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Waiting for Godot? – Global Equities Research Trip to the US

Northcape Capital, investment manager for the Warakirri Ethical Global Equities Fund, recently undertook a a research trip to the US. Given recent economic and market gyrations it was reassuring that business is for the most part still seeing strong demand, but also unsettling, as it is hard to move forward as we continue to wait for earnings confessions and resets from the anticipated downturn impacting consumers and businesses. We draw the analogy to the classic play "*Waiting for Godot*" as the stock market prices in a recession, even if '*Godot*' never arrives.

This information has been prepared by Fleur Wright, Portfolio Manager / Analyst at Northcape Capital, the underlying investment manager for the Warakirri Ethical Global Equities Fund.

Our two-week research trip included ~60 meetings (including 8 names from our Approved List and several of their direct peers), being a concentration of Tech, Healthcare and Industrial, with a few consumer stock meetings thrown into the mix. Here we summarise four key takeaways.

1. Tech in San Francisco and Seattle

"First you can't find people to hire, then you can't believe how much you have to pay them, then you can't get them to come into the office."

This quote from a tech company CEO we met with summed up things well. Finding staff and wage levels have been a big problem and whilst there was some easing of late there were still pockets of tightness such as specialist engineers or accounting and finance professionals. At the lower skilled end, advertisements for wait staff and drivers evident at the time of our trip earlier this year were still prevalent. I noted the buses in Seattle displayed big "Hiring" signs alternating with the bus number/destination on the front of the vehicle.

Finding staff is still difficult.

Most companies seemed to talk to 5-10% wage increases. Note, whilst staff are usually the biggest cost component for tech companies, wage inflation is a lot smaller than the COGS inflation experienced by those non-tech companies exposed to steel, shipping and energy.

Despite firms talking of business carrying on, the offices we visited felt incredibly quiet. 15-25% occupancy levels were noted by many tech companies. Several cloud native and even a few older school businesses were embracing work from anywhere, but it felt like a greater portion were keen to at least encourage more days in the office. One firm even had the initiative of a "work from work" day! I noted talk of a push to return to the office post Labour Day but in the two weeks after that, I didn't see it.

Californians not yet back in the office.

Source: Marketoonist.com

Long term structural drivers in tech remain

Despite the under-performance of the tech sector year to date, companies remained generally bullish on the long-term fundamentals and demand based on the shift to the cloud (still early overall), digitization, electrification and autonomy, AI etc. In particular, we met with cloud-based software solutions company, Salesforce, which reaffirmed our positive view on the long-term drivers.

Approved List Stock Insight – Salesforce (CRM US):

Cloud based customer relationship management software company, Salesforce, was added to our portfolio in July this year. Its share price had already halved from its peak in November 2021 and its P/E and Price/Sales ratio's were near decade lows. Through to September and indeed October to date the shares continued their downward trajectory and its P/E is now near GFC lows at ~28x due to concerns about its ability to improve margins and maintain a disciplined approach to allocating capital, without destroying value through dilutive acquisitions. This is despite what we saw as a continued medium-term outlook for fairly resilient 20% sales growth as corporates continue to shift to the cloud and embrace the value add that Salesforce products provide.

It was reassuring to hear a greater emphasis on profitability. They acknowledged that they "should be able to drive profitability and grow" and flagged a commitment to expanding margins each year. They also highlighted the strength of the pipeline as "really strong".

Seeing if there were clouds on the horizon…

(Source: Northcape Capital)

2) Healthcare in New York

Procedures and hospitalisations have normalized with lingering supply chain challenges remaining. Whilst animal health saw a Covid boost we see it as a long-term structural growth opportunity.

Whilst masks were still common in California ironically, they were few and far between at the two healthcare conferences I attended in New York where many companies talked of things returning to normal.

Masks no longer required!

Source: Rick McKee Cagle Cartoons

Encouragingly, many companies noted that procedures and hospitalisations have normalised post Covid, and company guidance largely assumes we are now at endemic levels for the virus. This is encouraging for companies like Becton Dickinson, a leading medical device company and one of our highest conviction healthcare holdings. Becton's revenues were temporarily impacted by fewer elective procedures but have since made a good recovery. At the same time, it now has some element of Covid testing in its core and has been able to reinvest its excess profits from this business for future growth.

Despite being healthcare focused, there was still a good amount of discussion on software and tech hardware for the companies I met, which were still struggling to access semi-conductor chips. One example of this was ResMed the leading manufacturer of medical devices for sleep disorders, who as a result were less able to take advantage of a competitor product recall.

We also met with animal health pharmaceutical company, Zoetis, which was timely given we added the stock to both our Approved list and Fund in August.

Approved List Stock Insight – Zoetis (ZTS US):

Zoetis is slightly different from most healthcare companies in that it focusses on Animal Health rather than Human Health. This is a more concentrated and less competitive segment with great structural growth. Whilst we have met the company a number of times it was good to get an update straight from the horse's mouth (pardon the pun!) meeting with Zoetis management as well as their closest peer, Elanco.

If you were like many people at Northcape and acquired a new pet during Covid, you weren't alone (there was up to a 10% increase in the pet population during the pandemic) hence there have been worries about Covid over-earning. Reassuringly both companies expect pet additions to normalise but more importantly (as I am discovering) a pet is for life (requiring regular care) and hence there is a new higher base of pets as well as spend per pet. In addition, the long-term structural growth potential remains with spend per pet still in the early days of penetration. They also highlighted the defensive nature of their revenues (notably their livestock business and their higher income pet owners tend to show little economic sensitivity). Zoetis' market leadership and scale as well as trusted brands and innovation are all key competitive advantages.

3) Industrials in Laguna Beach

Despite economic outlook concerns, corporates at Morgan Stanley's three-day Industrial Conference were surprisingly upbeat. Overall, the demand environment remains fairly resilient, and a slowdown seems well-anticipated.

