Magellan – In The Know: Episode 48

From Resilient Retailers to Struggling Brands - A Consumer Sector deep dive

Announcement (00:00):

The information contained in this podcast is for general information purposes and does not constitute investment advice. You should seek investment advice tailored to your circumstances before making an investment decision.

Host (00:14):

This is In The Know, a monthly investment podcast brought to you by Magellan Asset Management.

Tracey Wahlberg (00:20):

It has been a far more complex environment than usual, and it requires a real look under the hood before investing. The environment has caused really large divergences in share price performance across the sector as a result. For example, Costco, Walmart and Amazon have done really well in the current environment. On the other side of the coin, manufacturers of branded food and beverages have performed relatively poorly as they've suffered from consumer shifts to value. And then unsurprisingly, the consumer discretionary sector has also underperformed.

Lucina Martin (00:53):

Another interesting dynamic to call out when we look across the entire consumer sector at the moment, the fact that it's really dominated share price performance as well has been some of those company specific or idiosyncratic issues, COVID created some really unusual demand trends, and unfortunately some of those companies over extrapolated trends and invested in the wrong areas of their business.

Host (01:14):

That's Tracey Wahlberg and Lucina Martin, investment analysts here at Magellan, describing the complex consumer environment now facing some of the world's biggest brands. Welcome to Magellan, In The Know.

(01:33):

In this episode, Emma Henderson, Magellan's acting sector head for franchises in healthcare, along with investment analysts, Tracey Wahlberg and Lucina Martin, discuss the complexities of the current consumer landscape, who is winning, and who is at risk of decline. It's a cautious time where most consumers are spending less because of inflation and interest rates, but there are still opportunities for growth and wealth creation in the right areas. It's an insightful look into how the Magellan investment team researches and identifies standout companies, and what attributes they assess to determine strong investment opportunities.

(02:10):

But first, here's a warm welcome from Emma Henderson.

Emma Henderson (02:13):

Hi everyone, my name is Emma Henderson and I am the acting head of our consumer franchises and healthcare team here at Magellan. Today, I'm joined by my colleagues in the franchises team, Tracey Wahlberg and Lucina Martin. Thank you both for joining us.

Lucina Martin (02:28):

Thanks, Emma.

Tracey Wahlberg (02:28):

Great to be here.

Emma Henderson (02:30):

It has been over a year since our team was last on the podcast discussing the consumer sector, and it's a very interesting time to be back given the complex consumer landscape companies in our sector in navigating. Overall, I think it's fair to say the market is quite cautious on the consumer right now. And as we are heading into second quarter earnings, we are bracing for some pretty disappointing updates from companies and some potentially large share price moves. Historically, times like these have often presented great buying opportunities for quality consumer companies that can more cyclical. So today we want to talk through some of the sectors and companies we think stand out in the current environment, and how the team is evaluating these as prospective investments. But before we get into company or sector specifics, Tracey, can you help paint the broader picture on why the market is so cautious on the consumer and what has led us here?

Tracey Wahlberg (03:18):

Sure. So the consumer has really been dealing with dual forces of higher cost of living and higher rates, both really driven by inflation, for two years now. This is having pronounced impacts on how they spend. So we've seen larger cycles in the consumer sector over the past few years owing to the effects first of the pandemic, and now owing to impacts from higher cost of living. And so really taking stock of where we are in this cycle, a few things are impacting growth trends.

(03:48):

So if we can go to the US, we really see a bifurcated consumption environment in the US where the wealthiest cohort of consumers have actually benefited from a strong US dollar, positive wealth effects. And if they locked in a mortgage during the last low rate cycle, the hiking cycle we've just been through has been a benefit rather than a headwind to their savings. So we've seen this influencing growth in the travel sector, particularly in Europe as an example.

(04:20):

On the other side of the ledger in the US however, savings have dwindled for the rest of the population. And where impacts of cost of living pressures were initially contained to the lower income consumer, we're seeing it impact purchasing behaviour in the middle income consumer. Companies that offer value and convenience are gaining share, and companies exposed to more aspirational luxury are under pressure. And then if we move across the Pacific, we've seen broad base weakness in China, impacting the domestic consumer and growth for companies most exposed there have been really challenging.

