on its annual effort to guide readers through the trends and events that might shape economies, corporate fortunes and asset prices in the year ahead. The aim is not to hit the bullseye of forecasting accuracy, but to offer a way to think about some of the decisions that may crop up in the next twelve months.

The first challenge is to narrow down the range of topics. Geopolitical questions loom large: like most occupants of corporate boardrooms, our columnists are pondering the effects of tensions between the United States and China, not just on supply chains for Apple's iPhones and semiconductors, but also on raw materials like those vital to making electric-car batteries. The intensifying superpower rivalry may produce new winners, like a Vietnamese challenger to Tesla. It could also revive U.S. cities that have languished for years.



In finance, the big unknown is working out who else will be submerged by the rising tide of global interest rates. More expensive money has already stalled corporate dealmaking, sideswiped stock market valuations and plunged cryptocurrencies into a deep freeze. Even if central banks pivot away from aggressive rate hikes in 2023, entire industries and asset classes will grapple with financial conditions they have not experienced for at least 15 years. Meanwhile, expect the Bank of Japan to revisit its ultra-loose monetary policy, while Western central banks quietly shift their inflation targets.

Another reasonable bet is that the planet will continue to get warmer, producing more extreme events like the floods that devastated Pakistan in 2022. Though the invasion of Ukraine pumped up the price of fossil fuels, it has spurred Western countries to speed the shift to renewable energy. That is reordering old energy alliances. Watch whether the United Arab Emirates, which hosts the COP28 climate conference in November 2023, distances itself from the OPEC oil cartel.

Encumbered by lower stock prices and pricier financing, merger activity will remain subdued in 2023. Still, M&A bankers should find some bustling pockets: Big Pharma may aim its financial firepower at cheaper targets. Pet businesses could become tasty snacks for consumer giants. Big companies like Mark Zuckerberg's Meta Platforms may break themselves up. And as always, adversity will deliver some surprising good news: how about a divided U.S. Congress mounting a bipartisan effort to raise the country's debt ceiling?

### **WHAT IF A CYBERATTACK CRIPPLES CRITICAL INFRASTRUCTURE?**

Identifying possible scenarios is just the start, though. The harder bit is planning what to do if they materialise, and working out which extreme outcomes to prepare for. All these decisions involve real expenses, and the opportunity cost of investments shelved or innovations delayed. Such is the complicated and unpredictable world that we now inhabit. The only place to start is by thinking about what comes next.

*First published January 2023*



*CHAPTER 1*

# BACK TO BASICS



# CENTRAL BANKERS WILL SHIFT INFLATION GOALPOSTS

BY PETER THAL LARSEN

The Federal Reserve, ECB and others insist they're determined to get price increases back down to 2% a year. Though the target is arbitrary, changing it is tricky. But stubborn inflation means monetary authorities will have to find ways to tolerate rising prices for longer.

## TOO CLOSE TO ZERO

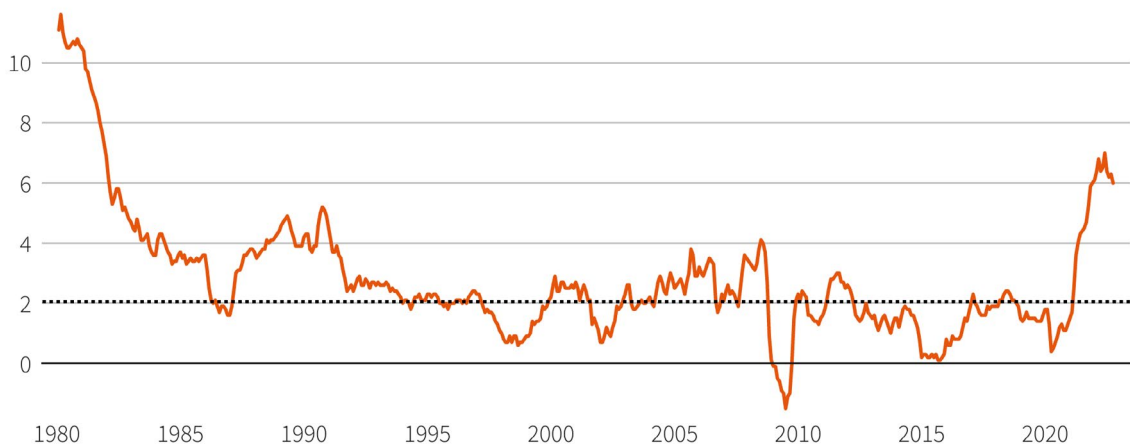
Central bankers spent the decade after 2008 worrying about deflation. Now they are once again trying to stop prices from rising too quickly. The Federal Reserve, European Central Bank and others are determined to limit annual price increases to around 2%, in line with their targets. Stubborn inflation may force them to shift the goalposts.

Most developed-world central banks define price stability as a 2% annual increase: low enough for most people not to notice while leaving wiggle room before damaging deflation sets in. After the 2008 financial crisis, economists worried the targets were discouraging authorities from launching aggressive economic stimulus. In 2010 International Monetary Fund economists argued a higher target would give central banks more firepower when battling a slump.

Today, monetary authorities are facing price increases they have not experienced since the early 1980s. Inflation in the euro zone was five times the ECB's target in November. In the United States the increase in the personal consumption expenditures price index, the Fed's preferred measure, has been 6% or higher for almost a year.

## MISSING THE TARGET

The Federal Reserve's preferred measure of inflation often eludes the central bank's 2% goal



Source: Federal Reserve Economic Data, U.S. Personal Consumption Expenditures price index, % change on previous year.

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**TODAY, MONETARY AUTHORITIES  
ARE FACING PRICE INCREASES  
THEY HAVE NOT EXPERIENCED  
SINCE THE EARLY 1980S**

Fed Chair Jerome Powell and ECB President Christine Lagarde say they are determined to restore price stability. Yet while inflation was under control for several decades, their record of hitting the 2% target is mixed. Take the Fed: During the 1990s, PCE inflation was at or below 2% in just 49 out of 120 months. Between 2000 and the beginning of 2010, monthly inflation met the Fed's goal just over a third of the time.

These figures suggest it would make more sense for central banks to set a higher target range for inflation, allowing them to tolerate annual increases of 3% or 4%.

A recent study of internet searches and social media from the Global Labor Organization suggests most people don't worry about inflation until it gets close to 4%. A revised target would also allow central banks to accommodate longer-term inflationary pressures, such as trade frictions, shrinking working-age populations, and climate change.

Central bankers say switching targets would damage the credibility of their commitment to get prices under control, while any new goal would be suspect. However, prices are hardly coming down quickly. All members of the Fed's Open Market Committee expect inflation will still be above 2% in 2024. A prolonged period of missing the target also erodes credibility. Even if they avoid saying so, central bankers will soon need to start shifting the inflationary goalposts.

*First published December 2022*



A customer pushes a shopping trolley as she shops in a Lidl supermarket in Gattieres near Nice, France, Dec. 2, 2022. REUTERS/Eric Gaillard



# BOWLING GREEN

KENTUCKY IS THE NEXT BIG U.S. CITY

**BY LAUREN SILVA LAUGHLIN**



NASA satellite image shows the United States, Mexico and Canada at night in this composite assembled from data acquired by the Suomi NPP satellite in April and October 2012.  
REUTERS/NASA/Robert Simmon/NOAA/Department of Defense



So is Syracuse, N.Y.; and Dayton, Ohio; and Normal, Ill. That's where manufacturing of semiconductors and electric cars is going, thanks in part to existing old infrastructure and new policies under Joe Biden. It means less profit – but a more evenly distributed U.S. workforce.

### HOWDY NEIGHBOR

Population growth in the U.S. state of Kentucky has lagged behind the rest of America overall for much of the last 75 years. A push by President Joe Biden to move manufacturing onshore will change not just its trajectory, but that of others like it, too. New investments will drive overhauls everywhere from upstate New York to Ohio to Illinois, reinventing parts of the country that languished for decades and redistributing the U.S. workforce – but at a cost to companies.

### NEW INVESTMENTS WILL DRIVE OVERHAULS EVERYWHERE FROM UPSTATE NEW YORK TO OHIO TO ILLINOIS

Biden solidified his push to reverse the tide of globalization in August 2022 with two major pieces of legislation. The CHIPS and Science Act provided \$53 billion to bring semiconductor manufacturing and development to the United States. The Inflation Reduction Act, meanwhile, earmarked \$30 billion in corporate tax credits to produce solar panels and renewable energy components domestically.

As a result, companies around the globe are opening up operations stateside. Some of that will be in new developments in already fast-growing states: Taiwan Semiconductor Manufacturing Company, for instance, is building a 1,100-acre, \$40 billion chip factory in Phoenix. But Rust Belt states – once manufacturing powerhouses that slumped in the era of deindustrialization – also stand to win big. A new electric-vehicle battery manufacturing plant is going up in Kentucky. Micron Technology is creating 9,000 jobs in the Syracuse, New York area, investing in a \$100 billion mega-complex. And high-tech manufacturing can find opportunity in abandoned old-tech infrastructure. Carmaker Rivian Automotive snapped up an old Nissan Motor plant in Normal, Illinois. Lordstown Motors took over an old General Motors facility in Ohio.

Workers in America are more expensive than those elsewhere, hurting profits at companies hiring in places like Arizona in 2023. Hourly wages in the United States are 12 times higher than those in India, according to data from NationMaster. A semiconductor engineer in China makes a third of a similarly qualified person in America.

For the United States, though, Biden's actions will be a boon to parts of the country left behind by the rapid economic growth of high-flier states on the coasts. The CHIPS bill authorizes \$10 billion over five years to create 20 regional hubs that "are not leading technology centers." So in 2023, semiconductor architects chasing this money will pack up the U-Haul and head to the cornfields. To the extent that it creates more good jobs in areas that are accessible to all Americans, even at the expense of profits, it's indubitably a good thing.

*First published December 2022*

# GLOBAL FINANCE UNKNOWNNS ARE MORE “WHO” THAN “WHAT”

BY AIMEE DONNELLAN

The blowup of the UK pension market has got regulators hunting for weaknesses in the over-\$200 trln shadow banking sector. Emerging market funds and leveraged loans both bring vulnerabilities. But in deciding what to police, the question is who’s exposed. That’s a blind spot.

## GUESS WHO

After British pension funds narrowly dodged catastrophe in 2022, regulators are hunting enthusiastically for hidden risks in the non-bank financial industry. Also known as shadow banking, it’s a market that could be over \$225 trillion in size. The key to stopping a crisis isn’t locating the landmines – it’s working out who’s most likely to stand on them.

When UK pension funds were caught short by a sudden fall in government bond prices in September, the Bank of England had to launch a 65-billion-pound scheme to stabilise the market. Had it not done so, it said, the funds would have had to liquidate investments to meet margin calls on their loans. Panicked sales of bonds could have pushed borrowing costs up in the mortgage market, rippling through the wider economy. As a result, regulators everywhere, including the G20’s financial stability task force, are on high alert looking for hidden leverage.

Emerging market funds are one place to start the search. When interest rates were low, investors sought out riskier assets in markets like Indonesia, Brazil and Mexico. But as U.S. interest rates rise past 4%, there is less need for investors to venture into riskier markets for returns. If a fall in demand for a country’s bonds coincided with a political upset, for example, investors might rush to liquidate holdings in emerging market funds, causing rapid and disorderly price falls.

## SHADOWLAND

UK 30-year government bond yields between January 2020 and November 2022



Source: Refinitiv Datastream

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Leveraged loans are also vulnerable to a similar fire sale. Before the pandemic, banks, hedge funds and other investors were happy to back corporate takeovers with high levels of debt. So-called open-ended funds, which make up 4% of the leveraged loan market, are a particular worry, because these allow investors to demand their money back, even though the fund's assets might not be easily sellable. In the market ructions of March 2020, open-ended funds sold \$14 billion of leveraged loans, which accounted for 11% of the transactions in the secondary market and contributed to a 19% drop in prices.

**LEVERAGED LOANS ARE ALSO  
VULNERABLE TO A SIMILAR  
FIRE SALE**

But not all market weaknesses deserve heavy-handed regulation. It might make sense to police investments crowded with pension funds whose activities also influence government bond prices, but not those where losses would be borne by other less interconnected investors. An obvious example is the collapse of cryptocurrency exchange FTX in November; it involved an investor panic, but left critical firms like banks unscathed, because most regulated institutions have given crypto a wide berth.

Regulators around the world are intent on preventing another crisis. It's good that they're focused on hidden leverage and potential fire sales. When it comes to stress-testing the system, though, it makes most sense to be clear about who has the potential to cause systemic risk, not just what. Otherwise watchdogs risk trying to regulate everything, and achieving little.

*First published December 2022*



A man holds an umbrella as he looks out at Canary Wharf financial district from Greenwich Park in London, Britain, July 2, 2012. REUTERS/Andrew Winning

# BOARDROOMS WILL REDISCOVER THE VALUE OF GRAY HAIR

BY JOHN FOLEY

The economy is headed for conditions not seen in over a decade, yet a third of the U.S. workforce was under 20 during the last real recession. CEOs are getting older, while tech and crypto blowups knocked youth off its perch. In 2023, companies will embrace an aging workforce.

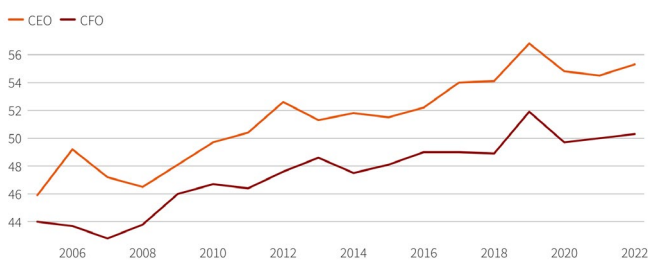
## SILVER LININGS

When opening an office in a new country, it helps to install an executive who has lived there. By the same token, as the economy heads for its first real recession in over a decade, there's value in having employees who have seen it all before. To firms keen to avoid repeating past mistakes, the graying of the Western workforce may not be a bad thing in 2023.

It's no secret that the labor supply is getting older. More than 180,000 Americans will turn 65 each month in 2023, the highest on record, according to a study from the St. Louis Federal Reserve. People are working longer, too. The share of European over-55s in jobs grew to 20% in 2019, from 12% in 2014, according to official data. Retailer Target scrapped its mandatory retirement age of 65 in September; Boeing raised its maximum age to 70 in 2021.

## OK TO BE GRAY

The age at hire for CEOs and CFOs of large U.S. companies has been on an upward march



Source: Crist Kolder Associates  
J. Foley | Breakingviews - Predictions 2023

## IT'S NO SECRET THAT THE LABOR SUPPLY IS GETTING OLDER

Chief executives too are more senior than they were. The typical incoming CEO is 55, a decade older than the average in 2005, according to Crist Kolder Associates. Walt Disney and Starbucks brought back retired bosses Bob Iger and Howard Schultz in 2022, aged 69 and 71 respectively. Bank of America chief Brian Moynihan says he hopes to keep running the giant U.S. lender until 2030, by which time he will be 70 and will have held the role for 20 years.

There's a fine line between prizing expertise and entrenching boomer privilege. But fresh-faced innovators made a particularly poor showing in 2022. The poster child for exuberance over experience is likely to be 30-year-old Sam Bankman-Fried, whose cryptocurrency exchange FTX collapsed in spectacular fashion in November, leaving billions of dollars of customers' money unaccounted for and financial backers like Sequoia Capital in the doghouse. Theranos founder Elizabeth Holmes was sentenced to more than 11 years in prison, while Meta Platforms, run by fellow millennial Mark Zuckerberg, burned more than \$582 billion of shareholder value.

In 2023, experience ought to be at a premium as low inflation and bull markets end. Money markets are pricing in U.S. rates of 5% by the summer. Last time they hit that level in 2007, fintech wasn't a word, and one-third of today's U.S. workforce was 19 or younger. Wall Street firms may therefore temper their appetite for digital natives, and bosses will find shareholders more tolerant of long tenure. The flip side is that as the market turns, youthful entrepreneurs may find themselves shunned, at least for a while. Financial markets will always love the next new thing, but for the time being, gray is good.

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# DEALMAKERS WILL BE LUCKY TO EKE OUT A 2022 REPEAT

BY JEFFREY GOLDFARB

With merger volume slumping from a record \$5.8 trln, bankers are regrouping to suit the times. The emphasis will be on buyout firms loaded with firepower and stock-based mergers. After the 2007 peak, though, it took two years for M&A to bounce back. Expect history to rhyme.

## SCREAM BLOODY MERGER

As with often value-destructive mergers and acquisitions, the numbers aren't adding up for dealmakers. After a record-breaking \$5.8 trillion of activity in 2021, they have endured a staggering reversal of fortune. The slump will last through 2023.

Once chief executives and buyout barons recovered from the initial pandemic shock in 2020, they embarked on an epic shopping spree. The following year brought 64% more M&A, according to Refinitiv data, 40% beyond the previous high of \$4.1 trillion in 2007, right before the world stared into the financial abyss.

The latest comedown is therefore understandable, especially given higher interest rates, which contributed to a 17% dip in the S&P 500 Index for the year to mid-December. Meanwhile, deal volume tumbled to about \$3.5 trillion, 36% down from the same time a year earlier, though it stayed ahead of 2020's pace. Those numbers also could face at least one significant revision: The year's biggest transaction, Microsoft's \$69 billion deal for video-game developer Activision Blizzard, hangs in the balance after U.S. trustbusters sued to stop it.

## INVESTMENT BANKERS ARE REORIENTING TO THE NEW REALITY

Investment bankers are reorienting to the new reality. The emphasis will be on private equity firms seeking to deploy some \$800 billion of ageing cash held in buyout funds worldwide as of late November, according to Preqin. Leveraged, the sum could plausibly back some \$2 trillion of investment. Private equity firms already accounted for an all-time high of 22% of deal volume in 2022.

Caught with billions of loans that investors no longer want to buy, banks want to clear out their balance sheets before lending again. Buyers and sellers also must adjust to the end of ultra-cheap money. Borrowing costs are up: Debt issued by companies with lower credit ratings yields nearly 9%, roughly double the rate a year earlier, per the ICE BofA Single-B High Yield Index. This financing environment suggests corporate acquirers will use more stock as payment, even as cash-rich industries such as pharmaceuticals can stay active.

Despite hopes of recovery, the acquisition annals portend another tough year for deal advisers, many of whom already are trimming jobs and slashing bonuses. After 2007, M&A volume declined for two years – falling 52% from peak to trough, before rebounding. The same happened after 2015, albeit with a shallower 21% dip. As potentially bleak economic circumstances loom, bankers will be lucky to eke out a repeat of 2022.

*First published December 2022*

# TRADERS WILL ANXIOUSLY WATCH THE BANK OF JAPAN

BY PETE SWEENEY

Governor Haruhiko Kuroda's retirement and rising inflation may prompt the central bank to revisit ultra-low interest rates. Gyrationing bond yields could force domestic investors to dump some of their \$6 trln in overseas assets. Though a panic looks unlikely, rebalancing is certain.

## YOU MUST CHILL

Shorting the Bank of Japan is the trade of 2023. Gyrationing in Japanese bond yields resulting from an abrupt increase in benchmark interest rates could force indebted domestic entities to dump overseas assets, roiling global markets. Portfolio rebalancing is already underway, but it will take a lot of really good news inside Japan for the shift to be bad news elsewhere.

The question on traders' collective mind is what happens when the central bank finally adjusts its "yield-curve control" policy, or YCC, which has held down government bond yields for more than six years. The country is the single largest holder of U.S. Treasury bonds, and cross-border claims on Japan stood at \$4.2 trillion at the end of June, according to the Bank for International Settlements, three times more than liabilities. Nomura estimates Japanese entities own \$6 trillion in overseas assets, half of that unhedged.

When the U.S. Federal Reserve began hiking interest rates in 2022 the BOJ declined to follow: Japanese inflation excluding food and energy remains below its 2% target. The spread between yields on 10-year U.S. Treasury bonds and equivalent Japanese government securities widened, the yen plunged, and sceptical bond traders tested the 0.25% 10-year yield that the central bank pledged to defend. The yen's slide pushed up hedging costs, forcing Japanese firms, insurers in particular, to unwind offshore positions.

## THE YEN'S SLIDE PUSHED UP HEDGING COSTS

YCC is the brainchild of BOJ Governor Haruhiko Kuroda, who is set to retire in April. His successor may feel freer to tweak the regime, especially if prices excluding food and energy keep rising. A higher-than-expected wage hike resulting from springtime negotiations could persuade officials that salaries are offsetting higher prices, bolstering the case for normalising interest rates. If government bond prices fall, investors who collateralised offshore loans with local debt securities could be in trouble.

