Compounding Earnings through Sustainable Growth

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Key Insights

- *We emphasise the sustainability of earnings growth over the magnitude of earnings growth.*
- *Consumer Staples companies are increasingly challenged as they face cost inflation and increased sustainability costs.*
- *A longer-term investment focus with a patient approach when analysing company and share price fundamentals is key to achieving sustainable, above-average returns.*

For several decades, a key tenet of our stock-picking process has been to focus on the sustainability of earnings growth over the magnitude of earnings growth. We have found that the market often extrapolates near-term, very high growth rates too far into the future and risks overpaying as the expected outsized growth seldomly materialises. Conversely, the market frequently underestimates the durability of slower but steadily growing companies. By avoiding large drawdowns in growth, these companies can outgrow the average company over a longer period, reinvest into their business with high visibility, and thus outmatch the competition.

The Consumer Staples sector is facing challenges

An important reason why companies can protect and sustain their earnings growth, when input costs are rising, is through their ability to raise prices and thereby protect their earnings margins. While high and stable gross margins are not the only things defining a good business model, they are an important barrier against huge swings in earnings growth.

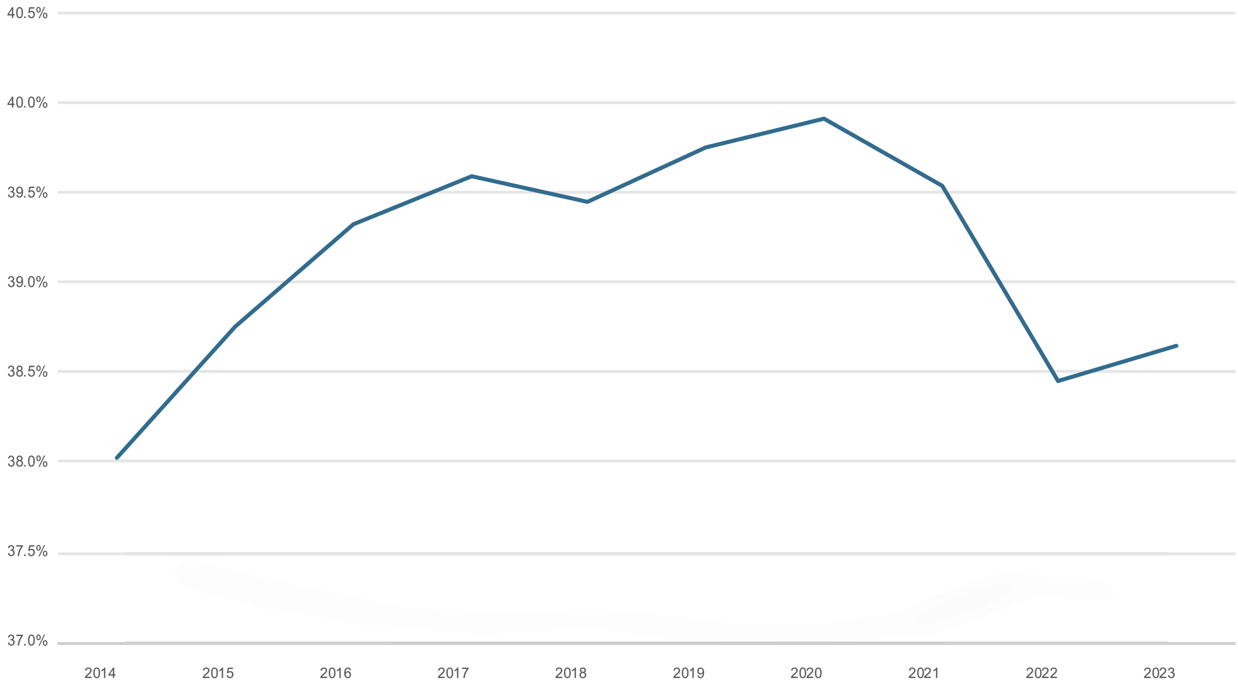
We have often found and valued these characteristics in the Consumer Staples sector. The hallmark of Consumer Staples has long been its consistency, stability, and ability to grow earnings sustainably and predictably.

However, over the past 3-5 years, many Consumer Staples companies have experienced significant cost inflation in raw materials, transportation, and packaging. Furthermore, the operational costs of complying with sustainability demands from lawmakers and customers have increased. As companies raised prices in the wake of cost inflation, cheaper private-label products gained share, and new brands entered the market. This has put pressure on gross margins, see figure 1 on the following page, and the earnings growth of several of the incumbent consumer staples companies.

"Many Consumer Staples companies have experienced significant cost inflation in raw materials, transportation, and packaging."

Figure 1

Gross margins have started to come under pressure



Source: Bloomberg, June 2024. Average gross margins for the 138 Consumer Staples companies with a market cap above USD 10 billion.