(04:56):

Looking forward, we think one of the key risks that's emerged here is employment. Slower growth is having a broad impact on companies' sales growth rates, which in turn raises the question of whether companies will choose to reduce their employment base to manage to profitability targets in the short term. So we really think employment is becoming a key risk factor to watch as we stay in this restrictive environment.

Emma Henderson (05:21):

Yeah, look, it really has felt like a more complex than usual consumer environment that our companies are trying to work through. How has this additional uncertainty and complexity played out in how consumer stocks have been performing?

Tracey Wahlberg (05:34):

Yeah, that's right. It has been a far more complex environment than usual, and it requires a real look under the hood before investing. The environment has caused really large divergences in share price performance across the sector as a result. For example, Costco, Walmart and Amazon have done really well in the current environment, their scale advantage and customer loyalty, the value they offer their customers are quality features of these business models and it's allowing them to take over 60% market share of retail sales growth this year. The certainty the market has around their ability to generate growth in this environment has really influenced valuation though, so Costco is trading on 50 times forward earnings.

(06:17):

On the other side of the coin, manufacturers of branded food and beverages have performed relatively poorly as they've suffered from consumer shifts to value. Many of these grocery staples are exposed to that lower or lower middle income consumer who, as we mentioned before, were under pressure. And so they chose to trade down into private label, or even trade down into fresh food and cooking from scratch allowed them to manage their budgets. In general, consumers have been more selective about how they're doing their weekly shop and they're trying to maintain a stable level of spend while modifying the basket of goods that they buy.

(06:53):

We even saw this most recently in Pepsi's results where in 2022, we saw Pepsi have some of the strongest pricing power during the last inflation cycle, but in their more recent results, we're finding value-conscious consumers are avoiding the category as the prices of potato chips have just moved out of their budget range.

(07:12):

And then unsurprisingly, the consumer discretionary sector has also underperformed, and we've recently seen results from Swatch, Hugo Boss and Burberry disappoint on expectations where that aspirational luxury consumer is really under pressure.

Lucina Martin (07:26):

And I think it's another interesting dynamic to call out when we look across the entire consumer sector at the moment, the fact that it's really dominated share price performance as well has been some of those company-specific or idiosyncratic issues. I think as you mentioned, COVID created some really unusual demand trends, and unfortunately some of those companies over-extrapolated trends and invested in the wrong areas of their business. I think Estée Lauder is a classic example here. They invested quite heavily in their Asia duty-free business and some regulatory changes there subsequently impaired the growth outlook. At one point that business actually represented about 15% of Estée's business, so it was a big bet by the management team at the time and shareholder returns have suffered as a result.

(08:11):

And then if we look to other companies that play in that space, so L'Oreal and some of the luxury brands like LVMH, their management teams deliberately chose to limit their exposure in that business market and therefore they've delivered greater earnings resiliency as a result.

Emma Henderson (08:26):

I think another example of a company-specific or idiosyncratic issue that has dominated share price moves has been Nike. We saw Nike's share price sell off 20% in a single day a few weeks ago after it downgraded its earnings outlook for the year ahead and announced a large reset of its product portfolio, particularly in its online channels. We've covered Nike here at Magellan for a long time. We like the sportswear category, which is gaining share of total apparel, and we do see genuine competitive advantages for the large incumbent brands. However, as Lucina mentioned with Estee, Lauder, Nike's management team unfortunately also made some executional missteps post COVID, which when you pair with a slowing consumer, is always a painful combination that we're trying to avoid.

(09:12):

To understand what went wrong with Nike, I think we need to rewind back to June 2021. Sportswear had been a pandemic winner and the sharp acceleration in online sales that we'd seen across multiple industries meant that Nike was capturing more sales from its own website and apps, which are both higher revenue and higher margin than when Nike sells a pair of shoes through a retail partner like Footlocker or JD Sports.

(09:38):

After seeing these trends, management announced a new strategy, Nike was going to aggressively shift the proportion of its shoes and apparel sold directly to the consumer from 30% of sales pre-COVID to 60% of sales, so lowering its reliance on those wholesale partners.