A messy unwind remains unlikely, though. With Fed Chair Jerome Powell and his colleagues hinting at milder rate hikes, the yield spread has narrowed and the yen recovered. If Japan's net overseas position reverts to where it was before the BOJ launched quantitative easing in 2013, Nomura estimates a manageable \$500 billion could move out of foreign assets. Meanwhile higher interest rates would allow Japanese companies to earn better returns on their 325 trillion yen (\$2.4 trillion) cash hoard. Japan had an earthquake, a tsunami and a nuclear accident in 2011 without setting off a global financial crisis. Investors betting on meltdowns have been disappointed before.

*First published Dec. 19, 2022*





# NEW THREATS

## WILL CORRODE INFRASTRUCTURE M&A

BY LISA JUCCA

Blasts that damaged Baltic pipelines in September alerted investors to the physical risks to energy networks from geopolitics. Add growing cyber concerns and the cost of insurance is set to rise. As the appeal of formerly quasi risk-free bets dims, states will surely step in.

### BRAVE NEW WORLD

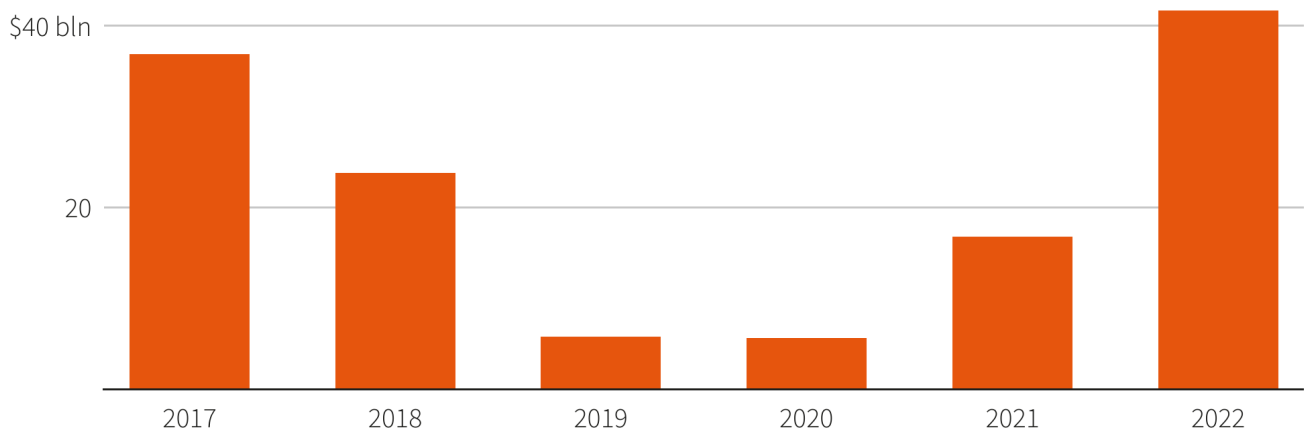
Investing in infrastructure is becoming more risky. The blasts that damaged the Nord Stream gas pipelines linking Russia with Europe in September have alerted investors to the physical threats that volatile geopolitics poses to energy networks. Cyber attacks, which were already on the rise before President Vladimir Putin invaded Ukraine, have also stepped up. As private investors reconsider, states will play a bigger role.

Capital has poured into assets like toll roads, telecom towers and electricity grids as investors seek stable regulated investments that provide some protection against inflation. Private equity infrastructure funds attracted \$121 billion globally in 2021, nearly 60% more than in 2017, according to data from PitchBook. In Europe, those funds acquired assets worth \$41.7 billion in the first seven months of 2022 – more than double the previous year's total – propelled by deals like Veolia's takeover of French water and waste management rival Suez.

Even so, investors are becoming more selective about their infrastructure bets. The as yet unexplained Baltic explosions exposed the fragility of marine infrastructure, senior bankers and investors told Reuters Breakingviews. Corrosive seawater can quickly make a submarine gas pipeline unusable. And damage from war is generally not covered by insurance.

### INFRASTRUCTURE FEVER

Private equity infrastructure investment in Europe hit a five-year high in the first seven months of 2022



Source: PitchBook. Deal value of investments by PE funds into European infrastructure; 2022 data is as of late July.  
L. Jucca, O. Taslic | Breakingviews – Predictions 2023



## **INVESTORS ARE BECOMING MORE SELECTIVE ABOUT THEIR INFRASTRUCTURE BETS**

The rising cost of insuring against cyber attacks will also dull the appeal of telecom networks and power grids. The premium to insure commercial property against hackers rose 27% year-on-year in the second quarter of 2022, well above the average increase of 7% for all lines of insurance, according to a survey by The Council of Insurance Agents and Brokers.

The need for infrastructure remains strong, though. The urge to make the world a cleaner place means building and upgrading power infrastructure in both developed and developing countries.

Assets like electricity grids, which are critical for the transition from fossil fuels to renewable energy, will remain attractive to investors and financiers. Yet they too are potentially exposed to sabotage, as demonstrated by the attacks on two electric substations in North Carolina in early December.

Pressure to establish energy security at home also means governments will want to own key infrastructure assets, regardless of the financial incentives. Germany, for example, took gas storage facilities from private Russian hands and is looking to take control of Dutch power-grid operator TenneT's local subsidiary, Reuters reported on Nov. 30. If private investors conclude some infrastructure assets have lost their appeal, states will step in.

*First published December 2022*



Aerial view of a construction site, in San Francisco, United States, Oct. 28, 2021. REUTERS/Carlos Barria



# HONG KONG IPOS GO BACK TO A LESS LUMINOUS FUTURE

BY KATRINA HAMLIN AND UNA GALANI

Bankers and officials see the end of China's Covid-19 restrictions as crucial to reviving the hub's once-booming IPO market. That understates the city's challenges. After vying for the hottest listings, the way investors and companies traverse the gateway to China is changing.

## NOT-SO-HOT ENTREPÔT

Hong Kong's bankers and officials fantasise about the moment China finally ditches its Covid-19 restrictions. The mainland's reopening is crucial to reviving the city's capital markets. But even that is not enough to ensure Hong Kong's future as an international financial centre.

## HONG KONG IS LOSING MARKET SHARE

It has been a horrible year for initial public offerings, and not just in Asia's main financial hub. IPO activity in New York and in London is down 95% or more year-on-year, compared to a 72% slump in Hong Kong, Refinitiv data shows. Many of the listings that have gone ahead in the Chinese city, like Tianqi Lithium, and nickel trader Lygend Resources, have relied on friendly cornerstone investors who commit in advance to invest a fixed amount of money in a deal.

Hong Kong is losing market share too. It claimed 5% of global IPO proceeds this year, a proportion that has steadily declined from 19% for the same period in 2018. New York had almost 40% last year. Hong Kong is winning some companies already listed elsewhere – particularly Chinese ones trading in the United States which want an alternative venue for their stock – but it is losing its share of first-timers.



## QUADRUPLE THREAT

An international IPO hub needs four basic things: companies that want to raise capital – which in Hong Kong’s case are mostly companies that come from elsewhere; ways for people and money to get in and out; plenty of middlemen ready to sell the shares; and investors who want to buy those shares. Hong Kong used to have an abundance of these. Now it’s challenged on all four fronts.

The first problem – a shortage of issuers – is likely to ease. Mainland Chinese firms account for eight of Hong Kong Exchanges and Clearing’s 10 largest ever IPOs. The bourse operator’s Chair Laura Cha told the Reuters Next conference at the end of November that a recovery will follow China’s reopening. Since then, Beijing has relaxed some of its Covid-19 restrictions, prompting a stock rally.

That recovery will at least make it more financially attractive for owners to sell shares. The Hang Seng Index is down 34% since the end of 2017, while the S&P 500 Index has soared 47% over the same period. At 9 times one-year forward earnings, Hong Kong’s benchmark is valued near a multi-decade low. Accessibility too should improve as China’s “zero-Covid” campaign fades, and executives and investors can once again hop on planes to travel in and out.

Other problems don’t disappear so easily. Rising competitive tension between the United States and China, the world’s two largest economies, is hardly an invitation for companies in the People’s Republic to raise capital for overseas expansion. Those frictions also make it harder for Wall Street banks like Morgan Stanley, Goldman Sachs and Citigroup to justify expanding in Hong Kong.

It doesn’t help that so many Chinese IPOs have political undertones that make them challenging to have as clients. American banks steered clear of artificial intelligence giant SenseTime, which delayed its float after it was added to a blacklist barring U.S. firms from investing. HSBC and Singapore’s DBS eventually helped take it public. No wonder China International Capital – the partly state-owned investment bank known more widely as CICC – looks set to top the equity-issuance league table in Hong Kong for the second year in a row in 2022.

And while signs of progress in resolving a fight between Washington and Beijing over auditing access to U.S. listed Chinese firms is good for the bilateral relationship, it could allow some 200 Chinese companies to remain listed on U.S. stock exchanges. If they stay in the Big Apple, they won’t need the Hong Kong board as a plan B.

## TOUCHING A NERVE

Then there’s the question of who wants to buy Hong Kong-listed shares. Regulatory crackdowns by Beijing and concerns about a possible information disadvantage worry international investors who prefer to buy shares onshore. That’s reflected in the premium at which Chinese-listed stocks trade to their Hong Kong equivalents. The Hang Seng China AH Premium Index, which measures that gap, is currently at 141, where 100 represents parity.

Bankers who spoke to Reuters Breakingviews express common grounds for optimism. They assume big Chinese companies will need offshore capital eventually. It remains faster for Chinese companies to list in Hong Kong, rather than join the long queue on the mainland. Venture capital investors looking for their regular exits from Chinese companies will continue to drive a steady stream of listings. Cha sees over 100 IPOs in the pipeline. Nasdaq boss Adena Friedman told the same Reuters Next conference that it has about 200.

There are also a few potential large listings in the pipes. One is Didi Global, the Chinese rideshare firm that delisted from New York in June. It hopes to float in Hong Kong, though it may still have to convince Beijing’s authorities that doing so will not jeopardise the security of its trove of data on Chinese consumers, one factor behind its flight from the United States markets.

Hong Kong could also host more offerings from places like the Middle East and Southeast Asia, as Cha envisions. That will work if her push to include more Hong Kong-listed foreign companies in a cross-border trading arrangement called Stock Connect materialises. The scheme might allow mainland investors to buy shares of thinly traded companies like Italy’s Prada, which is exploring the possibility of a second listing in Milan.

That sales pitch, though, sits uncomfortably against reality. True, Hong Kong is the main international gateway to China, and that is unlikely to change. Logistically, the worst effects of Covid-19 may soon pass too. But if investors and companies don’t want to traverse that gate the way they once did, the city’s planners and financiers will have to downsize their ambitions.

*First published Dec. 12, 2022*

# BUYOUT BARONS WILL COURT THE PANICKING MASSES

**BY JONATHAN GUILFORD**

KKR and rivals may have maxed out with traditional backers like pension plans for now. Blackstone's \$236 bln in private-wealth assets shows a fresh source: the common rich. The disarray at its flagship retail fund exposes the risks, but managers will chase the lure of new money.

## SHOPPING AROUND

Private-asset managers have a ferociously hungry growth machine to keep running. Since they've already scoured traditional funding sources like pension funds and insurers, they'll make a priority of tapping wealthy individuals in 2023.

Blackstone, KKR and others have already made a start on opening the retail-investor firehose. Steve Schwarzman's shop manages \$236 billion of private-wealth assets, a quarter of its total. Even those slower to embrace the trend, like Carlyle, are getting about 10% of inflows from individuals. These aren't mom-and-pop punters, but workaday millionaires who aren't wealthy enough to have a dedicated investment office.

That funding source is looking increasingly enticing, partly because the older institutional backers may be tapping out for now. Pension plans and other stalwarts have seen their stocks and bonds slump in value, potentially leaving them overexposed to buyout funds, private credit, real estate and infrastructure. That limits how much new money they can cough up, especially against the context of a recent fundraising surge. Private equity's assets grew at a rate of over 14% annually in the half-decade to 2021, up from 5% in the prior five years, per Preqin.

**AS THE MARKET TURNED,  
A FLOOD OF INVESTORS LOOKED  
TO PULL OUT**

Wealthy individuals, who typically have a much smaller proportion of their investments in private assets, could help keep the party going. The challenge is finding the right fund structure. These investors don't always have the resources or stomach to lock up their money for half a decade or longer. So managers created vehicles offering at least limited withdrawals at intervals. That's where Blackstone's retail-focused real estate fund, known as BREIT, came unstuck in December. As the market turned, a flood of investors looked to pull out, triggering its monthly redemption limit.

But if Blackstone and others can survive the turbulence, their enthusiasm will likely be undaunted. Third-party platforms like Moonfare are proliferating, pooling retail capital into vehicles that buy stakes in buyout funds. Investors can get liquidity on their holdings by offloading them, at a discount, to others on the platform or secondary-market players like Lexington. Private-asset managers are also linking up with financial advisers at the big wealth players, like Morgan Stanley and UBS, to gin up interest in their product. The longer-term holy grail would be to open the giant defined-contribution pension market to private capital. Blackstone's BREIT disarray was a punch in the nose for that dream. But managers' eagerness for fresh dollars means the hunt will go on.

*First published December 2022*



**CHAPTER 2**

# AGAINST THE ODDS





# NETFLIX WILL BE NEXT ON MICROSOFT'S SHOPPING LIST

BY JENNIFER SABA

The video-streaming service is expanding into gaming as the software titan fights for Activision Blizzard. Ever-bigger deals, including LinkedIn and Nuance, have been a staple of boss Satya Nadella's tenure. And there's logic behind fortifying its Xbox even more.

## X-FACTOR

Satya Nadella keeps thinking bigger. Microsoft's chief executive has been buying new businesses at an impressive clip. Look for him to add Netflix to the list in 2023.

Since his 2014 promotion into the technology titan's corner office, Nadella has embarked on a pricey shopping spree. It started with the \$2.5 billion acquisition of the company behind the hit game Minecraft. Later, Microsoft bought LinkedIn for \$26 billion and the speech recognition and artificial intelligence software developer Nuance for \$20 billion. Activision Blizzard was by far the largest disclosed target, at \$69 billion.

Microsoft is busy fighting U.S. trustbusters for the right to absorb the "Call of Duty" creator. Putting it under the same roof as gaming console Xbox has led to regulatory concerns about market dominance. Even if Nadella loses out on the video-game company for competition reasons, however, owning Netflix would make strategic sense and probably be an easier sell in Washington and Brussels.

## WINDOWS OF OPPORTUNITY

Percent change in market values since Satya Nadella became Microsoft's CEO



Source: Refinitiv. Rebased, 0 = 2014

J. Saba | Breakingviews - Predictions 2023

The two companies are already closely aligned. Netflix chose Microsoft as its advertising partner for a new advertising-supported subscription service. Microsoft President Brad Smith also sits on the Netflix board. Part of the rationale for a deal is that Microsoft wants to offer a video-game streaming service over multiple devices

### **NETFLIX HAS ITS OWN BIG PLANS IN GAMING**

Netflix has its own big plans in gaming. In 2022, the company co-led by Reed Hastings snapped up developer Spry Fox, its sixth in-house studio. Becoming part of the Microsoft empire would supercharge those ambitions. A bundle with streaming TV and games together is not hard to fathom.

With a market value 13 times that of Netflix, as of early December, \$1.8 trillion Microsoft can afford Netflix. A 30% premium would value the Netflix enterprise at nearly \$190 billion. Significant cost savings would be hard to find, however. And after taxing the \$8 billion of operating profit that analysts project for Netflix in 2024, the implied return on investment would only be half its 8% weighted average cost of capital, per Morningstar analysts.

Nadella has defied such back-of-the-envelope financial logic before. And if nothing else, he has shown a willingness to be a bold dealmaker. On that basis, it's easy to believe Microsoft will set its sights on Netflix.

*First published December 2022*





# CLIMATE CHANGE WILL BECOME A CEO DEALBREAKER

BY JOHN FOLEY

For corporate chieftains who profess to recognize the threat of climate change, the balancing act between pursuing shareholder value and helping the planet avoid a crisis is becoming unsustainable. Breakingviews imagines a missive from a CEO who opts to put values before value.

## HIGHER CALLING

The following is an imagined letter from Darcy Cook, the chief executive of StarMark Financial, which – if it existed – would be the world’s biggest money manager.

### Dear shareholder,

A few years ago, in my annual letter, I argued that a company without a clear purpose will struggle to create sustainable value. What applies to companies also applies to the people who run them. That’s why I will be standing down at the end of 2023. While StarMark Financial again delivered record earnings in 2022, my own views on climate change are no longer compatible with my duties as the CEO of a global financial firm.

As you know, I am a strong believer in the power of markets. The threat from global warming, however, is a clear example of market failure. Even energy producers like BP acknowledge there should be some way to reflect the cost of climate damage and biodiversity loss in the prices of carbon-based fuels. But without government action, schemes like carbon taxes that would address this deficiency are a non-starter.



An attendee poses for a picture near a model earth during the COP27 climate summit in Sharm el-Sheikh, Egypt, Nov. 19, 2022. REUTERS/Mohamed Abd El Ghany

Meanwhile, the world needs \$9.2 trillion of investment per year in order to transition to net-zero emissions by 2050, according to McKinsey, but we are still running roughly one-third short of that level. Markets cannot fix the problem, without help. Even the question of how to reach that destination is unclear, since there are over two dozen competing national and international “taxonomies” defining what counts as a green investment – none of them from the United States.

The last couple of years have shown that government action won’t be coming, at least in our home country. Democrats missed a historic opportunity to introduce a carbon price in 2022 as part of President Joe Biden’s Inflation Reduction Act. In any case, a carbon tax can be regressive unless receipts are used to offset costs borne by lower-income consumers. That would require political unity that does not exist.

Where does that leave us? As a giant asset manager, our job is not to play politics, but to reflect the views of our investors when we interact with companies exposed to climate risk. But the uncomfortable truth is that the views of our millions of investors are often ambiguous, and sometimes verge on indifference. A Pew Research survey last year showed that respondents in nine countries including the United Kingdom, France and Spain ranked climate change as the most pressing of five threats to the country. Americans ranked it fifth. Our rival Vanguard has already pulled out of the world’s biggest climate-finance alliance.

StarMark has increasingly come under attack by politicians in states like Florida and Texas who argue that when we engage with companies exposed to climate risk, or firms that are heavy emitters, we are making decisions without a clear mandate from our customers. In a sense, they are correct. While we believe that supporting measures that advance climate change mitigation creates value, it is clear that some large public-sector clients disagree. We have worked hard to offer our customers the chance to guide our voting habits, following the work done by our peer BlackRock; the majority of them decline to do so.

That tension has cost StarMark business already, as some Republican-led states like Texas and Florida have pulled our investment mandates. At the same time, some Democrat-led local governments have threatened to take business away from us if we take too mild a stance on climate risk. Since we must deliver adequate returns to our own shareholders, this situation is not sustainable. One option is simply not to vote when customers don’t give us clear instructions. Yet large asset managers own around 20% of all U.S.-listed companies. Those votes may end up being wasted.

My retirement from the firm I founded more than 30 years ago will not solve these problems. It will, though, leave me free to use my \$1 billion of personal wealth to start a new fund, Fifth Season Capital. This will provide funding with the expectation of below-market returns for projects that can contribute to emissions reduction, the idea being that these schemes can then attract private capital on top. I welcome executives at other firms facing similar challenges – and who would like the added bonus of a more harmonious relationship with their climate-conscious grandkids – to join me.

**I BELIEVE WE FACE THE RISK THAT CLIMATE CHANGE WILL PROVE CATASTROPHIC WITHIN OUR LIFETIMES**

I believe we face the risk that climate change will prove catastrophic within our lifetimes. If I am correct, we may reach a moment where executives, directors and investors are asked to explain why capitalism failed to avert the crisis, and why money kept pouring into polluting industries as emissions targets fell by the wayside. They will reply that their hands were tied, because they were simply doing their job: pursuing shareholder value, maximizing returns and avoiding political brickbats. I can’t say they are wrong. All I can do is ensure I’m not part of that chorus.

*First published December 2022*



# DISNEY'S NEXT 100 YEARS HINGES ON A METAVERSE

BY JENNIFER SABA



A century ago, the media giant crafted theme parks that withstood decades of changing technology. It isn't a huge leap from a real Disneyland to a virtual one that melds brands and streaming. Innovation is necessary, but for it, boss Bob Iger's days need to be numbered.