“We look for defensive and stable companies with strong pricing power and an ability to compound.”

We have selectively tried to calibrate our exposure accordingly in the portfolios. For example, Unilever was sold in 2022 partly due to inflationary pressure and partly because we questioned whether management spent shareholders’ money wisely. The company made several highly valued acquisitions and even tried to acquire GSK’s consumer healthcare at elevated earnings multiples. The latter would have meant biting off more than it could chew, and the debt Unilever would have had to assume would not have left much room for error.

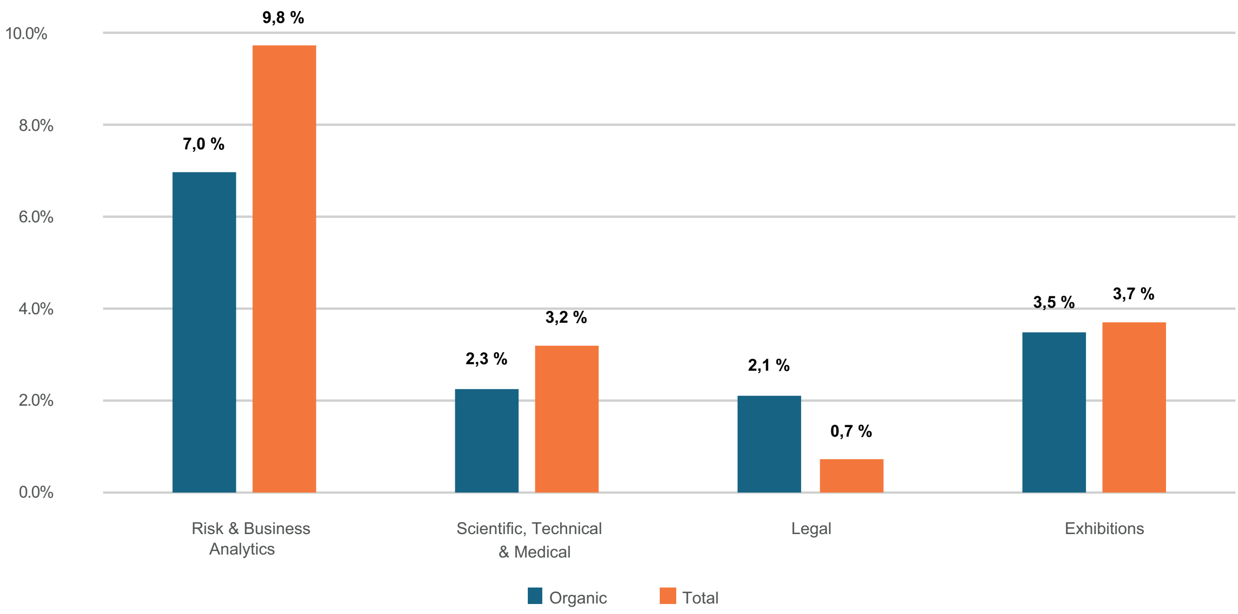
We have portfolio exposure in selected Consumer Staple companies, like Procter & Gamble, one of the few companies that has managed to sustain volume growth and price increases in the aftermath of COVID-19. We have also maintained an active position in Nestlé because it is exposed to growing consumer categories like coffee, pet care, and confectionery. Nestlé has also been successful with the premiumisation of its product portfolio over the years. Furthermore, Nestlé is seen as a leader in sustainable sourcing and packaging.

Fortunately, our portfolios are not constrained regarding benchmark sector weightings, and we can find investments in all sectors. We have found interesting investments in non-traditional defensive sectors in companies with stable compounding earning and strong pricing power.

On the following pages, is a short description of some of the companies that we have invested in:

Figure 2

RELX' organic and total revenue CAGR (2010-2023)



Source: RELX, 2023.

RELX: Data and artificial intelligence at work

RELX is a British data and analytics company. RELX's success is rooted in its ability to combine hard-to-replicate data (legal, medicinal, technical, etc.) with a highly trusted brand. RELX is deeply embedded within the systems and operations of its clients, often as the sole data provider, making it difficult for customers to switch providers. For example, RELX's Risk and Business Analytics business has close to a monopoly on data and software used for property and casualty insurance claims. The two other large divisions are Scientific Technical & Medical and Legal, which offer data and workflow analytics in duopolistic and oligopolistic markets. These three businesses have consistently delivered positive organic revenue growth after 2010, see figure 2 (RELX also have a smaller business division called Exhibitions). RELX is one of the most reliable sources of structured data and workflow systems, which are must-haves for clients even when economic times are challenging, which is the reason for the consistant performance. It is also a natural beneficiary of a world increasingly driven by data and artificial intelligence.