(09:55):

Fast-forward to today and unfortunately things haven't played out like management hoped, and this strategy turned out to be a pretty risky move. E-commerce penetration, while booming through the pandemic, returned to trend, and it became clear that consumers still want to shop for sneakers in a multi-brand physical retail format. By pulling back from these key wholesale partners, particularly in running. Nike also created this unique window for smaller competitors like, On Running and Hoka, to grow their shelf space and build brand awareness like they've never been able to before.

(10:26):

And finally, whilst management was focused on this distribution direct to consumer strategy pivot, they were also slower to invest in product innovation and missed some consumer trends, which they're now peddling hard to fix.

Tracey Wahlberg (10:38):

What you've just highlighted there, Emma, when we think about Nike, it's such an iconic brand, and Lucina, you mentioned Estée Lauder, their brands are also iconic, like Mac and NARS and Clinique, we're starting to highlight that it's not enough to have a brand advantage and a scale advantage to succeed through these cycles.

Emma Henderson (10:57):

Yeah, I agree. For me, the key issue for both of these examples has really been management and execution. I don't believe that there's been any permanent impairment or damage to Nike's brand. I think it still has industry-leading R&D innovation capabilities and a huge amount of marketing advantages. And I am confident that in time, and with the right management team at the helm, Nike will be able to restore its brand heat and compete well to capitalise on the sportswear growth opportunity. That said, turnarounds like this can be messy and there is a lot of uncertainty ahead when we think about both the macro environment, but also some uncertainty around who will be in this management team and what will their long-term distribution strategy look like. I think stepping back as a cross-sector learning, this has also just been such an important reminder of never losing sight of your end consumer and how they want to shop and connect with your brand.

Lucina Martin (11:48):

Yeah, I think it's a really interesting point you raise. Brands, they need to sell through the channels where the consumers are shopping and, as we've mentioned, consumers are increasingly going to Amazon. I think it's really interesting to reflect on the fact that Nike actually delisted their products on Amazon back in 2019, and we've seen other brands historically be hesitant to list on the platform because brands want to control that distribution through their own websites typically, and that ensures that they have good control of pricing power, product presentation and ultimately brand equity. So it's been really interesting actually to see a shift in this narrative. We've seen several premium beauty brands list on the Amazon platform such as Lancôme, which is owned by L'Oreal, and we have a really high opinion of L'Oreal as a steward of its brands. So its tick of approval is it's a really positive signal for Amazon's retail business. And now that Amazon's an even more important retail partner for consumer brands, it'll be interesting to see if there are other brands that come to the platform. Perhaps Nike makes a return.

Tracey Wahlberg (12:47):

Hearing you talk about that really think about the power of Amazon's network effect. It's really on display with that example. We really like network effects here at Magellan. There are other companies in our sector that also benefit from this quality factor and one that comes to mind here owing to the fact that we see strong travel demand at the moment is Booking. Lucina, you cover Booking, what's going on there?

Lucina Martin (13:11):

Yeah, so Booking is, they own the online platforms, like Booking.com, Priceline and Agoda. I think the important thing to remember here when we think about network effects is scale being such an important issue for their business model, and Booking over time has successfully established a dominant two-sided marketplace. Guests and travellers visit the Booking platform. They trust they're going to find a suitable hotel anywhere they want to travel in the world. And equally, and also most importantly, those hotel owners, they list their properties on the platform knowing that they gain access to those prospective guests. So that network effect you mentioned, it's powerful, but there are also aspects of Booking's quality that I think are underappreciated at the moment, and actually I'd argue that are improving. So when we think about Booking on a P of 20 times, valuation is looking quite attractive at the moment.

Emma Henderson (14:04):

The valuation point's really interesting given that more broadly, travel has been one of those parts of the consumer sector that we have seen outperform recently. It's been on the right side of the shift of spending from goods to experiences. Given that a lot of the positive drivers behind the current travel cycle are well understood by the market, what do you think the market is underappreciating about Booking?