## METAVERSARY

Mickey Mouse is turning triple digits in 2023. Walt Disney in October will celebrate its 100th anniversary. In the past century, the Magic Kingdom's theme parks have survived technological forces. Taking the real Disneyland as a blueprint for the metaverse that marries its brand and streaming ambitions is not hard to fathom.

Disneyland, the theme park business that opened 32 years after the company began, was based on the vision of founder Walt Disney, who oversaw its completion in an orange grove in Anaheim, California. The theme park was revolutionary at the time, because Disney wanted a destination attractive to both kids and adults. Rides and experiences extracted from Disney's hefty trove of animated characters and movies such as Sleeping Beauty's Castle and the Mad Tea Party formed the basis for the playbook. The idea expanded and now the company operates parks in Paris, Hong Kong, Shanghai, not to mention the Walt Disney World Resort in Orlando, Florida.

The theme parks, and their related consumer products, are an increasingly important part of the company. In the year ending September 2018, the division had a chunky 25%

operating margin and represented almost 40% of Disney's total operating profit of \$16 billion. The company's TV and cable assets, like ESPN, are declining. And so, Disney will lean evermore on the theme parks to help it boost profit, and offset losses from the company's streaming video division. By 2024, the parks, experiences and consumer products' margins are expected to increase to 30% while accounting for two-thirds of Disney's operating profit, according to estimates from Goldman Sachs.

## DISNEY WILL LEAN EVERMORE ON THE THEME PARKS TO HELP IT BOOST PROFIT

In that way, Disney has the blocks for its metaverse. Take the Star Wars franchise. It has spawned over 10 movies, several TV series for the flagship streaming service Disney+ and serves as the backdrop at Disney World for Star Wars: Galactic Starcruiser, a two-night immersive experience that mimics life in the faraway galaxy. Creating an augmented reality-based world next is not that far-fetched.

That, however, requires beating a company like Meta Platforms, which is already spending on its version of the metaverse, to the punch. Disney Chief Executive Bob Iger, who is at his second stint at the helm, will have to hand the reins to someone who can oversee the transition. Tim Sweeney who is ahead of the curve as boss of "Fortnite" owner Epic Games, or former Meta executive Carolyn Everson, who is on the Disney board, could lead the way. For the Magic Kingdom, the next century hinges on the virtual world.

*First published January 2023*

# APPLE FINDS A HAPPY HOME IN INDIA

BY PRANAV KIRAN

iPhone makers Foxconn, Pegatron and Wistron are ramping up factories: \$30 bln of official handouts help to make India an attractive place to set up. Trade tensions between Beijing and Washington only speed up a shift that will place India at the core of Apple's supply chain.

## MADE IN INDIA, AT LAST

India is taking a bite out of Apple's supply chains, and it will end up at their core too.

Helped by generous subsidies, Taiwanese Apple suppliers are starting to churn out more iPhones in India. Wistron was the first to set up a factory to make the devices in 2017 around the technology hub Bengaluru. Foxconn, formally known as Hon Hai Precision Industry, and Pegatron followed. Analysts at JPMorgan reckon India will have 6% of iPhone manufacturing capacity in 2022, and the rest will remain in China.

## INDIA IS AT AN INFLECTION POINT

Shipment numbers are small, but India is at an inflection point. The newest iPhones used to be made in China first, with Indian factories only following with the same models some six to nine months later. This gap has narrowed substantially with the iPhone 14 and it could vanish over the next few years. JPMorgan reckons India might produce one in four iPhones by 2025. The product delivered \$205 billion of revenue for Apple in the year to September, 52% of the company's net sales.

Trade tension between Beijing and Washington, and Covid-related supply chain snarls, are merely an accelerator. India has used hefty import taxes as a stick to get companies to set up factories on its shores: The country is no longer a net importer of mobile phones because budget handset makers like China's Xiaomi produce enough cheap devices locally to cater to booming domestic demand. New Delhi's more recent, generous production-linked incentives are designed to address the premium market for products costing over 15,000 rupees, about \$180.

Incentives and other subsidies partially compensate for inefficiencies in India, where demand for pricier devices is slowly picking up. A phone that costs \$100 to make could be produced for \$80 in China, \$89 in Vietnam and \$92 in India, factoring in local subsidies and other expenses, per the India Cellular & Electronics Association. Apple will continue to rely on China too because India is years away from making key components, including the finished circuit board that can comprise half the value of parts that go into handsets. HDFC Securities estimates that for an average smartphone, as little as 14% of the value is added in India.

It's the start of a bigger shift. Top exporters like South Korea and China focused on assembling electronics using imported items before trying to add more value. Whether or not India gets that far, Apple at least gets a happy new home.

*First published December 2022*





# **BIG PHARMA WILL FIND** RIGHT FORMULA FOR M&A BINGE

**BY AIMEE DONNELLAN**





Pfizer, AstraZeneca and peers have nearly half a trillion dollars of firepower to deploy on deals in 2023. Looming loss of exclusivity on key drugs gives them little choice. Luckily targets like Ascendis or Incyte are trading on depressed valuations, and less likely to resist.

### FEEDING FRENZY

Drugmakers are primed for a shopping spree in 2023. Companies like Pfizer and GSK are in relatively rude health, thanks to bumper sales from vaccines and a post-pandemic recovery in cancer treatments. Chief executives have a potential half-trillion-dollar war chest to use on dealmaking. Their likely targets, listed biotechnology groups, are not in a position to play hardball.

The year 2022 was relatively thin for pharma M&A, with deals worth nearly \$66 billion being announced by early December – 60% below the 9-year average, according to Refinitiv data; 2023 will be better. It helps that drug companies are relatively healthy, with debt around just 1.6 times forecast EBITDA in 2023, according to Berenberg analysts. Assume they could double that to 3 times EBITDA, and the top 15 listed drugmakers including Pfizer, Moderna, Novartis and Roche would have \$486 billion of firepower.

### EXPIRING PATENTS MAY PUT A FIRE UNDER CEOS TO USE THAT MONEY

Expiring patents may put a fire under CEOs to use that money. Bristol-Myers Squibb, Amgen, Pfizer and GSK will all lose exclusivity on some of their bestselling remedies in the coming years. Buying fast-growing biotech groups is the easiest way to find new revenue. Bristol-Myers Squibb alone reckons it could lose up to \$14 billion of sales by 2025 as patents on Revlimid, a treatment for multiple myeloma, expire.

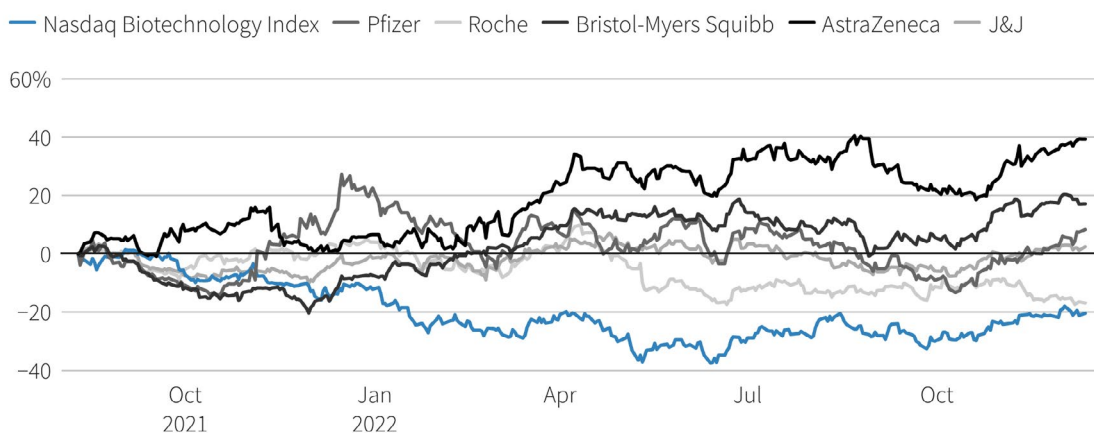
Takeover conditions also look favourable. The value of the Nasdaq Biotechnology Index had fallen around 20% by the middle of December from its peak in August 2021. Potential targets include Ascendis Pharma, which develops drugs that treat growth hormone deficiencies. Incyte, an oncology specialist, was worth \$18 billion, or 23 times forward earnings, in early December, a sharp fall from its peak in 2021, when it was trading on 30 times, according to Refinitiv data.

Biotech CEOs may be reluctant to sell or demand a high takeover premium. Seagen, for example, worth \$22 billion in early December, has fought off Merck & Co. But higher interest rates and depressed stock prices will make it increasingly difficult for cash-hungry biotechs to raise funding or fresh equity. That puts Big Pharma in an ideal negotiating position.

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### BOOSTER SHOT

Big Pharma share price performance since August 2021 vs. the Nasdaq Biotechnology Index



# HOW ANA BOTÍN CAN DEFEAT THE SANTANDER SCEPTICS

BY LIAM PROUD

The Spanish bank suffers from a lower valuation, relative to its return on tangible equity, than rivals. If its executive chair can keep costs low and show the group is worth more than the sum of its parts, that might change. If not, it's time to sell assets, starting in the United States.

## CRUNCH TIME

Investors aren't buying what Ana Botín is selling. Banco Santander has a much lower valuation than rivals. Unless the Spanish lender's executive chair can change that in 2023, it's time to think about a breakup.

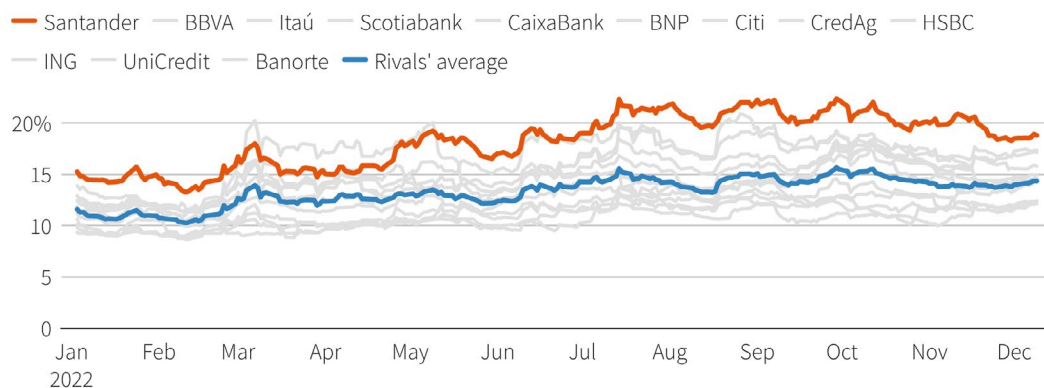
The bank's mid-December market capitalisation of nearly 50 billion euros is less than two-thirds of its expected tangible book value at the end of 2023.

It's been stuck around that multiple for almost a year. That's striking because analysts expect Santander to earn a respectable 11% return on tangible equity (ROTE) over the next 12 months. One way to express the dissonance between those numbers is to infer the return investors require to hold the bank's shares. On this measure, Santander's cost of equity averaged 18% from the start of 2022 to mid-December, according to Reuters Breakingviews calculations. For global rivals the implied figure is 13%.

Investors may be worried about bad debt in the bank's Brazilian and Mexican units, where defaults are typically higher. In that case, Botín can show she has a handle on credit risk by keeping loan-loss charges low. But Santander's implied cost of equity is higher than for South American rivals like Brazil's Itaú Unibanco and Mexico's Grupo Financiero Banorte, suggesting the discount transcends its emerging-market exposure.

## PERSISTENT GAP

Implied cost of equity, based on analysts' consensus forecasts, for Santander and global rivals



Source: Refinitiv, IBES, Breakingviews calculations. 12-month forward return on tangible equity divided by multiple of price to 12-month forward tangible book value

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## **SANTANDER'S IMPLIED COST OF EQUITY IS HIGHER THAN FOR SOUTH AMERICAN RIVALS**

A more plausible explanation is that investors dislike Santander's geographical sprawl. Botín reckons her global businesses, which stretch from Rio de Janeiro to Rotherham, offer diversification. But investors can diversify for themselves. Valued on a country-by-country basis, the sum of the group's parts should add up to around 70 billion euros, Credit Suisse analysts reckon.

To shed that discount, Botín must prove Santander is the best owner of its components. That's not always apparent. For example, its Spanish business earned a ROTE of 7.5% in the first nine months of 2022, trailing CaixaBank's 8.4%. Santander's Mexican unit, at 17%, lags Banorte's 25%. The British arm's 11% ROTE was behind the larger Lloyds Banking Group, which reported a 13% return.

Botín could improve those numbers by spreading technology spending and other costs more widely. That should lower the average cost of serving Santander's 160 million customers around the world.

Her rivals are taking a different route, though. HSBC, BBVA and BNP Paribas have all recently offloaded their North American retail banks for bumper valuations. Santander's U.S. unit, which mostly writes subprime auto loans and which Credit Suisse analysts reckon is worth 11 billion euros, could conceivably attract a local suitor. A more radical option would be to spin off national businesses to investors. That would go against everything Botín is trying to do. But unless the discount narrows, she will have to consider it.

*First published December 2022*





# FOXCONN REINVENTS ITSELF AND EV SUPPLY CHAINS

BY ROBYN MAK

The Taiwanese giant plans to make electric vehicles, and the chips and batteries that go into them, for global automakers. That's a twist on its business of churning out iPhones for Apple in China. As far as strategic pivots go, this one is ambitious and much needed.

## TEST DRIVE

Foxconn's most important project in 2023 will be to remake itself. The Taiwanese company is best known for churning out Apple iPhones in China and shipping them around the world, but Chairman Liu Young-way is looking elsewhere for the next phase of growth. It's a well-timed pivot.

**VERTICAL INTEGRATION IS RARE IN THE AUTO INDUSTRY FOR A GOOD REASON**

Liu is repurposing the top electronics contract manufacturer into an electric-vehicle powerhouse. Foxconn, formally known as Hon Hai Precision Industry, is gearing up to supply cars, and the chips and batteries that go into them, to global marques. It sees automakers entrusting the company with production in Indonesia, Thailand, Saudi Arabia, the United States and beyond. By 2025, Liu wants to take 5% of the global electric-vehicle market and generate annual revenue of T\$1 trillion (\$32.6 billion) – roughly 15% of Foxconn's forecast 2022 top line, per analyst estimates from Refinitiv.

Getting there requires Foxconn ditching a tried and tested business model. To make smartphones, the company relies on a few factories it owns in China and it has little say over the underlying supply chains and which components to use. Cars, on the other hand, are bigger and harder to move, so Foxconn is setting up regional production hubs in partnership with potential customers. Its 40%-owned joint venture with Thailand's PTT aspires to manufacture for automakers in Southeast Asia. Foxconn has also tied up with Ohio-based Lordstown Motors in the United States; its factory is already making electric pickup trucks and could start supplying to other American brands within a year. The Apple-like prize would be to convince a big established carmaker, like Tesla, to outsource production.

Vertical integration is rare in the auto industry for a good reason: Despite the allure of greater efficiencies and higher margins, upfront costs are huge, and it requires scale to take on chipmakers and battery giants like NXP Semiconductors and China's Contemporary Amperex Technology. Recent chaos at Foxconn's major factory in China, and the Taiwanese company's falling gross margins, suggests its two-decade-long relationship with Apple is past its prime. That's a good reason for Foxconn to shift gear in the year ahead.

*First published January 2023*



# INTREPID BANKERS WILL FIND BOUTIQUE BOULEVARD JAM-PACKED

BY JEFFREY GOLDFARB

Slower periods of M&A often inspire rainmakers to hang up their own shingles. Independent shops already pocket 36% of a \$35 bln fee pool, up from 14% two decades ago. The cutthroat deal advice business leaves less room to muscle in on the likes of Blair Efron and Simon Robey.

## SHINGLE-MINDED

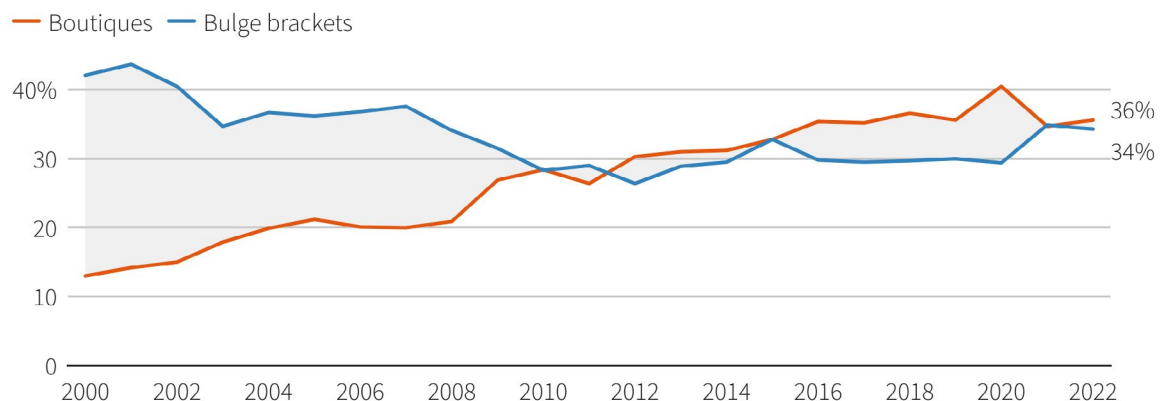
Deal advice has become a crowded trade. The situation complicates things for rainmakers considering their next steps in a weaker environment for mergers and acquisitions. Making the well-trod move from Wall Street to Boutique Boulevard will be much harder in 2023.

The entrepreneurial spirit often hits investment bankers when times get tough, and their mega-bank employers start cutting staff or restricting access to the balance sheet. Such a stretch is probably in store; Goldman Sachs analysts in early December forecast a 20% decline in M&A volume over the ensuing 12 months.

The lucrative run for independent advisers makes hanging out a shingle seem enticing. Two decades ago, firms such as Lazard and Evercore collected only about 14% of the merger fees, according to Refinitiv data. Their share crept up to nearly 20% of a much bigger pool by the time the global financial crisis struck in 2008. Since then, they have vaulted to claim 36% of the roughly \$35 billion clients had paid out in 2022 through mid-December, roughly the same proportion as the top five banks.

## FEE FOR ALL

Share of global merger and acquisition fees



Source: Refinitiv. "Bulge brackets" include Goldman Sachs, JPMorgan, Morgan Stanley, Citigroup, Bank of America; "Boutiques" include firms earning at least 85% of their investment banking fees since 2000 from M&A and equity underwriting, with M&A fees accounting for at least 70% of these fees.

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It's easy to see how the likes of Blair Efron's Centerview, Robey Warshaw and Ken Moelis' eponymous firm established themselves. A decade ago, Barclays, Credit Suisse, Deutsche Bank, Nomura and UBS combined for 17% of the worldwide market. By late 2022, their share had tumbled below 9%. Other Canadian, European and American regional banks also lost big chunks of M&A business.

The competition has become so fierce that boutiques may even be snatching work from each other. Greenhill and Houlihan Lokey are among those that have slipped in the Refinitiv fee league tables. New entrants will struggle to nab customers from stalwarts such as Goldman and JPMorgan, or even from smaller shops that have become go-to consiglieri over the last 15 years or so.

## **BOUTIQUES MAY EVEN BE SNATCHING WORK FROM EACH OTHER**

Only deal mavens with a unique specialty will have a shot at successfully putting their names on the door. Byron Trott carved out a place for his BDT with family-owned businesses, Aryeh Bourkoff's LionTree targeted media moguls, Frank Quattrone and his Qatalyst captured segments of Silicon Valley, while Steve McLaughlin collared a chunk of the financial-technology M&A market with his FT Partners. Absent those kinds of industry-specific or geographic relationships, idle investment bankers may find themselves just spending more time with their families.

*First published December 2022*



A city worker walks through the City of London, Britain, Dec. 16, 2014. REUTERS/Toby Melville/Files



# VIETNAM'S ELON MUSK CHALLENGER TURNS HEADS

BY KATRINA HAMLIN

Le Thi Thu Thuy is steering VinFast onto Western roads to race the entrepreneur's premium marque, Tesla. She'll have to convince investors in its New York IPO to look past niggles at its powerful parent. It's a complex route, and puts the former Lehman banker in the spotlight.