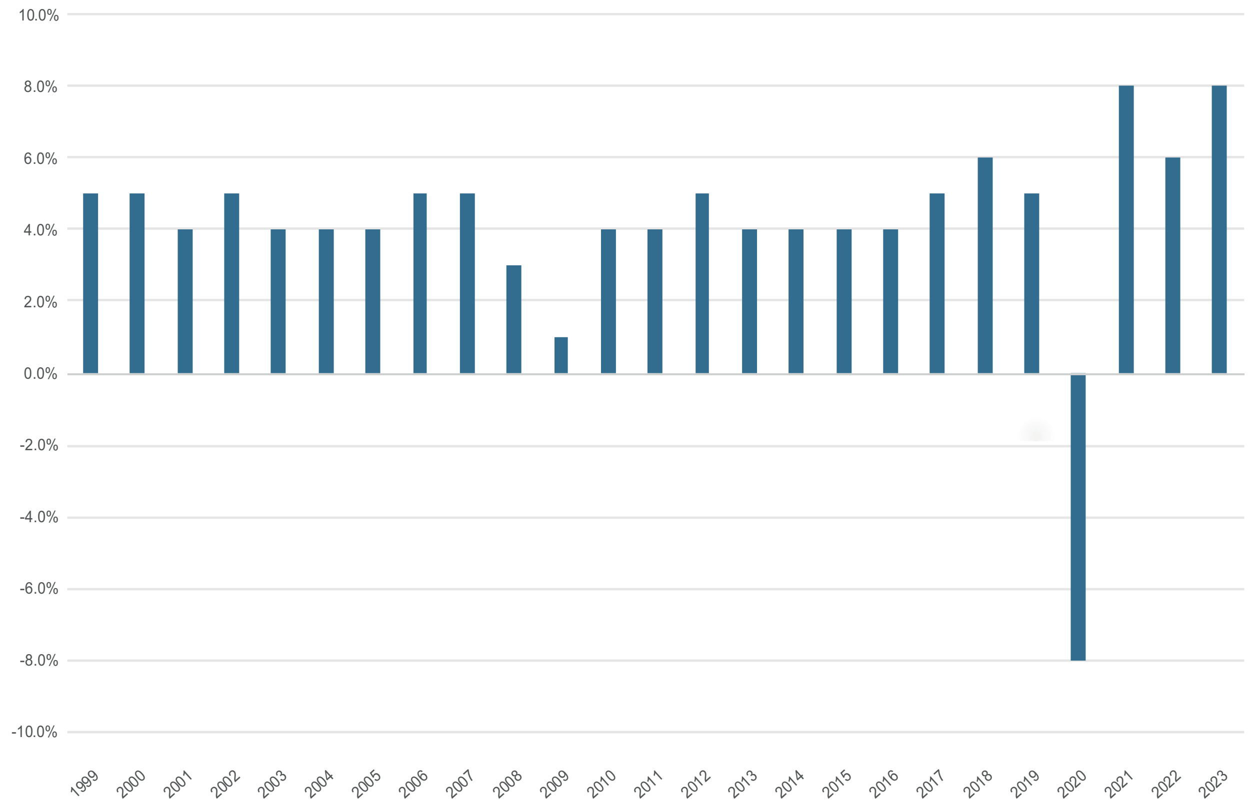
L'Oréal: Beauty all around

L'Oréal is the world leader in beauty with the industry's most diverse brand portfolio that gives them a 15% global market vs. number two player Unilever (9%) and number three Estee Lauder (5%). Its scale means it has more resources to outspend the competitors. L'Oréal spent € 21b on sales, general and administrative expenses (SG&A) in 2023 (51% of sales). In comparison, Unilever and Estee Lauder spent €6bn, respectively, €9bn. Furthermore, L'Oréal spends more than €1bn or 3% of sales each year on product R&D, which is the largest R&D budget in the industry. The number two player, Unilever, spends 1.6% of sales. This is L'Oréal's right to win.

Through its mass-market sales, it gains customer connectivity early in its buying lifecycle and effectively trades consumers up to its prestige brands. Its scale means it can outspend the competitors on innovation and marketing while its brands are constantly being reinvented so that they match consumer demand. L'Oreal has been very successful in the premiumization of its portfolio by constantly improving its quality, benefits

Figure 3

The stability of the global beauty market is apparent



Source: L'Oréal presentation at CAGNY Investor Conference, 2024.