Lucina Martin (14:26):

Yeah, I'd say there's probably two things that stand out for me. The first one is that the market, I think, is overplaying the competitive threat from Google. And the second thing is the market also is underappreciating Booking's initiatives that increase consumer loyalty. So the market is concerned that Google will become an online travel agent itself and effectively make Booking redundant. Booking's actually one of Google's largest ad revenue customers and this generates a really attractive high margin profit stream for Google. If Google was to replicate Booking's infrastructure, they would have to navigate what's quite a complex and fragmented network of hotel owners and guests and provide them with high quality customer service that's really complex and costly. We think Google will continue to take the cream in this situation without doing the grunt work, so we ascribe a lower probability than the market that Google will disrupt Booking.

(15:23):

Then on that second aspect, customer loyalty. Booking's management team have been really busy over the last few years creating a one-stop shop for all your travel needs. They actually have accelerated and scaled offerings in flights and car rentals and short-term rentals as well. They've also unified their brands behind one loyalty programme, and that creates a really sticky consumer that's now incentivized to come straight to the Booking platform rather than starting their search journey on Google or say a competitor like Expedia. This means that Booking doesn't need to spend as much money on Google Ads to drive demand, and this is really positive for their profitability and shareholder returns.

(16:01):

The market's also a little unsure if Booking may be a winner or loser when we think about new AI search formats that might try to own this travel customer. It's something that we're monitoring, but the more that Booking tries to drive direct traffic to its platform, the better insulated they are against a potential threat there. And more broadly, we have conviction that their tech and innovation capabilities are leading edge and will help them stay ahead of this change. So I think Booking, it's a really good example of a company who understands the consumer well. They haven't taken their eye off the ball during a period of volatility, and they've carefully invested to improve that user experience, and they're really well positioned behind that growing travel market.

Emma Henderson (16:42):

The ongoing strength in travel has been really interesting to watch across a lot of our sectors. One statistic I find fascinating against this broader backdrop of consumer uncertainty is really this ongoing strength we've seen in the US consumer travelling to Europe and spending up big. Duty-free retail is an important sales channel for beauty and luxury brands, and we are seeing US consumers spending three times more, 300% of the amount that they were spending on duty-free shopping prior to the pandemic, still today. This is clearly supported by strong US dollar and the positive wealth effects Tracey mentioned earlier, but there have also clearly been some category losers on the other side of this shift of spending from goods to experiences. Tracey, what other larger ticket items are US consumers pulling back on as part of this?

Tracey Wahlberg (17:31):

Categories exposed to the home come to mind here because we've really seen share of all it recede back from pandemic highs. When we were all locked down, we were buying everything for our homes, things like furniture, barbecues, appliances, where we even engaged in larger renovation activity like adding on spaces to our homes or gut renovating the home. And early drivers of this share shift or mean reversion back to more normal levels were that reopening event post pandemic, post lockdown. And while it's shifted back to travel, what you just noted, Emma, and seemed to have really shot past what was normal prior to the pandemic.

(18:11):

But then last year we saw mortgage rates in the US rise above 7% for that 30 year fixed rate mortgage that a lot of consumers in the US take out. And that's really a level we haven't seen in the US since early two thousands. But shockingly and surprisingly, housing prices on average remain at all time highs. And this is really because of low supply, and that's a structural shortage of supply that is going to persist for some time. So this has had dual impacts on the consumer demand for mortgage refinancing, as well as housing churn, which refers to the level of buying and selling a home. And these factors have then made the housing market in the US present us with really interesting opportunities.

Emma Henderson (18:54):

So we have a small exposure to the second-largest home improvement retailer in the US, Lowe's, which is similar to Bunnings in terms of a retail concept, what is the thesis there given this uncertainty?

Tracey Wahlberg (19:07):

Yeah, so the thesis here is really driven by three factors: valuation, industry growth outlook, and company specific factors. So the headwinds I mentioned are largely in the price at this point, given the rate cycle is likely skewed to the downside, and therefore we would anticipate activity to start to pick up next year. Longer term though, if I think about some really attractive industry drivers, industry fundamentals such as the age of housing stock in the US at over 40 years old provides a growth driver for non-discretionary repair and maintenance. Homeowners are also staying in their home longer as they age, and this provides another area of renovation growth to help people age in place. And while housing prices also remain high, homeowners have confidence that investing in their home will yield a positive return. So while activity has slowed, repair and maintenance expenditures continue to look relatively healthy.