## DRIVING HARD

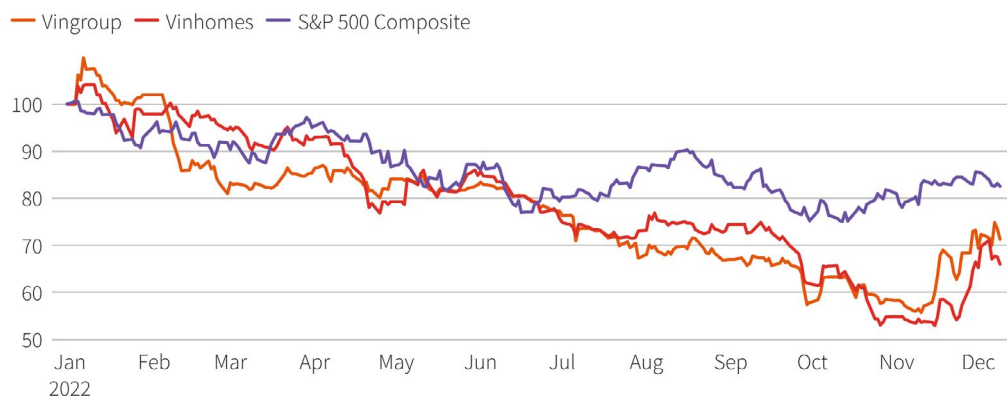
Vietnam is an unlikely home of the next Elon Musk. That's why Le Thi Thu Thuy is one person to watch in 2023. The 48-year-old is at the wheel of VinFast, a money-losing electric-vehicle maker racing the U.S. entrepreneur's Tesla on Western roads. It's a complicated route.

VinFast has made its name selling gas guzzlers in the Southeast Asian nation, where its parent Vingroup is the top conglomerate. Now Thuy is heading in an entirely new direction by turning the carmaker fully electric, and by taking its brand global. Within a year, she plans 70 showrooms across the United States, Canada and the European Union to sell cars like the VF9 sports utility vehicle, which is priced at \$76,000, versus around \$120,000 for Tesla's comparable Model X.

The former Lehman Brothers investment banker is leaning on sophisticated suppliers like battery-maker Contemporary Amperex Technology and electronic products-outfit Aptiv rather than counting on VinFast to develop proprietary technology. It is building a local factory in the United States too, something that's hard for Chinese auto rivals like Nio and Xpeng to replicate as tensions fester between Washington and Beijing. An expensive marketing campaign is starting to yield results: VinFast reported 58,000 reservations as of December.

## ROUGH RIDE

Shares of Vingroup companies are performing poorly



Sources: Refinitiv data (stock price rebased, 100 = Dec. 31)

K. Hamlin | Breakingviews - Predictions 2023

A planned initial public offering in New York is key to fund the expansion. Thuy must convince investors that the company isn't desperate for money. Hanoi's crackdown on the real estate sector is a drag on the property-heavy Vingroup. That makes it look like VinFast has a weak parent at a time when the auto business is also deep in the red: its net loss almost doubled to 34.5 trillion dong (\$1.48 billion) in the first nine months of 2022.

### **ACCESSING VIETNAM'S STOCK MARKET IS TRICKY**

Yet accessing Vietnam's stock market is tricky and, to date, only nine Vietnamese companies have listed overseas, raising less than \$1.5 billion in total, Refinitiv data shows. VinFast's listing would, therefore, present a rare opportunity to tap an economy the International Monetary Fund expects will grow 6.2% in 2023. Thuy can at least count on a scarcity premium to fuel her big drive.

*First published December 2022*



Le Thi Thu Thuy, VinFast's chief executive, speaks during the unveiling of a line of electric SUVs at the Las Vegas Convention Center in Nevada, United States, Jan. 5, 2022. REUTERS/Steve Marcus



# STRAY PET BUSINESSES WILL FIND NEW OWNERS IN 2023

**BY SHARON LAM**

Americans are expected to spend more than \$275 bln on their furry friends by 2030, outpacing GDP growth. Even so, exuberant pandemic-fueled valuations have come crashing down. Nestlé, Mars or Colgate-Palmolive are strong candidates to target the industry's stand-alone operators.

## ANIMAL SPIRITS

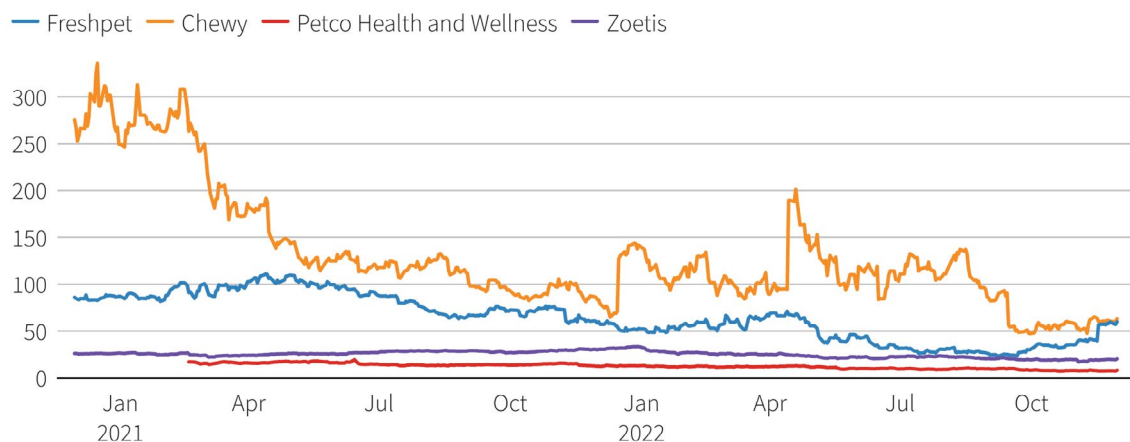
Like dogs seeking forever homes, stray pet businesses will find new owners in 2023. Splurging on furry and feathered

friends has proven to be inflation-proof, even as exuberant pandemic-fueled valuations have cooled off. Big companies are the best candidates to snap up stand-alone operators.

Americans keep pampering their pit bulls, Persians and parakeets. They are projected by Morgan Stanley analysts to spend more than \$275 billion to feed, harness, groom and play with them by 2030, implying annual growth that will exceed that of expected GDP. Consumers may trade down for themselves in tighter economic times, but not when it comes to their pets. After a surge in Covid-19 lockdown adoptions, some seven out of 10 U.S. households owned one, according to a recent survey by The American Pet Products Association. Animals are one long-term investment many people are willing to make.

## PET PEEVE

Forward EV-to-EBITDA multiples have mostly come down in the past two years



Source: Refinitiv Datastream. Data as of Nov. 30.

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Some parts of the industry are expanding rapidly. Specialty retailers Chewy and Petco Health and Wellness noted in August that necessities such as kibble and healthcare products were proving resilient. Fancier fare is the latest craze. Frozen food sales have grown 36% since 2020, while refrigerated options are up about 70%, per NielsenIQ.

### **THE PET BUSINESS IS NO LONGER THE CAT'S MEOW FOR INVESTORS**

The pet business is no longer the cat's meow for investors, however. The stock prices for 11 out of 12 companies chosen by Reuters Breakingviews have lagged the S&P 500 Index in the year through November. Only three of them – Germany-based Zooplus, Canada's Pet Valu and Central Garden & Pet – have generated a positive two-year total shareholder return.

Many stand-alone companies that struggle with distribution and profitability would benefit from a bigger backer. Nestlé boss Mark Schneider, for one, said he is open to opportunities in pet food, while Colgate-Palmolive recently bought additional manufacturing facilities to beef up its Hill's Pet Nutrition division. Privately held Mars, which acquired Canada-based Champion Petfoods and Nom Nom, also could be on the hunt.

Niche outfits such as Freshpet, a preservative-free meal maker that has been targeted by pushy hedge fund Jana Partners, could be one attractive target. In 2018, General Mills paid a whopping 25 times adjusted EBITDA for natural pet food maker Blue Buffalo, one indication of the healthy appetite. Given the latest financial trends, the pet industry will be roaring with animal spirits.

*First published December 2022*



Puppies sit in kennel near the town of Smorgon, Belarus, Jan. 11, 2013. REUTERS/Vasily Fedosenko





CHAPTER 3

# RACE TO THE BOTTOM



# QUIET QUITTING CHINA WILL START WITH THE CHINESE

**BY YAWEN CHEN**



A worker in a protective suit looks out through a gap in barriers at a closed residential area during lockdown, amid the Covid-19 pandemic, in Shanghai, China, May 25, 2022. REUTERS/Aly Song



Western companies have had a hard time dealing with Beijing's zero-Covid policy, rising labour costs and U.S. tariffs. But uprooting and finding suppliers elsewhere is tough. Local partners could help by building factories elsewhere, like Tesla's suppliers are doing in Mexico.

### BACKUP PLANS

China has become a headache for Western executives. But uprooting supply chains and rejecting the buying power of 1.4 billion people is hard. The good news is that the dilemma need not require drastic action from U.S. and European chief executives, since local Chinese partners could solve the problem by relocating themselves. Tesla's increasing footprint in Mexico is a case in point.

### LOCAL CHINESE PARTNERS COULD SOLVE THE PROBLEM BY RELOCATING THEMSELVES

Foreign executives have had a hard time dealing with China's zero-Covid policy, rising labour costs and U.S. tariffs. Complicating things further is the potential fallout from sanctions if the People's Republic ever invades Taiwan. On the other hand, existing economic interests plus Beijing's renewed push to attract foreign investment both argue for staying put. China still accounted for a chunky 16% of global foreign direct investment inflows in the first half of 2022, according to the Organisation for Economic Co-operation and Development.

Western companies in the Middle Kingdom overwhelmingly rely on local suppliers, rather than running their own operations on the ground or dealing with other foreign firms. For example, a senior Tesla executive disclosed in August that its Shanghai factory was 95% supplied by domestic producers. Their prominence in the supply chain means local partners could offer Western groups a painless way out of their stay-or-go dilemma. Chinese companies in the mobile, computer and electric-vehicle sectors are increasingly looking to replicate their operations in cheaper, friendlier markets. Building factories elsewhere offers a hedge in case foreign firms quit the People's Republic. From the Western companies' point of view, it's a straightforward way to relocate without rebuilding a supply chain from scratch.

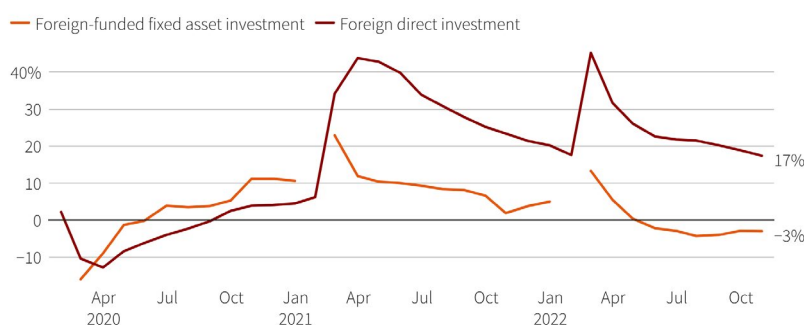
Besides Southeast Asian countries like Vietnam and Eastern European nations such as Hungary, one popular destination is Mexico, where a trade treaty with the United States enables tariff-free exports. As of September, at least 25 Chinese manufacturers that provide parts to Tesla have laid out plans to invest in Mexico, per analysts at Hangzhou-based Zhesang Securities. That includes JL Mag Rare-Earth, which is investing \$100 million in a recycling plant that turns scrapped alloy into permanent magnets.

Beijing may even be able to get behind the trend. A previous instantiation of China's "going out" policy, initiated at the turn of the century to encourage state champions to venture abroad, was abruptly halted when officials started worrying about capital flight. That's always a risk. But if Chinese suppliers now start boosting foreign investment to keep hold of key customers, the government may have little choice but to give its blessing.

*First published December 2022*

### SLOWING INFLOWS

Year-on-year % change in foreign capital flows into mainland China



Source: Refinitiv. Note: Data to Oct. 22. China releases Jan. and Feb. data together.  
Y. Chen, T. Shum | Breakingviews - Predictions 2023

# EAST-WEST BATTLEGROUND WILL SHIFT TO METALS

**BY LISA JUCCA**

After clashing with gas producer Russia, Europe has scrambled to diversify energy supplies to prop up its industries. Western companies will soon feel uneasy relying on China for lithium and nickel, key to a \$5.3 trln green push. Expect a pile-up of mining and recycling deals.

## **HOT METAL**

The global trade war will shift from fossil fuels to metals and raw materials. Russia's invasion of Ukraine highlighted the risk of relying on autocratic states for energy. Even if Europe's gas crisis eases, Western manufacturers' focus will switch to reducing China's dominance in materials key to a cleaner economy.

**EUROPE NEEDS TO CUMULATIVELY SPEND \$5.3 TRILLION ON CLEAN ENERGY PROJECTS BY 2050**

Europe needs to cumulatively spend \$5.3 trillion on clean energy projects by 2050. That requires a sixfold increase in the global production of copper, lithium, graphite, nickel and some rare earths by 2040, International Energy Agency estimates show. Yet China dominates the processing, and to a lesser extent the extraction, of many critical industrial ingredients. It refines 58% of lithium produced globally, 65% of cobalt and over one-third of nickel and copper. Ostracised Russia is also big in nickel, palladium and cobalt. Europe, which imports between 75% and 100% of most metals, looks particularly vulnerable.

In response, Western companies can strike deals with suppliers in friendly countries, open mines at home, or boost recycling. The first approach is the fastest and is underway. In 2022 carmakers have ramped up partnerships with mines and invested directly in mining projects, data from Fitch Solutions shows. General Motors took a stake in Australia's Queensland Pacific Metals to secure nickel and cobalt for green SUVs.

Opening new mines at home looks safer but takes longer. Take lithium. Europe doesn't currently mine an ounce of the key electric-vehicle battery component. And the United States only supplies 2% of global demand. But things are changing.





Sibanye Stillwater is aiming to operate Europe’s first lithium mine in Finland in 2025; France’s Imerys is seeking to extract 34,000 tonnes of lithium hydroxide annually from a mine opening in 2028. If all European lithium mining projects transpire, they could supply around 40% of its expected demand of 600,000 tonnes of lithium carbonate equivalent a year by 2030, says one European miner. The United States, which only holds 3% of the world’s lithium reserves, has passed legislation to subsidise domestic extraction of crucial materials.

Neither approach is foolproof. Mining in developed markets may mean pushback from environmentally conscious citizens. Critical metals producers could also make life trickier for buyers by forming cartels.

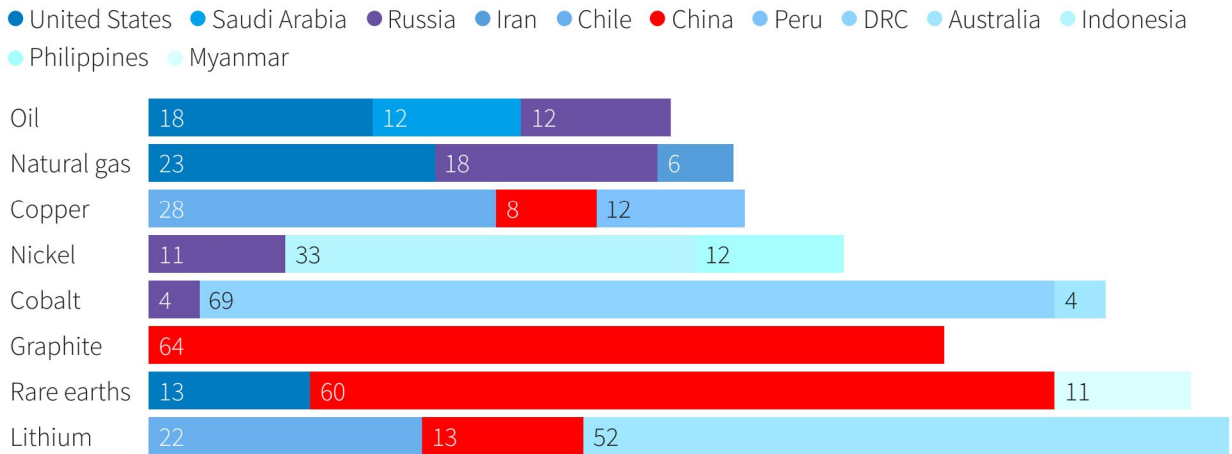
That’s why Western nations’ best option is ultimately to recycle metals from used appliances. Companies like Umicore and Redwood Materials already own the technology to reuse batteries and smartphones. Europe recycles 17% of the globe’s battery production. But this share will rise to 48% by 2025, Fitch Solutions suggests.

Unfortunately, recycling is costly. But in a polarised world, protecting Western industries and jobs will merit a premium.

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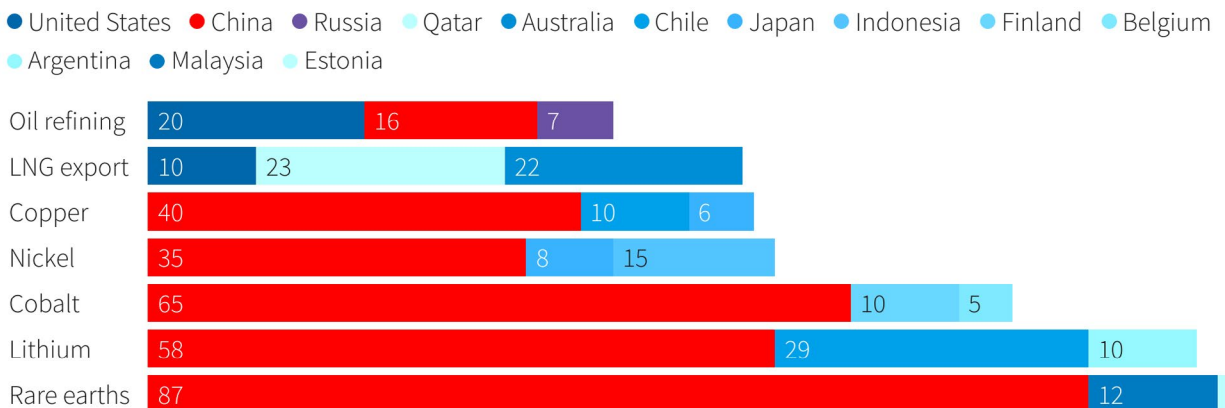
**RACE FOR MINERALS**

Share of top producing countries in extraction of selected minerals and fossil fuels, 2019



**REFINING BOTTLENECKS**

Share of top producing countries in total processing of selected minerals and fossil fuels, 2019



Source: International Energy Agency  
 Lisa Jucca and Oliver Taslic | Breakingviews – Predictions 2023

# PUTIN'S RUSSIA WILL LOOK MORE LIKE NORTH KOREA

BY PIERRE BRIANÇON

The Kremlin leader will strengthen his hold over the ailing economy, from banking to industrials. Massive nationalisation, along with the end of U.S. and European investments, could soon be followed by strict capital controls. The complete closure of the Russian economy is next.

## KIM-IL-VLAD

The Western sanctions that followed the invasion of Ukraine have made it impossible for Russia to import what it needs. Foreign investors are staying away, thousands of the country's elite have emigrated, and the price of its main export has sunk. President Vladimir Putin's war has isolated his country. The great shut-off of its economy will accelerate in 2023, as Moscow moves closer to the North Korean economic model.

The invasion of Ukraine has inflicted damage on Russia, which depends heavily on the export of oil and gas.

Though high prices in early 2022 helped the country, the rest of the world quickly adjusted, moving around supplies and, in some cases like the United States, exporting more. The price of Russia's Urals crude oil has already fallen 40% from its March 2022 peak, and Russia could now lack the resources to cushion the blow of the recession on its population.

As a result, the Russian economy will take a hit. In October 2021, the International Monetary Fund predicted Russia's economy would grow 2% in 2023. Now, the agency sees the country's GDP falling by 2.4% after shrinking 3% in 2022. Based on the rouble's 2021 exchange rate, that translates into some \$200 billion in lost GDP.

That will add pain to already worsening finances. Spending jumped more than 20% in 2022 mostly because of an increase in defence outlays estimated at some \$53 billion by Bank of Finland economists. The Russian government had to raid a rainy-day fund to make up for the first budget deficit in years. Keeping the rouble convertible into other currencies will become harder by the month.

## THE RUSSIAN GOVERNMENT HAD TO RAID A RAINY-DAY FUND

Putin has already tightened his and his government's control of the economy, demanding to sign off on the sale of assets by Western companies in the banking or energy sector. State-owned companies or banks, or Kremlin-friendly oligarchs, such as nickel magnate Vladimir Potanin, have already bought banking or industrial assets on the cheap, and the trend will only intensify.