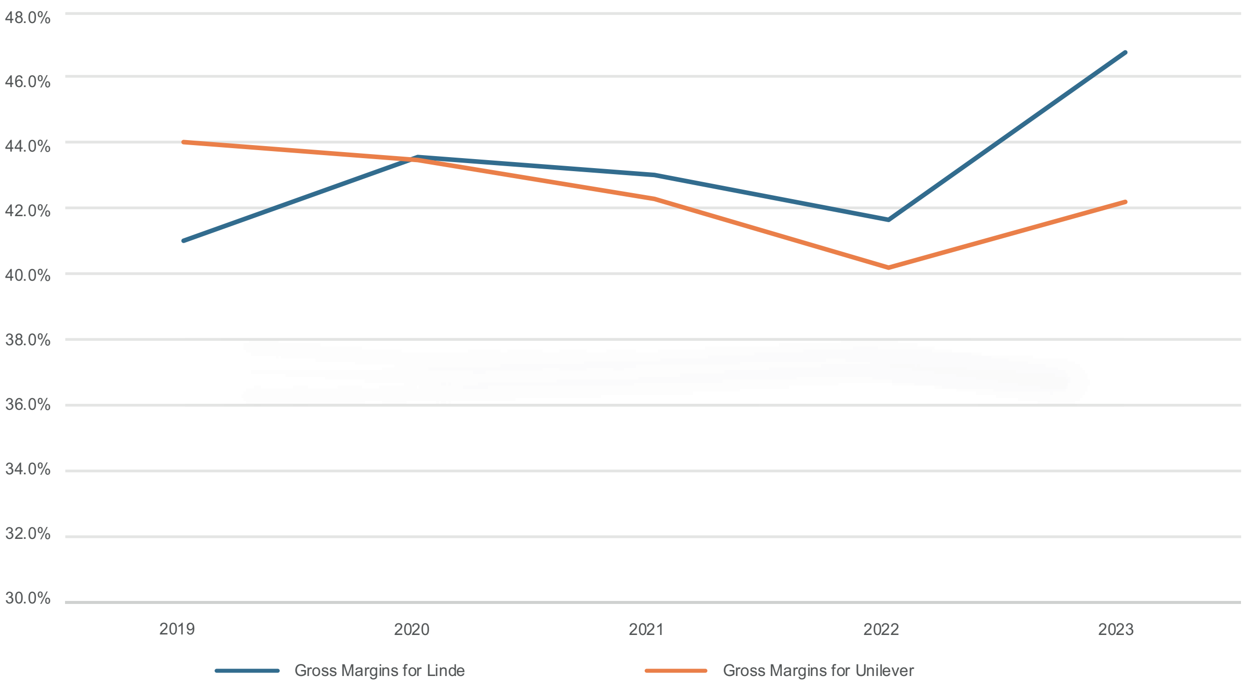
and performance, thereby attacking new consumers as the desire for beauty goes across countries and cultures. The Global Beauty Market has grown ~4% p.a. since 2000, with L'Oréal growing faster organically. L'Oreal has successfully integrated e-commerce and digitalization by making online discovering and buying simpler, which has increased penetration in new markets, particularly in emerging countries and unexplored categories and countries.

L'Oréal's solid cash flow has allowed for acquisitions, which have accelerated the company's market penetration and further contributed to organic growth. We like the steady-growing global market for beauty products (see figure 3), and L'Oreal is very well positioned to extend its global leadership.

Linde / Air Liquide: Industrial Gases are powering the world

Earnings in the industrial sector are typically volatile, as companies tend to have large fixed costs, are sensitive to macroeconomic factors, and are subject to large price swings. The industrial gas industry is different; it benefits from increased industrial investments without the dependency on cyclical factors, providing more stable and predictable earnings. Industrial gas companies like Linde and Air Liquide cater to a wide range of industries, including manufacturing, healthcare, energy, and electronics. The market for industrial gases has consolidated over the last 25 years, where Linde and Air Liquide have gone from a total market share of 30% to 60%. This supports market stability and the profitability of the companies operating in it.

Figure 4
Which one of these is a Consumer Staples company?



Source: Bloomberg, June 2024.

Linde and Air Liquide are "pick and shovels" because they are interconnected with their customers. Their plants are anchors for chemical industries bound by long-term take-or-pay contracts (contracts where customers pay whether they use the gas or not). This creates a lock-in of clients and makes it uneconomical for new players to enter. Typically, 60-70% of sales come from long-term take-or-pay contracts or resilient end-markets like healthcare and pharma. The stability and predictability of the business make it a non-cyclical investment even though it belongs to a cyclical sector, see figure 4.

Maintaining a long-term mindset in changing markets

We embrace a long-term mindset, prioritise lasting knowledge over market noise, and focus on company fundamentals and the long-term outlook. We always keep our eyes open for opportunities with constant competition for capital in ever changing markets. If traditional sustainable growth companies become challenged, the key is to use that same investment mindset and find sustainable growth companies in other market areas.

Our risk management focuses on understanding what we own to mitigate permanent capital loss while achieving effective diversification. This has been a successful philosophy for more than 30 years, and we will keep looking for attractive investments that fit these criteria. Our investment style and philosophy are consistent with a patient, long-term investment approach, and we believe it is one of the few systematic ways to achieve above-average returns.

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Q2 2024