(20:06):

And then at a company level, Lowe's is reinvested to improve its customer service experience in-store as well as online. It's also invested to recapture share of the professional trade customer and regain their loyalty, which, despite this current cycle, we're seeing these investments pay off. Lowe's has actually been comping positive comps in the pro category as compared to some of its peers. So it's doing everything we want to see from a specialty retailer. It's focused on delivering value, driving loyalty, maintaining newness, while leveraging its scale advantage to take share. And Lowe's is trading on 18 times relative to, as I mentioned before Costco, now on 50 times. So the valuation there is relatively attractive.

Lucina Martin (20:51):

Yeah, the spirits category is another example of a sector that's been through a normalisation cycle. It benefited from a surge in consumption during COVID and then an unwinding spend as it shifted to experiences like travel. So at the moment it's also a beaten down sector, trading at a decade low, multiple. High rates actually had an impact on this sector as well. Spirits is a long shelf life product, and that means retailers typically hold inventory for a few months before it's sold onto the consumer. So in a high rate environment, it's a much more costly process to do this and we see retailers reducing inventory levels to save money here. And so that's also impacted short-term growth trends for the spirits names.

(21:32):

But we still like the sector on a long-term view. There are some really nice structural trends of consumers choosing to drink more premium, high quality alcohol, which means spirits have consistently taken share from wine and beer. So we have conviction that the category will return to that more normal 4 to 5% growth algorithm again, and there'll be some excellent companies in the sector, which we cover here, Diageo and Pernod Ricard, they've got really strong brands and we'd like to own them at the right price.

Emma Henderson (22:02):

Thanks, Lucina, and I think that sums up really nicely some of the themes we've touched on here across a wide range of companies and sectors. These companies are in our Magellan universe because of the confidence we have in their long-term category growth opportunities, as well as the strength of their brands and what they offer consumers. As you've heard from our conversation today, each investment opportunity does come with different macroeconomic and cyclical factors, as well as idiosyncratic strategy and executional dynamics that the team is spending a lot of time working through to try and find the most attractive valuation opportunities where business quality is intact and where we can lean in with a long-term view.

(22:37):

Tracey and Lucina, to finish the conversation, I wanted to ask both of you for any final thoughts on what you are most focused on when looking for long-term investment opportunities in a volatile economic period like we are in today.

Tracey Wahlberg (22:49):

Yeah, so I really like looking for companies with strong dynamic capabilities and that's really established through their culture of innovation and through a good track record of capital allocation and balance sheet management. When combining these quality features in the consumer sector where brand and scale advantages are present, these combined typically generate good value for shareholders over time. And then of course where industry tailwinds provide favourable operating conditions, investment returns over time tend to be positive.

Lucina Martin (23:18):

Yeah, I think given growth is much harder to come by in the sector at the moment, it's a really great reminder of the importance of high quality management teams and a focused strategy. So in this environment I'm looking for management teams who are investing behind those core capabilities through the cycle and leveraging those structural growth opportunities, some of which we've talked about today. I don't want to see management teams steering away from their bread and butter or making rash decisions that might boost short-term growth either, because over the long-term, those decisions may add unnecessary complexity to the business, it could disrupt that brand perception with consumers and ultimately erode shareholder returns.

Emma Henderson (23:57):

Thank you team. All really valuable insights to remember when evaluating investment opportunities, particularly in an environment like we're in today. Thank you. It's been a great conversation.

Lucina Martin (24:06):

Thanks, Emma.

Tracey Wahlberg (24:06):

Yeah, thanks.

Host (24:08):

That was Magellan's acting sector head for franchises and healthcare, Emma Henderson, speaking with Magellan investment analysts, Tracey Wahlberg and Lucina Martin.

(24:17): We trust you've enjoyed this episode. For more information on previous episodes, visit magellangroup.com.au/podcast, where you can also sign up to receive our regular investment insights programme. Thanks for listening.