Far from the scrutiny of foreign investors, Russian business will be free to take to new levels the widespread corruption that has held back the economy for years. And Putin can complete his task of devising a regime where nobody can replace him, with oil it can't sell and roubles it can't use.

*First published December 2022*





# CHIP DILEMMA WILL BUY BEIJING PRECIOUS TIME

BY ROBYN MAK

America is pushing Asian and European allies to stifle semiconductor progress in China. But antagonising the \$466 bln market will be costly for South Korea's Samsung and Dutch ASML as global demand slows. Their hesitancy to fully embrace the blockade will benefit Beijing.

## CHIP DIVIDE

America's chip war against China will make only partial inroads in 2023. After unveiling sweeping new export restrictions in October, Washington appears to have successfully lobbied friendly governments including Japan and the Netherlands to join. A full anti-China alignment, however, will be tricky while global semiconductors demand slows.

The latest U.S. trade rules effectively make ultra-high-performance microprocessors used in supercomputers off limits to Chinese buyers; as are software and equipment required to make semiconductors above certain technological thresholds, including high-end memory chips from China's YMTC.

The move has prompted Apple to freeze plans to buy components from YMTC, Nikkei reported. Yet, most of the chips made in and shipped to China are less advanced technologies unaffected by the restrictions. This blunts the hit for both Chinese and American companies. Last year, Chinese imports of integrated circuits and related equipment topped \$466 billion.

**A FULL ANTI-CHINA ALIGNMENT,  
HOWEVER, WILL BE TRICKY**

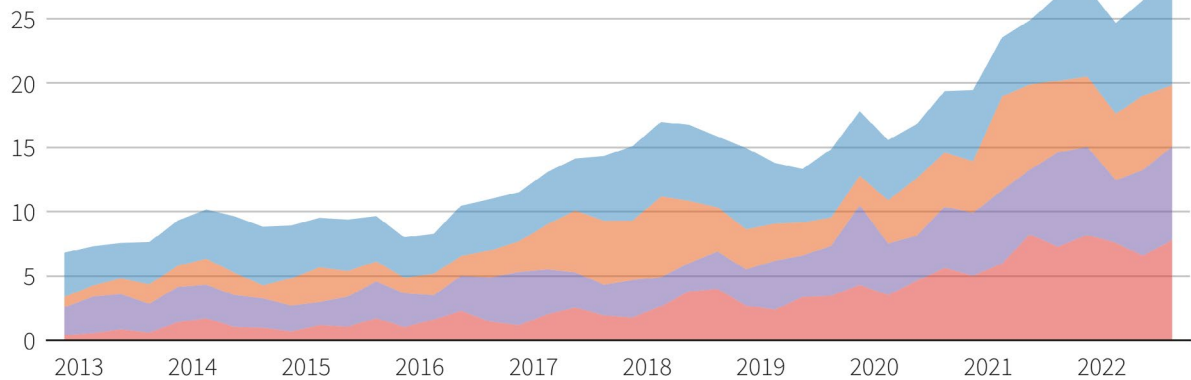


**CHIP CRAVING**

China is a top buyer of semiconductor equipment

● China ● Taiwan ● South Korea ● Rest of the world

Billings of semiconductor equipment by region, \$, bln



Source: Refinitiv. Quarterly data to Q3, 2022.  
R. Mak | Breakingviews – Predictions 2023

The outlook for China-dependent players in South Korea, Japan and the Netherlands is more uncertain. Memory giants Samsung Electronics and SK Hynix have factories inside the People's Republic and won't be able to maintain them without a U.S. licence. Both have secured a one-year waiver from the restrictions, but what happens afterwards is unclear.

For ASML, which has a monopoly in advanced chipmaking equipment, the picture is similarly hazy. The company had already stopped exporting its most cutting-edge machines to China. But Washington policymakers are pressuring their Dutch and Japanese counterparts to also ban less sophisticated tools from ASML and Japanese peers. Both governments have agreed in principle to adopt "at least some" of the U.S. restrictions, Bloomberg reported on Dec. 12. But the devil is in the details. Dutch Trade Minister Liesje Schreinemacher already said in November her government "will not copy the American measures one-to-one".

Curbs would be painful for the Veldhoven-based company: 2.7 billion euros, or 15% of total revenue, came from the People's Republic in 2021. Rival Nikon made sales of over 153 billion yen (\$1.1 billion) in China, some 28% of the total.

Slowing demand is another worry: Total chip sales will shrink 4% to \$557 billion in 2023, a sharp reversal from the 26% growth in 2021, according to World Semiconductor Trade Statistics.

That will probably make companies wary of quickly and fully embracing Washington's requests. The hesitancy will play in China's favour. It will buy it time to stockpile on foreign components and tools and help President Xi Jinping court trade partners. As Beijing knows, wars are seldom fought and won unilaterally.

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# CONSCIOUS CONSUMERISM WILL BE LEFT ON THE SHELF

BY OLIVER TASLIC

Shoppers have been forking out for organic and plant-based food for health, environmental or other reasons. Squeezed incomes will test their ethical commitment. Throw in higher input costs, and 2023 looks an unappetising year for fake burger purveyor Beyond Meat and its rivals.

## MAKE NO MISSED STEAK

Tough times mean tough decisions. In recent years more shoppers have forked out for organic and plant-based food. But persistent inflation and skimpier incomes, coupled with high input costs, will make it a tough year for conscious consumers and the companies that serve them.

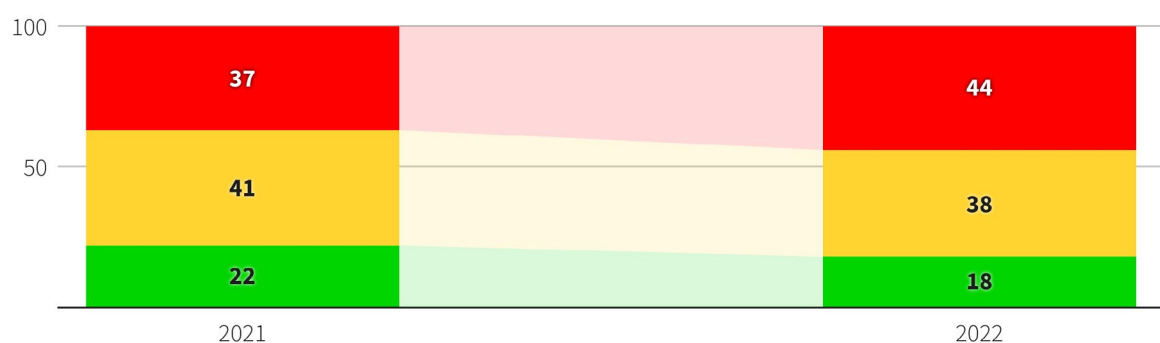
Take plant-based meat substitutes. They produce 30%-90% fewer emissions than their animal-derived counterparts, but a pound of the stuff costs shoppers twice as much, according to the Good Food Institute, a think tank. That puts fake meat on the chopping block when buyers are watching their wallets. Numerator, a market researcher, reckons 29.8% of U.S. households bought planted-based meat alternatives in the year to Sept. 30 – 1.1 percentage points lower than in the previous 12 months.

It's part of a broader onset of eco apathy. Market researcher Kantar surveyed attitudes towards plastic use among almost 100,000 consumers in 24 markets. The proportion of shoppers who were "highly concerned" about waste and took action accordingly was down 4 percentage points year-on-year to just 18%. Meanwhile 44% of consumers were uninterested and took little to no action, a 7-percentage point increase.

## OTHER THINGS ON MY PLATE

The percentage of shoppers concerned about plastic waste declined between 2021 and 2022

- Highly concerned about waste, take action accordingly
- Concerned about waste but take little action
- Unconcerned, take little to no action



Source: Kantar

O. Taslic | Breakingviews – Predictions 2023

## IT'S PART OF A BROADER ONSET OF ECO APATHY

Companies that have been riding the sustainability wave are preparing for leaner times. Beyond Meat, a maker of plant-based burgers, announced in October that it was laying off 19% of its workforce and targeting positive operating cash flow in the second half of 2023. But weak demand will weigh on its top line, while high input costs will pressure margins. The price of U.S. pea protein isolate – a key ingredient in many meat substitutes – rose 10% between April 2021 and November 2022, according to Mintec Benchmark Prices. Forecasts compiled by Refinitiv suggest Beyond Meat's

revenue will shrink almost 1% in 2023, and its operating cash flow is still projected to be negative in the second half of the year. Sales at Oatly, which makes milk substitutes from oats, are projected to grow 25%, but it may still have to raise money.

There are some signs of hope for ethical consumers. UBS analysts note that significant rises in the price of grain, used in animal feed, could push up the cost of conventional meat more than that of plant-based alternatives. That would edge meat substitutes closer to their goal of one day costing the same, or less, than their animal-based equivalents. But in the meantime, 2023 looks set to leave a sour taste.

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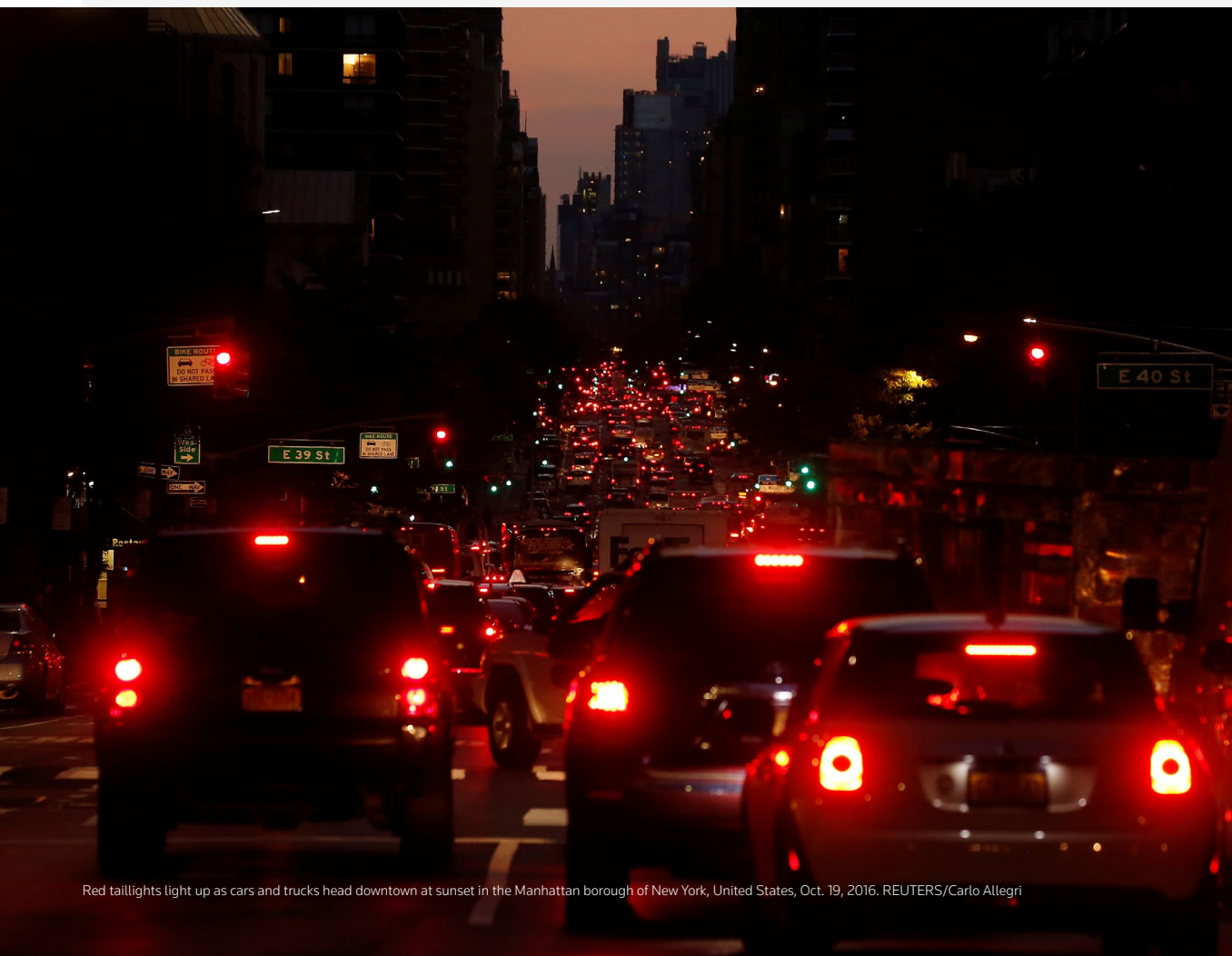


Vegan meat dishes, produced by Israeli start-up Redefine Meat, are displayed at an exhibition in Villepinte, near Paris, France, Oct. 19, 2022. REUTERS/Benoit Tessier



# CARMAKERS WILL REVERSE OUT OF PUBLIC MARKETS

**BY NEIL UNMACK**



Red taillights light up as cars and trucks head downtown at sunset in the Manhattan borough of New York, United States, Oct. 19, 2016. REUTERS/Carlo Allegri

Shares of companies like Stellantis and BMW are depressed on fears of a recession, and the threat of Chinese rivals. Yet the groups are profitable and throwing off cash. One way to make the most of low prices is to buy back shares. The logical next step is to go private.

### GEAR SHIFT

Automotive groups may soon be in line for a private equity pimping. Shares of carmakers like Stellantis and BMW are suffering as investors fret over a potential recession and falling car sales. It's an opportunity for deep-pocketed funds or backers to steer them out of public markets altogether.

There are plenty of reasons to feel nervous about auto stocks. The transition to electric vehicles may sap margins, while Chinese upstarts are threatening to grab market share. Still, carmakers are already priced for the scrap heap, especially in Europe. Volkswagen, Mercedes Benz, BMW and Stellantis are trading on average at 5 times forward earnings, a roughly 25% discount to their 10-year average.

True, a 2023 recession may depress demand for vehicles and cut prices. Yet the outlook is far from bleak. Auto groups sold fewer cars in recent years due to the semiconductor shortage, and so are not the bloated beasts they once were. The same four carmakers are expected to grow revenue by 3% a year through 2024, according to Refinitiv data, a far cry from the more than 10% annual declines seen in 2009.

One way to profit from the depressed valuations is to buy back stock. BMW, for example, has a 2 billion euro repurchase programme, but has the authority to retire up to 10% of its shares in coming years. Assuming that the controlling Quandt family doesn't participate, its stake will rise. More companies may follow BMW in 2023.

### A BOLDER MOVE WOULD BE TO DELIST A COMPANY ALTOGETHER

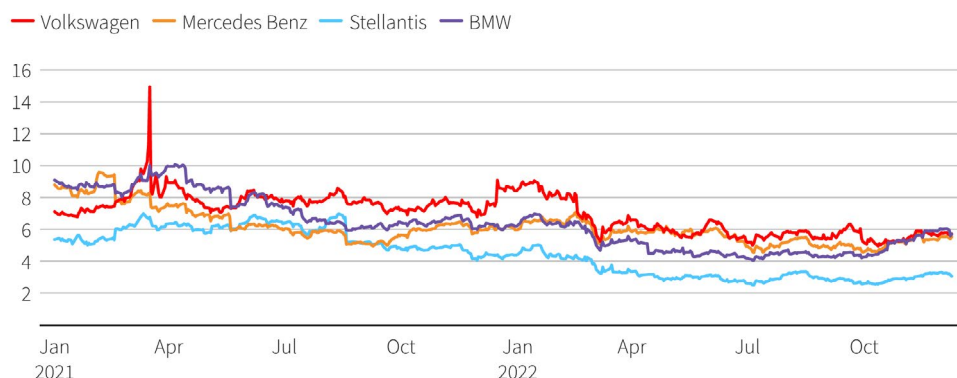
A bolder move would be to delist a company altogether. There are risks: Carmakers are loath to borrow too much, for fear of damaging their financial services divisions. Yet the sector is also sitting on cash. BMW, for example, will in 2023 have net cash equivalent to 47% of its market capitalisation in December, according to Refinitiv data.

Assume a private equity buyer teamed up with the Quandt clan and acquired minority investors' shares at a 25% premium, using debt, for 37 billion euros. After netting off cash, BMW would only have around 10 billion euros of borrowings, which is less than half of forecast 2023 EBITDA and not much more than its medium-term free cash flow target of almost 7 billion euros. That implies the buyers could pay off the debt fast and subsequently extract hefty dividends. If public markets dislike European carmakers, there may be a private market solution.

*First published December 2022*

### SPUTTERING VALUATIONS

Selected European carmakers' forward price-to-earnings multiples since the start of 2021

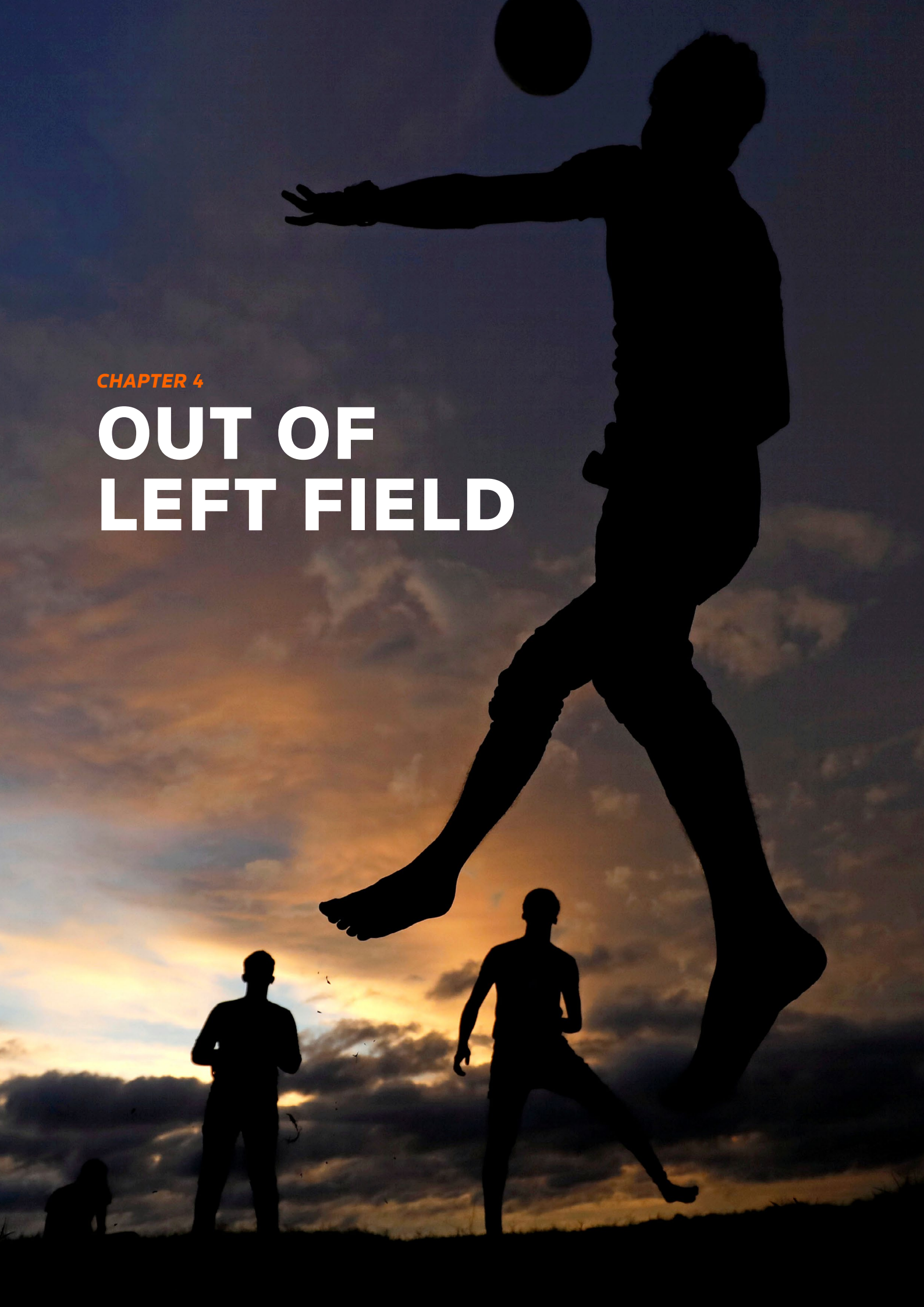


Source: Refinitiv

N. Unmack | Breakingviews - Predictions 2023

CHAPTER 4

# OUT OF LEFT FIELD







# MARK ZUCKERBERG WILL SPLIT META, TAKE THE 'VERSE

BY LAUREN SILVA LAUGHLIN

The Facebook founder's belief in the promise of a virtual world is failing to sway investors. He may control the company, but capital flight is a problem. The solution will be to break off his pet project and find someone else to run and rebuild the social media empire.

## NEW CHAPTER AND THE METAVERSE

Meta Platforms is the tale of two companies, tied together only by their potential to sell advertising and their owner Mark Zuckerberg. As big marketers tighten pocketbooks in 2023, the social media firm, which operates Facebook and Instagram, will become less of a cash machine. This will encourage its founder and chief to pluck his pet project, the metaverse, away from the rest of the business.

## META IS EXPECTED TO INK SOME \$15 BILLION IN FREE CASH FLOW IN 2022

Meta is expected to ink some \$15 billion in free cash flow in 2022, according to estimates from Refinitiv, a 60% decline from 2021, in large part because of spending on the virtual universe. That equates to a 5% yield on its market capitalization of about \$300 billion. But cash flow from Meta's operations alone – mostly the business without spending on the metaverse – would represent a yield of 15%. That's three times the free cash flow yield of consumer giant Procter & Gamble, and more than oil major Exxon Mobil, which had a banner 2022.

Rather than make Meta shareholders collectively pay for Zuckerberg's ambitions, he could fund them himself through dividends from the parent company. If all the cash flow from operations went back to shareholders, representing about \$18 a share, Zuckerberg would find himself with some \$6 billion to reinvest in the project based on his stake. That's not enough given current spending plans, but a few key investors who sign on to his vision might be keen to invest alongside him.

Zuckerberg might, for now, be more comfortable spending investors' money. And with a 57% voting stake, any shareholder will struggle to force him to do otherwise. Still, there's a financial case for him to refocus his efforts. Facebook and Instagram are under the regulatory microscope – and that is starting to hurt the metaverse, too. In December, a high-profile trial between the U.S. Federal Trade Commission and Meta kicked off over the company's deal to buy virtual reality app developer Within. If Meta were smaller, or the metaverse were a separate company, it might not attract the same attention.

Plus, the social media business needs intense focus as spending starts to slow. Zuckerberg – who has never been an operator of a public company through an economic downturn – might not be the best person to lead during a slump. He may loathe to hand over the reins without a distraction. Splitting Meta and taking the 'verse could be a good plan.

*First published December 2022*

# UAE WILL LOOK TO A WORLD BEYOND OPEC

BY GEORGE HAY

The United Arab Emirates suffers from the oil cartel's output restrictions. Distancing itself from the club would boost revenue and potentially attract more Western capital. President Mohammed bin Zayed al-Nahyan has a good moment to do so when he hosts the COP28 climate meet.

## HOT TOPIC

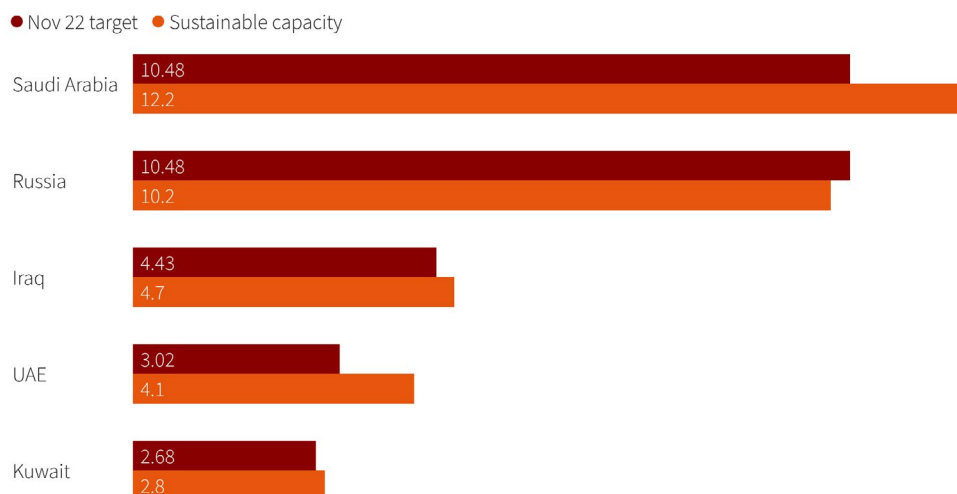
The United Arab Emirates will have a busy 2023. The Gulf state wants to pump more oil, shore up its status as the main destination for Western capital in the region, and make a big splash when Dubai hosts the COP28 climate conference in November. That may lead President Mohammed bin Zayed al-Nahyan, known as MbZ, to re-examine one of his country's oldest alliances.

The UAE has been a key member of the Organization of the Petroleum Exporting Countries for 55 of the 62 years that the club has existed. But current OPEC policy is far from helpful for MbZ. The state is only allowed to pump 3 million barrels a day, which is considerably below its 4-million-barrel capacity. It's even further below a 5-million-barrel daily production target that the Abu Dhabi National Oil Company recently brought forward to 2027 from 2030.

The UAE has chafed at OPEC restrictions before, in 2020 and 2021. But the oil cartel's de facto leader, Saudi Crown Prince Mohammed bin Salman, has taken it in a particularly destabilising direction of late. Ostensibly, OPEC's current cuts are supposed to offset the risk of an oil price slump as the United States and Europe enter a recession.

## RAW DEAL

UAE's OPEC+ oil production target is far short of its capacity (all data in millions of barrels a day)



Source: International Energy Agency. Sustainable capacity defined as the output level that can be reached within 90 days and sustained for an extended period. UAE recently brought forward its 2030 target to produce 5 million barrels a day to 2027.

G. Hay, O. Taslic | Breakingviews – Predictions 2023

But they also offer a way for MbS to needle U.S. President Joe Biden, who wants producers to pump more. OPEC's alliance with Russia, as part of the wider OPEC+ group, similarly risks lumping its members in with a wider anti-Western bloc.

MbZ could change that by quitting, as Qatar did in 2019. The UAE would then get the proceeds from being able to pump whatever it likes, while also benefitting from a warm fuzzy glow in the eyes of the United States and its allies. That would help to secure Abu Dhabi and Dubai's places as the primary Gulf destinations for Western capital and corporate headquarters, fending off Saudi efforts to displace them.

Officially, OPEC thinks crude demand will keep growing until 2035. But ADNOC's accelerated oil production timetable is arguably more in keeping with a different outlook, preferred by the International Energy Agency, whereby oil demand peaks much sooner. If MbZ were to use the COP28 conference to make that more explicit, it could push the UAE further away from OPEC.

## OFFICIALLY, OPEC THINKS CRUDE DEMAND WILL KEEP GROWING UNTIL 2035

All this can be true without the two actually parting ways in 2023. And quitting OPEC to pump more oil would be awkward while hosting a climate conference. But that might not trouble MbZ, who could use COP28 to champion technologies that reduce the damage from oil emissions, while also charting a more convincing route away from fossil fuels in the long term. Distancing the UAE from the oil producing club would represent a hugely powerful signal.

*First published December 2022*



Kuwait's Haitham Al Ghais, secretary-general of the Organisation of the Petroleum Exporting Countries speaks during the Abu Dhabi International Petroleum Exhibition and Conference in Abu Dhabi, United Arab Emirates, Oct. 31, 2022. REUTERS/Amr Alfiky



# SINGAPORE WITHSTANDS **A GLOBAL PROPERTY DOWNTURN**

**BY THOMAS SHUM**



Cleaners spray clean the tourism icon of the Merlion on the resort island of Sentosa in Singapore, July 8, 2015. REUTERS/Edgar Su

The Lion City's housing prices are up 14% in a year, compared to declines in Hong Kong and other major cities. A pandemic-induced construction shortfall and rising foreign demand are factors. Rising interest rates will cool, but not halt, Singapore's real estate boom.

### DEFYING GRAVITY

Property is crashing everywhere, except in Singapore. The Asian city-state's private residential prices are up 14% year-on-year, according to third-quarter data from Knight Frank. That's a sharp contrast to major cities like Hong Kong and Sydney, which saw decreases of 7% and 4% respectively over the same period.

After years of dizzying growth, real estate in financial centres is getting hammered on the back of rising interest rates and fears of a global recession. Home prices in Hong Kong, the world's least affordable property market by far, could fall by as much as 30% by the end of 2023 from 2021 levels, reckon analysts at Goldman Sachs.

Singapore is grappling with the opposite problem. The city-state boasts a home ownership rate of nearly 90% as of 2021, thanks to the government's public housing policies. With average annual real wages growing almost 20% since 2017 and total employment expanding, many households are now looking to

upgrade to private residences. Yet due to Covid-19 disruptions, net new housing has fallen below the 10-year average. As of the third quarter, 78% of planned private residential units were under construction, down from 90% in the same quarter in 2021, according to the Urban Redevelopment Authority.

### THE CITY-STATE BOASTS A HOME OWNERSHIP RATE OF NEARLY 90%

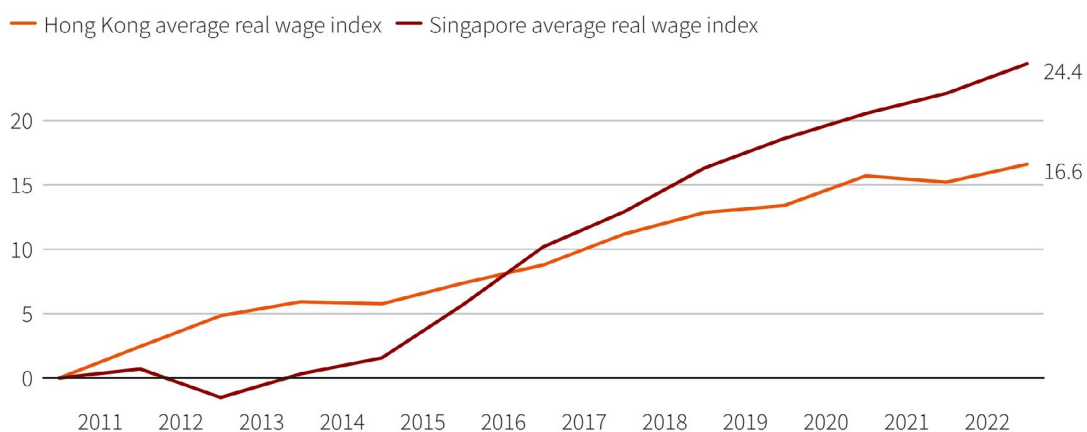
The construction shortfall should ease. Demand, though, will remain robust: Foreign talent is steadily returning, as the city's non-resident population nears pre-pandemic levels of 1.68 million. Moreover, wealthy Chinese are increasingly seeking safe havens to park their assets beyond the reach of Beijing's common prosperity drive. In the first eight months of 2022, buyers from the People's Republic accounted for about one-fifth of the 425 luxury condos sold in Singapore, Reuters reported. As China gradually reopens, even more capital outflows could follow.

That will help buffer the city-state against a painful and sudden correction. Real GDP growth is forecast to slow to 2.3% in 2023, from 3% a year earlier, per the International Monetary Fund. Still, Leonard Tay, an analyst at Knight Frank, predicts an up to 5% increase for private home prices in 2023. Singapore's housing boom is sturdy enough to withstand a turbulent year ahead.

*First published January 2023*

### SINGAPORE RISING

The Lion City's wages are increasing faster than its rival financial hub



Source: Refinitiv, Rebased, 100 = 2010.

T. Shum | Breakingviews - Predictions 2023



# GREEN SURGE IS CIRCUIT BREAKER ON NUCLEAR REVIVAL

BY ROBERT CYRAN

High energy prices and decarbonization desires have reignited plans to build atomic power plants. Yet wind and solar are growing far faster, even in China, because they're quicker and cheaper to build. And expanding power storage is eroding nuclear's big advantage: reliability.

## POWER OF THE FUTURE

Nuclear power received what seem like two plum gifts for 2023. High energy prices and the desire to decarbonize have spurred renewed interest in the technology that provides about 10% of the world's electricity supply. Yet a surging supply of green power is likely to limit any renaissance.

## THERE ARE 425 ACTIVE REACTORS WORLDWIDE

There are 425 active reactors worldwide, according to the World Nuclear Association, about the same as three decades ago. Plants have opened in places like China and closed in Western countries.

Nuclear plants are expensive to build, and their complexity often causes projects to go way over budget. Plant Vogtle in the state of Georgia will be America's first since the 1990s when finished in 2023. The \$30 billion price tag is twice the initial estimate. Reactor opening delays in Finland and China show difficulties transcend borders.

The cost of a new nuclear power station is around \$168 per megawatt hour according to Lazard. An efficient gas plant costs about a third as much, and solar and wind about one-fifth as much. So there's little incentive to build. Running existing nuclear plants makes sense. A depreciated plant costs around \$29 per MWh, reckons Lazard. And power is available rain or shine, day or night.

This reliability is the big reason there are 55 plants under construction, despite the cost, as wind and solar power currently need backup. Yet that appeal is limited. Over the past decade, green power production, excluding hydropower, has grown 15% annually worldwide according to BP's Statistical Review of World Energy. Nuclear production was unchanged. China has 22 nuclear reactors under construction but built renewables about twice as fast.

The price discrepancy keeps widening as wind and solar get cheaper, while nuclear hasn't budged. Moreover, the cost of storing power in batteries is plummeting. NextEra Energy, America's biggest deployer of green energy, estimates that by the late 2020s, wind and solar tied to batteries will be about as reliable as other sources during peak hours, but for roughly half the cost of depreciated nuclear or gas plants, and about one-seventh that of a new, small nuclear plant.

Shareholders may yet get some juice from nuclear players like \$10 billion uranium producer and wannabe reactor servicer Cameco. But wind and solar power's burgeoning advantages have \$172 billion NextEra and its rivals looking more plugged in.

*First published January 2022*



# ECONOMIC CHAOS WILL BREAK ORBÁN'S STRONGMAN SPIRIT

**BY PIERRE BRIANÇON**

The Hungarian leader needs EU funds to prop up his country's struggling economy. With inflation at 20% and the forint in free fall, social unrest is brewing. Backing down on civil rights restrictions and tackling corruption would be a small price to pay for the EU's support.

## FORINT AFFAIRS

Caught between a severe economic crisis, a restive population and his country's need for foreign capital, Hungarian Prime Minister Viktor Orbán will spend 2023 trying to make friends with the European Union partners he scorned for years.

Taking the road to Canossa looks like a no-brainer after the pandemic and the war in Ukraine ravaged Hungary's landlocked economy harder than its European neighbours. Inflation hit 22% a year in October, more than twice the EU average. GDP growth is seen slowing to 1.8% in 2023 after growing 5.7% in 2022, according to International Monetary Fund forecasts. Meanwhile the Hungarian forint fell 13% in 2022 against the euro, and 18% compared to its pre-pandemic level.

Orbán, who has been in power since 2010, was re-elected to a fourth term in April with a comfortable parliamentary majority. But thousands of students and teachers took to the streets in October to protest against rocketing prices and stagnating wages.

## LOSING GROUND

Exchange rate of 100 forints in euros, 2018 to 2022



Source: Refinitiv

P. Briançon and O. Taslic | Breakingviews – Predictions 2023

With public debt at 75% of GDP and foreign investors reluctant to buy the country's government bonds, the Hungarian strongman cannot turn the economy around without 13 billion euros of EU pandemic and budget funds earmarked for Budapest. For now Brussels has only approved the release of 5.8 billion euros of the funds, after Orbán made concessions on Ukraine aid and taxation. The rest is however withheld in retaliation for Hungary's reluctance to relent on laws curbing human rights and the independence of local judges.

**THE HUNGARIAN STRONGMAN  
CANNOT TURN THE ECONOMY  
AROUND WITHOUT 13 BILLION  
EUROS OF EU PANDEMIC AND  
BUDGET FUNDS**

The IMF has warned Budapest against "untimely or incomplete delivery" of the aid, a clear encouragement to mend fences with its EU partners. Without all the EU funds, Orbán will have to row back on his most populist economic measures. Price caps on energy and some goods have led to a surge in demand for fuels, and have also led to market distortions: retailers have bumped the prices of uncapped items to preserve their margins.

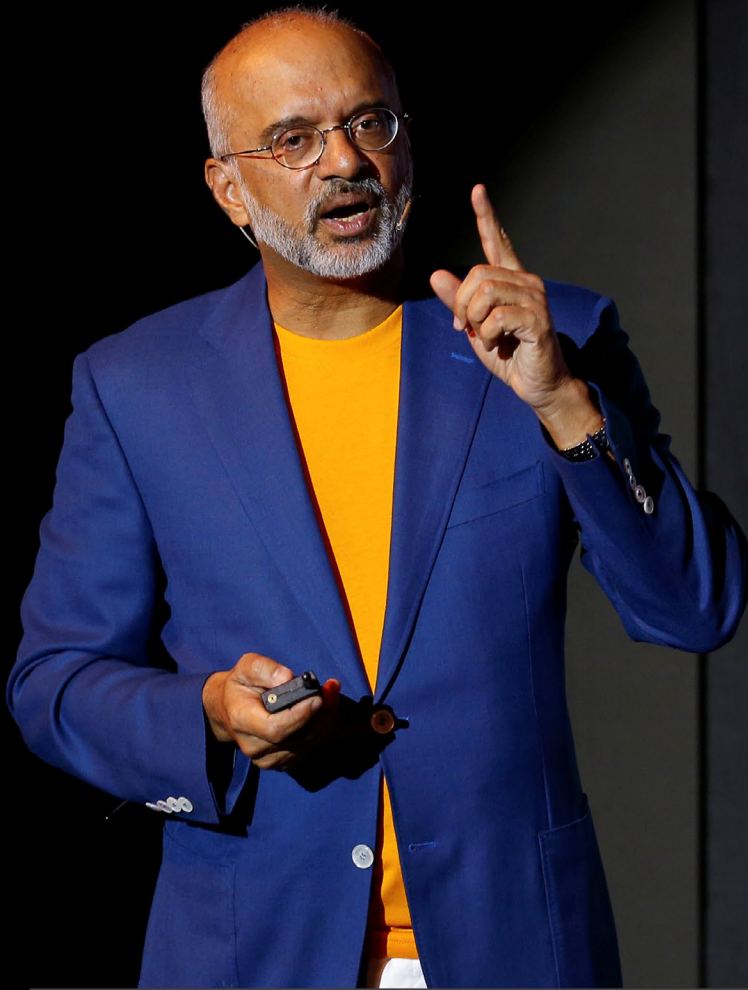
To claim the EU money, Orbán has to implement reforms serious enough to convince the EU the funds will not end up in the pockets of friends or businessmen close to his ruling Fidesz party. He has his work cut out: Hungary has slid to 73rd place in Transparency International's global Corruption Perceptions Index, down from 54th a decade ago.

Orbán's popularity at home looks less steadfast. The risk of economic chaos will provide him with a strong incentive to step down from his most defiant, illiberal stances.

*First published December 2022*



People use flashlights as they attend a protest in support of teachers fighting for higher wages, in Budapest, Hungary, Dec. 3, 2022. REUTERS/Marton Monus



# PIYUSH GUPTA MIGHT BE **BANKING'S BOLDEST BOSS**

**BY UNA GALANI**

Buying banking assets is complex at the best of times. Singapore's \$65 bln DBS added a geopolitical twist when it agreed to acquire Citi's Taiwan consumer bank. As tensions rise, Gupta is holding his nerve on the deal due to close next year. Then again, he has little choice.

## **KEEP CALM**

Buying bits of a bank is complex at the best of times. When it involves one of the planet's most highly charged territorial disputes, it takes a truly daring chief executive to take the plunge. Piyush Gupta of \$65 billion Singaporean lender DBS Group appears to be that CEO, whether he thinks of himself that way or not.

The 62-year-old former Citigroup banker has led what's now Singapore's largest bank by assets since 2009. During that time, DBS' total return to shareholders is more than 340%, around seven times the level of UBS and 11 times that of HSBC. In part DBS' growth reflects Singapore's own growing popularity as an easy place

to live, work and invest, in contrast with an increasingly troubled Hong Kong.

Gupta may be paid a lot less than his Western peers – Jamie Dimon, who has run the \$400 billion JPMorgan for just a few years longer, gets roughly triple the DBS boss' annual \$10 million. Yet the two banks trade on a similar multiple of 1.5 times their estimated 2022 book value, according to Refinitiv. Gupta's 16% return on equity in the third quarter beat Dimon's 15%.

## **GUPTA'S 16% RETURN ON EQUITY IN THE THIRD QUARTER BEAT DIMON'S 15%**

It's not just pay practices that are widely different. There is limited room for growth in DBS' tiny home market, a city with a population of 5.5 million people. Gupta is addressing that by making acquisitions. DBS has swooped when Western rivals like Societe Generale and ANZ have retreated, or when banks fall into distress. Gupta's recent buys include a 13% stake in China's Shenzhen Rural Commercial Bank and a rescue of India's Lakshmi Vilas Bank.



DBS' purchase of Citi's consumer arm in Taiwan, announced in January, fits the pattern. The U.S. bank run by Jane Fraser has been pulling back in some of its foreign markets to focus on cleaning up messes at home, including regulatory fines and embarrassing trading mistakes. Gupta is spending about \$1.6 billion, including paying a \$700 million premium, to expand its existing decades-old operation and make DBS the largest foreign bank by assets in Taiwan.

Taiwan has been a geopolitical hotspot for decades. But since DBS inked its deal, the self-ruled island that China claims as its own territory has only got hotter. Russia's invasion of Ukraine, and Chinese President Xi Jinping's securing of an unprecedented third term in power, have changed expectations of how quickly China might pursue its goal of reunification with the island. President Joe Biden has said the United States would be willing to use force to defend the island, though on Monday, after meeting Xi in person while at the G20 summit in Indonesia, added that he did not think China was planning any imminent assault. Xi's statement included a pointed warning that Taiwan was "the first red line that must not be crossed".

Gupta's response is pragmatic – brutally so. He has consistently said that the bank spent a lot of time thinking through the geopolitical risk. And in a war, he pointed out earlier this month, the fate of its newly acquired consumer bank would be the least of DBS' worries. He has a point, and it makes the deal look more logical than contrarian: as an Asia-centred financial institution, DBS has much greater exposure than its Western rivals to conflict in the region even without Citi's cast-offs. Hong Kong and the rest of Greater China generated 24% of the bank's net profit in 2021.

Gupta may quietly be hoping that his franchise would retain some value even in a conflict. Singapore has so far pursued a balancing act to stay on good terms with both China and the United States, the planet's two largest economies. The Lion City backs Washington's financial sanctions against Russia, while the city-state's banks attract rich Chinese customers looking to diversify their risk away from their own country. By virtue of its nationality, DBS might have a slightly better chance of being able to appear neutral than U.S.-based Citi.

For now, the potential upside gives Gupta a reason to downplay the negatives. Taiwan is rich, boasting 870,000 millionaires, over 4% of the adult population, thanks to its vibrant technology industry. Citi's 2.7 million Taiwan-based credit card customers are more affluent than DBS' own and spend about 20% more, and the average balance held by Citi's private-banking clients, at \$2.5 million, is almost twice DBS' average, Gupta says. DBS is buying a business that was earning a 21% return on equity before Covid-19.

Besides, sitting still isn't an option. American banks are seeking growth too, bolstered by huge balance sheets and windfall profits from the pandemic. Fraser and her peers have been renewing efforts to open doors in China, some recently visiting Hong Kong. Citi and Goldman Sachs are among those looking to build up their transaction and trade finance businesses, which will include targeting profitable corporate relationships in DBS' back yard.

That, plus the pressure to maintain that 1.5-times-book market value, means Gupta needs to keep finding ways to grow. Doing so means combining an opportunistic eye and political smarts with nerves of steel. The DBS chief's Taiwanese expansion may make him appear more daring than his peers, but as an Asia-centred bank boss with big ambitions, he also has less choice.

*First published Nov. 15, 2022*

# SOCCER GIANTS' NEW OWNERS MAY GET TINY RETURNS

BY STREISAND NETO

Manchester United, Liverpool and Paris Saint-Germain are up for sale, either in part or in full. A near \$3.7 bln price tag each seems possible, banking the sellers a tidy return. Yet slowing TV rights deals and spiralling player wages mean the buyers will probably fare worse.

## HIGH BAR

Europe's soccer tycoons are substituting themselves off the pitch. The owners of Manchester United, Liverpool and Paris Saint-Germain will make some decent money by selling all or part of their clubs, though the new buyers might not.

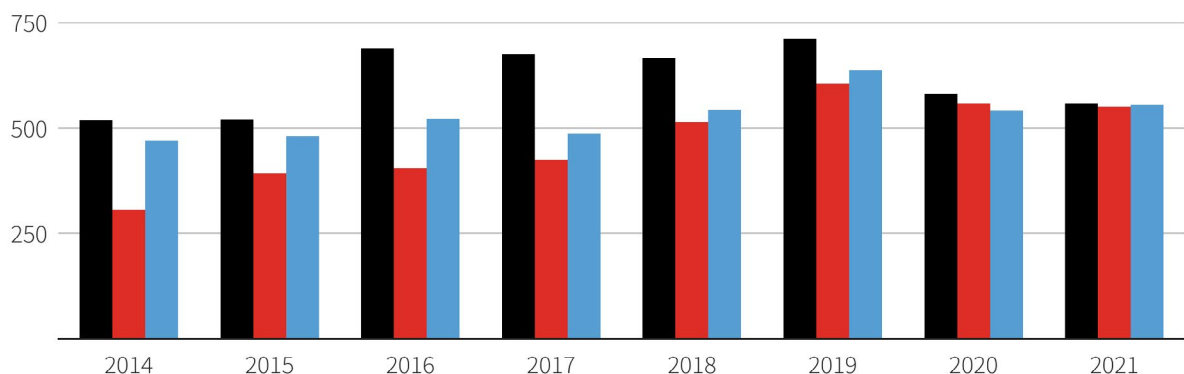
Man United's controlling Glazer family and Liverpool's owner Fenway Sports put the storied clubs up for sale in November, while keeping open the option of holding on to a stake. The Financial Times reported that PSG's Qatari owners wanted to offload 15% of the French champions.

The sellers will probably crystallise a nice return on their investments, judging by Chelsea FC's valuation in a recent sale. A consortium led by American billionaire Todd Boehly bought the London club for 5.7 times the revenue it generated in the financial year that ended in 2021. Apply that to Man United, Liverpool and PSG, which had similar levels of sales that year according to Deloitte, and they'd be worth almost 3 billion pounds (\$3.7 billion) each. That's a huge uplift from the owners' takeover prices of 790 million pounds for Man United, 300 million pounds for Liverpool and next to nothing for PSG, though the Qataris subsequently pumped in a lot of money.

## SLOWING DOWN

Annual revenue for selected European soccer clubs (euros, mln)

● Man United ● Liverpool ● Paris Saint-Germain



Source: Deloitte Football Money League. Years refer to the sporting season that ended in that year.

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The most likely buyers are American billionaires or cash-rich U.S. private equity firms. The dollar's surge against the pound and euro in recent years means U.S. trophy hunters can, literally, get more bang for their buck. And they might view European soccer clubs as a cheaper alternative to sports franchises back home. Recent deals valued the National Football League's Denver Broncos and basketball's Utah Jazz at over 9 times revenue, according to Forbes. Possible Man United, Liverpool and PSG owners might hope that the teams will eventually reach such valuation heights.

### **THE MOST LIKELY BUYERS ARE AMERICAN BILLIONAIRES**

It's hard to see why that would happen. The European media and telecoms groups that bankrolled the sport for years, like Sky and BT, seem less willing to pay up. Streaming giants have dipped their toes but are unlikely to come to the rescue: Netflix co-Chief Executive Ted Sarandos recently said he can't see a way to make streaming live sports profitable. The clubs also come with baggage: Man United's stadium needs renovating; PSG may seek a new one, Bloomberg reported. All three share the ubiquitous problem of rising player salaries and transfer fees, which eat up the bulk of revenue. In other words, the current owners' possible returns may be as good as it gets.

*First published January 2023*

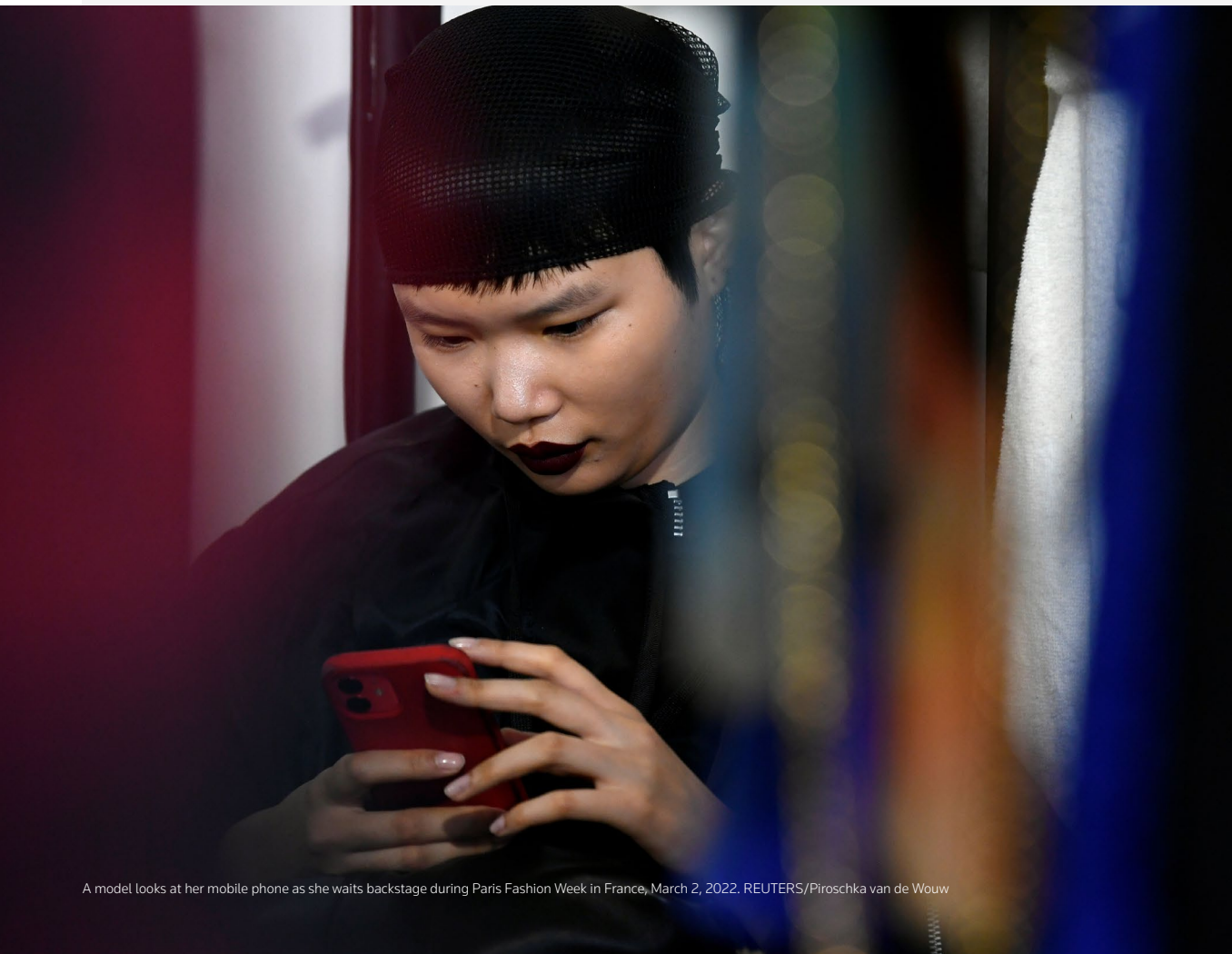


An England fan reacts ahead of football game in Manchester, Britain, Dec. 4, 2022. Action Images via Reuters/Craig Brough



# E-COMMERCE WILL GO VIRAL ON SOCIAL MEDIA IN 2023

**BY KAREN KWOK**



A model looks at her mobile phone as she waits backstage during Paris Fashion Week in France, March 2, 2022. REUTERS/Piroschka van de Wouw

TikTok and YouTube are among those fighting for a piece of the estimated \$46 bln shopping market that's growing twice as fast as ads. It's a sensible strategic move, but recession would dash some plans. Many products also won't suit the apps and competition is expanding quickly.

### SOCIAL CLIMBERS

One of China's biggest exports in 2023 will be its social e-commerce phenomenon. TikTok, YouTube and Amazon.com are among the companies rolling out features that blend online sharing and shopping. The latest craze also is destined to run into some limitations.

There's early evidence that selling goods over live social networking works beyond the People's Republic. Viewers enjoy interacting with celebrities and so-called influencers, but the ultimate goal is clicks to buy. Social sensation Nisrin, for one, has attracted 500,000 TikTok followers, while selling as much as 10,000 pounds (\$12,313) of makeup and other products in a single video session.

ByteDance-owned TikTok introduced the concept in the United States and Britain to replicate the success of Douyin. Its Chinese sister app enabled goods valued at \$119 billion to be sold in 2021. Amazon recently unveiled its own copycat, Inspire. OnlyFans, a video service known for its sexual content, also allows creators to sell personalised merchandise to subscribers.

### SOCIAL SENSATION NISRIN, FOR ONE, HAS ATTRACTED 500,000 TIKTOK FOLLOWERS

Live online shopping revenue will help offset shrinking marketing budgets. U.S. social media advertising spending, which had been growing at around 30% a year, is set to slow to about 12% on average over the next three years, to reach \$114 billion in 2025, according to data portal Statista. By contrast, consultancy McKinsey projects U.S. social media e-commerce sales will increase 20% annually over the same span, to \$80 billion.

The appeal makes sense. Retailers want to attract and keep shoppers online. With customers able to learn more about products from interactive live streams, it should reduce returns, a costly aspect of the e-commerce trade.

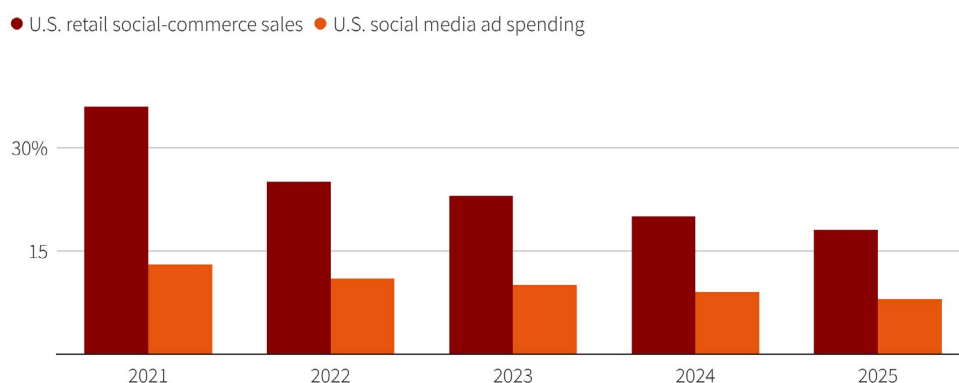
Many products won't suit the medium, however. Cosmetics work better than, say, electronics. Social-media services also may struggle to charge influencers and retailers extra fees. Amazon and others are offering shopping features at no additional cost. And competitors may ultimately be their clients. Venture capitalists have invested \$700 million, per research outfit Pitchbook, into startups such as Firework that provide such technology to brick-and-mortar retailers.

Network effects will be powerful. On TikTok, a two-hour live shopping event helped one small beauty brand generate the equivalent of a week's worth of sales at its flagship store. Such anecdotes are what will make e-commerce go viral on Western social media.

*First published December 2022*

### REVENUE STREAM

Year-on-year growth of social media e-commerce sales outpaces social media ad spending



Sources: McKinsey, Statista, Oberlo

K. Kwok | Breakingviews - Predictions 2023





*CHAPTER 5*

# **BLUE SKIES**



# DIVIDED AMERICA WILL UNITE UNDER ECONOMIC DISTRESS

BY BEN WINCK

A split U.S. government in 2023 will mean gridlock on topics like social spending and clean energy. But to continue operating, Congress must lift the ceiling on government debt. To do that, moderates will unite Democrats and Republicans against a common enemy: inflation.

## UNITED WE STAND

Gridlock plagues the U.S. government if one or both chambers of Congress are dominated by a party not represented by the president. That will happen when a new term begins in 2023, making it difficult for American legislators to accomplish goals. But one thing needs to happen: Congress must raise the debt ceiling so the U.S. government can continue to chug along. That will give lawmakers on both sides of the aisle a chance to fight inflation.

The debt ceiling, currently at \$31.4 trillion, needs to go higher for government employees to get paid and welfare checks to be delivered, among other things. If the U.S. Senate and House of Representatives don't agree on increasing it, the government shuts down and risks defaulting on U.S. debt. Congress got dangerously close to reaching the limit in 2011, when Republicans and Democrats feuded over how to raise the ceiling. Fears of a government default fueled the most volatile week for U.S. markets since the financial crisis, led Standard & Poor's to cut the country's credit rating, and forced a last-minute deal between the two parties.

In 2023, the stakes are as great as they have ever been. U.S. debt has more than doubled since the 2011 episode.

At the same time, the U.S. dollar has continued to strengthen against other currencies, despite big economic cracks. Dysfunction, not other economic issues, will put U.S. finances under a microscope.

## U.S. DEBT HAS MORE THAN DOUBLED SINCE THE 2011 EPISODE

So Congress will pass a bill early in the year to raise the limit. But such bills have riders attached, and often these include special interests or pet projects. In 2023, that will be no different, only Congress can be instructive by fighting inflation. For example, Senator Kyrsten Sinema, who recently left the Democratic Party, could join forces with Democratic Senator Joe Manchin to add a measure that would block Congress from passing other spending legislation that could drive prices higher.

Other moderates such as Representatives Don Bacon or Henry Cuellar could advocate for bipartisan commissions that investigate how Congress contributed to inflation. That would put policies from both parties under greater scrutiny.

It's not as altruistic as it may sound. Congressional members can find just about any reason to bicker – in 2022, they couldn't even unite to make a change to daylight savings time. Still, both parties have a lot at stake with the debt ceiling. If the limit isn't increased, Americans will blame a Democratic president and a dysfunctional Congress, putting both parties under fire. If only because they are all vying for a win in the presidential election in 2024, Congress could unite under high inflation and economic duress.

*First published December 2022*

# “LIFETIME VALUE” IS SILICON VALLEY’S NEXT BUZZWORD

BY KAREN KWOK

As the cost of recruiting customers rises, tech firms and investors are paying more attention to the revenue users bring in. It’s a welcome shift from breakneck growth. Yet as with previous favourites like “total addressable market” or “flywheel effect”, the idea may get garbled.

## LIFETIME BINGO

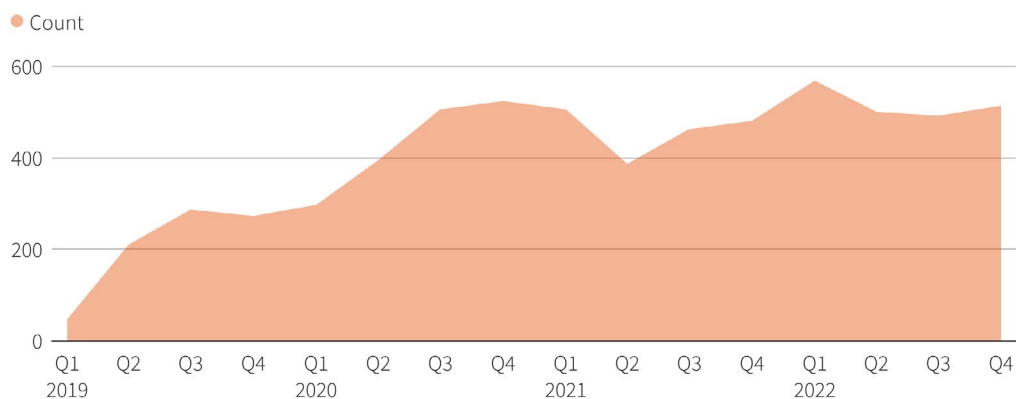
So long, “total addressable market”. Farewell, “flywheel effect”. Silicon Valley has a new buzzword. As the cost of signing up new customers rises, “lifetime value” is set to become must-use jargon for technology executives, investors and analysts in 2023. Companies like Uber Technologies, DoorDash and Spotify Technology want shareholders to know they can squeeze more revenue out of users than it costs to recruit them. As with previously popular jargon, though, the idea can quickly get garbled.

The concept of lifetime value is not new, but a common definition remains elusive. The venture capitalist Bill Gurley defines it as “the net present value of the profit stream of a customer”. Hollywood uses it to estimate the cumulative income from streaming movie titles, after deducting the cost of making the film.

It’s catching on in the tech world. Uber boss Dara Khosrowshahi and his team invoked the term seven times during the ride-hailing firm’s investor day. At a similar event in June executives from music streaming service Spotify mentioned it 14 times, with another 47 references to the abbreviation LTV. Earnings transcripts for 4,800 U.S.-listed companies analysed by Bedrock AI show executives and analysts mentioned “lifetime value” over 500 times between October and mid-December, up from just 47 times in three months to March 2019.

## BUZZWORD BINGO

Mentions of “lifetime value” by executives and analysts in earnings calls



The growing enthusiasm for measuring customers' long-term value comes as many companies grapple with slowing growth in users. Rising prices and interest rates are squeezing disposable incomes, forcing some consumers to ditch Uber rides or entertainment subscriptions. The lost customers are harder to replace. Marketing company WordStream reckons the average cost for a business of making one sale through a Google advertising campaign rose 19% in 2022 from a year earlier.

**THE PROBLEM IS THAT EVERYONE SEEMS TO HAVE A DIFFERENT DEFINITION OF LIFETIME VALUE**

The problem is that everyone seems to have a different definition of lifetime value. Food delivery firm DoorDash looks at it as a metric to measure "customer retention, order frequency, and gross profit per order" over a fixed payback period. Uber and its Southeast Asian peer Grab treat it as the ability to bring in one customer and then cross-sell different services at a lower cost. The \$49 billion e-commerce firm Shopify defines lifetime value as the total amount of money a customer is expected to spend with the business over the course of an "average business relationship".

But lifetime value isn't a silver bullet, as Gurley noted a decade ago. As capital becomes more scarce, generating free cash flow remains the most important target. As with previous buzzwords, investors may find that references to lifetime value do more to confound than clarify.

*First published December 2022*



Tony Xu, CEO and co-founder of DoorDash, speaks at the TechCrunch Disrupt event in New York, United States, May 11, 2016. REUTERS/Brendan McDermid



# BANKS WILL PUMP H<sub>2</sub>O TO TOP OF CLIMATE AGENDA

BY ANTONY CURRIE

Recent floods and aridity show global warming is undermining water security. Yet the resource gets a trickle of the dollars and attention Barclays, Citi and rivals devote to sustainability. The first COP-like water confab in decades is an apt time to divert more of that flow.

## A RIVER RUNS THROUGH IT

If there's one date in 2023 for lenders' calendars, it's March 22. That's when the United Nations' first water confab in almost five decades starts in New York. It's almost an aquatic version of the UN's annual Conference of the Parties (COPs) and is the perfect opportunity for bank bosses to show they grasp how important water security is to climate change.

Achieving that globally requires spending \$1 trillion a year on the sustainable provision of drinking water and sanitation, and preparing for floods, scarcity and pollution, per the World Resources Institute. But Citigroup directed just 1.3% of its \$222 billion-worth of environmental and social transactions during 2020 and 2021 to the resource; transport and renewable energy enjoyed more than a third. Barclays's 600 million pounds accounted for a similarly low percentage into water in 2021. JPMorgan's 6% included financing the Nature Conservancy's project to remove thirsty invasive plants depleting Cape Town's scarce H<sub>2</sub>O. Goldman Sachs racked up 658 sustainability-tagged deals in oil and gas, but just a dozen in water.

With investors and governments similarly parsimonious, the funding gap is huge. Yet 10% of greenhouse-gas emissions stem from the water industry. And 90% of climate change's effects manifest through water, as recent floods and scarcity demonstrate.

## 10% OF GREENHOUSE-GAS EMISSIONS STEM FROM THE WATER INDUSTRY

Well-designed water projects can have multiple benefits: disaster mitigation; carbon storage; improved agricultural conditions; lower pollution. Some are harder to monetise as water is often underpriced or free, especially in emerging markets. That's a challenge to relish, akin perhaps to HSBC, Citi and Bank of America supporting a public-private partnership to reduce coal power in Indonesia.

Knowing when to turn off the funding tap is important, too, just as many banks won't back Arctic drilling or new coal mines. Hydropower can be prone to floods and aridification, and bad for the environment; wannabe green hydrogen producers often ignore H<sub>2</sub>O needs. It would be smart for banks to insist on standard water risk disclosures, and to include conservation and transparency targets in loans and other deals – as BBVA did with its 2.5-billion-euro "water footprint" loan for Iberdrola in July.

With some financial groups distancing themselves from umbrella climate change bodies, it's a challenging time to make this case. But water can't be ignored any longer. The aquatic answer to COP needs to make a splash.

*First published January 2023*



# FEMALE FANS WILL FUEL FORMULA ONE IN 2023

BY KATRINA HAMLIN



Driver Jamie Chadwick celebrates after winning the W Series race at Silverstone, Britain, July 2, 2022. REUTERS/Molly Darlington

Liberty Media's testosterone-powered franchise is ready to shift gear. A docuseries following its drivers was among Netflix's best-watched shows and lured more women to the racing stands. Forget Lewis Hamilton: Finding a Louise Hamilton could rev up that trend and boost revenue.

### FULL THROTTLE

Liberty Media will find new ways to shift Formula One up a gear. If more female fans tune in, they will help Chief Executive Stefano Domenicali fuel revenue at his motor-racing division. Forget Lewis Hamilton: In 2023, he'll find himself chasing a Louise Hamilton.

The \$29 billion media goliath bought Formula One Group, which holds commercial rights to the F1 championship, for a racy \$8 billion in 2017. While sales for 2021 hit \$2.1 billion, just 5.6% above pre-pandemic levels, operating income was modest at \$40 million, and earnings fell 6% year-on-year in the quarter ending September 2022.

Domenicali can take two roads to speed growth. Scheduling more races would boost sales from sponsorship, tickets and broadcasts. But F1's race calendar for 2023 is saturated.

**AROUND 40% OF F1 FANS ARE NOW FEMALE**

Luring more spectators to stands and screens, especially female ones, is a better approach. Netflix's "Drive to Survive", a docuseries tracking F1 teams, topped the streaming company's viewing rankings in 33 countries when it was released at the beginning of the 2022 season, according to Formula One. The company says it has been "vital" for reaching new fans, including women. Around 40% of F1 fans are now female, up 8% from 2017, and more women are attending races too, Domenicali said in November.

One way to accelerate the trend could be featuring female drivers. Audiences for women's sports are "going nowhere but up" according to media consultancy Nielsen. Sponsorship for top-level female soccer and rugby rose 146% in 2021 from a year ago, says Nielsen. Yet, F1 hasn't welcomed a lady to the grid since Maria Grazia "Lella" Lombardi, who raced in the 1970s. The all-women "F1 Academy", starting in 2023, is a mere feeder for lower-level races. Domenicali predicts women won't drive F1 in the next five years.

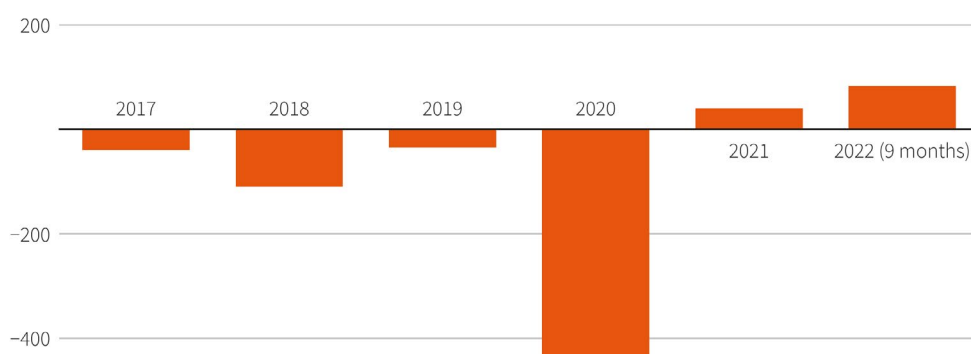
However, there is a contender. Britain's Jamie Chadwick, 24, won every edition of the W Series, an independent women's championship that became a supporting event for F1. She also boasts a fanbase of over half a million social media followers – more than the W Series itself. Unfortunately for Formula One, when financial pressures ended W Series 2022 early, she absconded to Andretti Autosport's team for the U.S. IndyCar NXT races.

Even so, Chadwick still dreams of racing a Grand Prix. Given the financial benefits, finding ways to attract more women on and off the track will keep Domenicali busy in 2023.

*First published December 2022*

### BUMPY ROAD

Liberty Media's Formula One Group is starting to rev up operating profit (\$, mln)



Source: Company filings

K. Hamlin | Breakingviews – Predictions 2023



# VENTURE CAPITALISTS' PAIN COULD BE HUMANITY'S GAIN

**BY PETE SWEENEY**

Rate hikes have sapped enthusiasm for crypto, metaverses and gimmicky startups, with funding down 27% year-on-year. That will free up money to focus on nanotechnology and AI, which can boost lifespans and productivity but take longer to commercialise. Less frivolity is welcome.

## GET SERIOUS

At its 2021 peak, the aggregate market capitalisation of cryptocurrencies was nearly \$3 trillion, roughly equivalent to the economic output of Africa. A record \$630 billion poured into venture capital investments that year. Now, as interest rate hikes tear into alternative assets, money going into innovation is being reallocated.

Global VC funding fell to \$329 billion in the nine months to September 2022, per a report from CBInsights, down 27% year-on-year. The liquidity crunch exposed governance flaws, dumb ideas and solutions looking for problems: metaverses, non-fungible images of bored apes, flying cars. Other ideas that appeared on the cusp of commercialisation may not be. Ford Motor disbanded its self-driving car unit in October, for example, amid doubts about how soon vehicles will learn to drive and park themselves to the satisfaction of regulators and insurers. Elsewhere the pace of advance is slowing, such as in semiconductors.

The new buzzword is "hard tech", which contains many fields traditionally dominated by corporate labs inside industrial giants like U.S. chip equipment specialist Applied Materials. Designing microscopic robots to fight disease and biochemical computers to outperform silicon chips entails higher upfront costs and longer commercialisation cycles than the consumer app plays many Silicon Valley backers are accustomed to. Over the last decade, for every VC dollar put into nanotechnology startups trying to manipulate matter at the near-atomic scale, \$44 went into fintech, Prequin data shows.

It's high time for a shift. The exponential expansion of human output and lifespans that began with the industrial revolution in 1760 shows signs of gradually flattening out in wealthy countries, even as global patent filings continue more-or-less apace. It is striking that while U.S. research and development continue to outperform, the life expectancy of its citizens has started to decline. One factor may be the misdirection of research and the imbalanced distribution of its fruits.

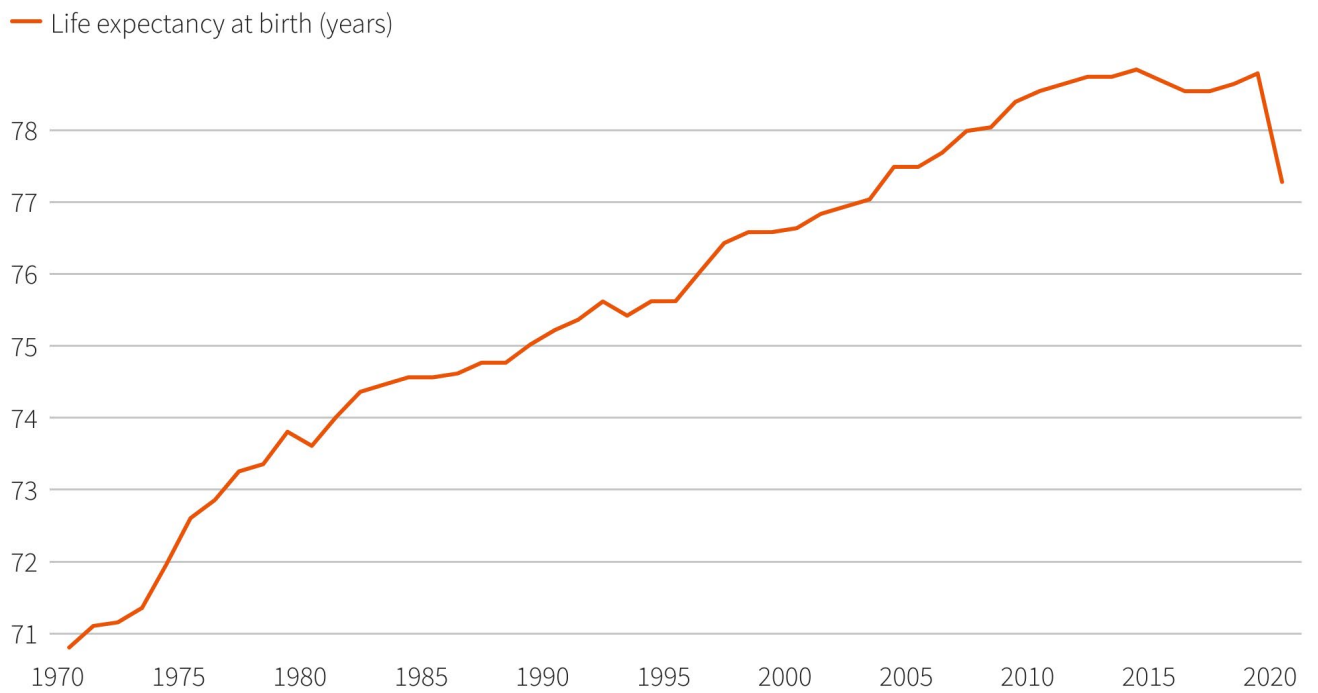
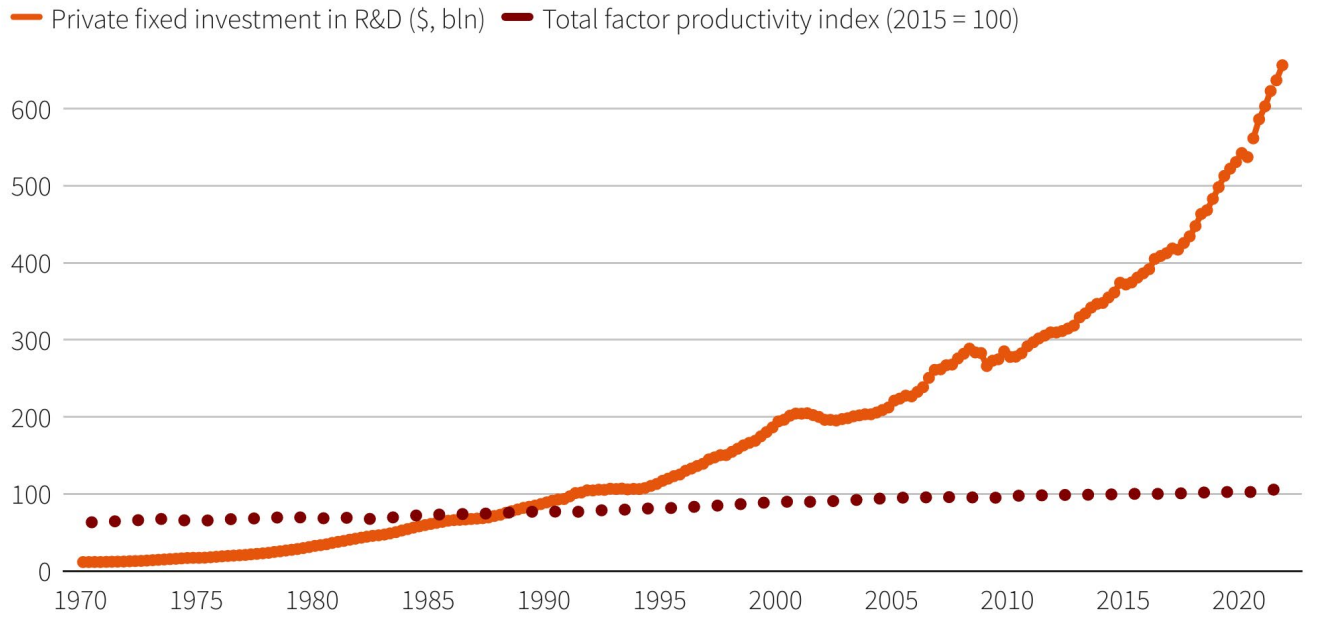
At the same time, the ultra-low interest rate environment following the 2008 global financial crisis saw average quarterly VC deal values rise from below \$10 billion to \$178 billion at the end of 2021. Negligible yields on conventional investments encouraged staid insurers and pension plans to put money into speculative enterprises like the bankrupt crypto exchange FTX. Hopefully higher rates will push some or most of that capital back toward real problems, with big dividends for output and health. It will just take a bit longer for everyone to cash out. The enlightened capitalist will look forward to a less frivolous era.

| **THE NEW BUZZWORD IS "HARD TECH"**

*First published December 2022*

**OUTGROWN**

U.S. R&D spending has had a diminishing effect on its productivity and lifespans



Source: Refinitiv  
 P. Sweeney, K. Hamlin | Breakingviews - Predictions 2023



# WEED'S NEXT FRONTIER IS IN ASIA

BY THOMAS SHUM

The cannabis market is estimated to be a \$100 billion industry by 2026, but largely confined to the U.S., Canada and parts of Europe. While legalising ganja has been a slow burn in Asia, official attitudes are shifting. Demand from regional consumers will slowly light up.

## GATEWAY DRUG

Asia is beginning to warm up to the use of cannabis. Thailand legalised marijuana cultivation at home in 2022, while South Korea, Japan and Malaysia are paving the way for pharmaceutical applications. With the weed market estimated to be a \$100 billion industry by 2026, according to research firm Prohibition Partners, regional businesses are preparing for demand from Asian consumers.

The Thai decision to remove cannabis from narcotics control lists is nominally to support its medical use, but this will naturally ease recreational consumption, which may boost international tourist inflows. Renewable energy firm Gunkul Engineering committed 2 billion baht (\$57.6 million) to building a new cannabis plantation and extraction facilities, local Thai media reported. Cannabis-leaf chicken leg snacks and cannabidiol-infused green teas made by Bangkok-listed Srinanaporn Marketing and Ichitan Group already line the shelves of local supermarkets.

Even Japan, known for its strict cannabis-possession laws, allows cannabidiol, an active ingredient in cannabis that does not get users high, commonly referred to as CBD. E-commerce company Rakuten and Pan Pacific International's Don Quijote supermarkets now offer a wide range of CBD oils and gummies. South Korea was the first country in East Asia to legalise pharmaceutical cannabis, and Japan, Malaysia and Taiwan are all considering similar moves. If American experience is any guide, regulated pharmaceutical use will inevitably trickle into the recreation market, boosting aggregate demand.

China is a question mark. The country was scarred by its experience with opium, which it associates with imperialism. On the other hand, the marijuana plant grows naturally in Yunnan province. China is also responsible for around 70% of global hemp fibre production. Extraction of full spectrum hemp oil, which contains CBD, is legal for export under tight scrutiny, notes Andy Li, founder of Yunnan-based Hempson. Given conservative attitudes in Beijing, Chinese recreational and medical use of cannabis will probably occur in neighbouring countries.

Weed enthusiasts should be optimistic, though. Conor O'Brien, former lead analyst at Prohibition Partners, thinks the Asian market will grow at least 10 times to roughly \$120 billion by 2026. That's only a fraction of the \$100 billion industry that the devil's lettuce is becoming, but it's a start. Cannabis in Asia will burn slowly, but where there is smoke there may eventually be fire.

*First published December 2022*

**WHERE THERE IS SMOKE THERE MAY EVENTUALLY BE FIRE**



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### COVER AND CONTENTS PAGE IMAGE

Stellar nursery 30 Doradus, nicknamed the Tarantula Nebula, is seen in this image captured by NASA's James Webb Space Telescope. NASA, ESA, CSA, STScI, Webb ERO Production Team, 2022.

### CHAPTER TITLE IMAGES

#### BACK TO BASICS

A storm cloud can be seen behind a yacht as it sails off the coast of Sydney, Australia, March 31, 2014. REUTERS/David Gray

#### AGAINST THE ODDS

Britain's Red Arrows flying display team perform during an air show, the China International Aviation and Aerospace Exhibition in Zhuhai, Guangdong province, China, Nov. 1, 2016. REUTERS/Stringer

#### RACE TO THE BOTTOM

Competitors jump into the water during a cliff diving competition near the central Bohemian village of Hrimedice, Czech Republic, Aug. 5, 2022. REUTERS/David W Cerny

#### OUT OF LEFT FIELD

Youths play soccer at Galle Dutch Fort, in Galle, Sri Lanka, Nov. 7, 2018. REUTERS/Dinuka Liyanawatte

#### BLUE SKIES

A paraglider flies above the mist in the Swiss Alps in Sonchaux near Montreux, Switzerland, Nov. 3, 2007. REUTERS/Denis Balibouse



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