Concerns about the economic cycle were raised in most of the company meetings. Whilst the companies were all preparing for a downturn and generally saying they were more resilient this time (e.g. more recurring revenue, better cost control, really high backlogs for a number benefitting from secular growth such as decarbonization and infrastructure spending programs), intriguingly barely any were seeing weakness currently, with still decent growth.

Whilst supply chains were mostly easing, chip shortages were yet again an area that still plagued quite a few. Interestingly, every company seemed to be raising prices 10%+ with little impact on demand and talking about being cost plus by early 2023 if they weren't already. This suggests inflation is here to stay!

Some Covid winners, including FedEx the global freight company, warned on slowing package volumes. Whilst this doesn't bode well for consumer stocks and potentially the economy more broadly, I noted that there was some speculation that part of the decline may be due to an expected earlier and flatter (Christmas) peak due to pre-ordering by retailers etc.

Europe was another area of general concern and we heard of company plans to source gas energy alternatives in the event of supply restrictions over the winter. Worries (and FX) aside, most companies felt that their European business was still performing OK and the EU commitment to sustainability goals provided areas of support.

Other companies that appeared very confident were Deere and the Canadian Pacific Railway, with both benefitting from a stronger than expected agricultural cycle and the steady nature of food consumption.

Both seem to have strong competitive advantages. Deere with its brand, distribution, leading market share and data and technology lead in large agricultural equipment and Canadian Pacific with the rail line that connects Canada to Mexico and across the food bowl of the USA.

"Laguna Matada": it means no worries – at least for now!

Source: Northcape Capital

Given the mixed demand environment, we remain focused on finding ideas with secular growth drivers to withstand slower economic demand. One example of this was Advanced Drainage Services, manufacturer of water drainage structures.

Approved List Stock Insight – Advanced Drainage Services (WMS US):

We added this stock to our Approved List in May this year. We really like the fact that it is a beneficiary of infrastructure spend and the shift to the regions but at the same time a secular grower, as its plastic pipes and accessories take share from the costly (and more difficult to work with) incumbent concrete and steel alternatives. Furthermore, Advanced Drainage uses approximately 50% recycled plastic in its products, making it an environmentally friendly solution and the largest plastic recycler in the US!

This was a name that we had never met face to face – with our interaction limited to Zoom's during Covid. Added to this, despite this business seeming relatively unexciting (storm water piping and sewage systems!) the share price has been more volatile than we expected (in the month post adding it to our Approved List it fell ~20% then rose ~85% from its June lows in just under two months!) hence a face to face with management was very valuable. The company has been putting through substantial price increases (up to 50%), in line with some of the cost inflation they (and more of their conventional peers) have been experiencing.

Historically the industry as a whole has maintained pricing as these are multiyear project-based contracts where it is difficult to source an alternative. Their non-residential and agricultural exposed divisions are seeing good growth and the company is preparing for any possible headwinds on the residential side noting that there should be some offset from repair and maintenance. Notwithstanding, in an economic downturn resin prices tend to fall whilst Advanced Drainage are able to hold their prices and hence increase their margins.

4) Consumer meetings across the US

No obvious consumer concerns and structural growth opportunities are still evident, but we think its best to stay selective. My consumer meetings were a more limited selection of names but included Approved List and portfolio holding Estee Lauder, US airline Alaska Air, retail farm store chain Tractor Supply and restaurant company Chipotle Mexican Grill.

Whilst I didn't notice consumer weakness overall during my time on the road nor from the companies I met, we as a team are conscious that rising interest and mortgage rates as well as high levels of inflation in the US are likely to take their toll on the consumer and hence, we want to be exposed to those idiosyncratic growth areas or the more defensive consumer segments. Many of the companies I met have unique structural growth drivers and elements that make them more resilient than peers.

Tractor Supply is benefitting from the move away from the big cities to the regions as a rural one stop shop for yard and farm products, animal feed as well as seasonal and discretionary needs including clothing and jewellery. Alaska Air (which is now part of One World) likewise benefits from having the right routes and planes to transport people to the regional growth areas. It is also now at cost parity with the original low-cost airline, Southwest and taking market share.

Chipotle's slogan is "Food with Integrity" offering healthy and sustainable Mexican meals. They have grown to 7,000 stores mostly in the US but think they can double this over time. Their two-year cash on cash returns for new stores are industry leading and they still see further opportunity for store revenue growth via a continued focus on productivity, automation and marketing/rewards.

Approved List Stock Insight – Estee Lauder (EL US):

Estee's ownership of a range of ultra-premium beauty brands, which are seeing increased penetration not just in its typical "ageless" woman but from the growing middle class in Asia and China in particular, millennials who appreciate the 'beauty premium' and increasingly the male consumer.

The well documented lipstick index (or potentially post Covid the moisturizer index) appears to be holding true with Estee Lauder seeing no evidence of trade down, indeed their highest priced brand, La Mer is seeing the strongest growth! Whilst Covid lockdowns in China haven't helped, Estee is unwavered in its positive outlook on China and the eventual recovery and long-term growth potential there.

Still sitting pretty: Estee Lauder samples

Source: Northcape Capital

Conclusion

Whilst our trip didn't forewarn us of the pain in stock markets in recent weeks, in some ways it supports the Fed path of continued rate rises to fight the persistent inflation being observed. One clear overarching theme was that companies with secular drivers are navigating through the challenging economic backdrop and supply shortages better than most. Importantly, many of these are being supported by high backlogs, recurring revenues, ability to pass on cost increases by raising prices, secular growth drivers such as the cloud, digitization, automation, sustainability as well as government driven spend.

The US also seems in a better place than Europe where energy prices and the war in Ukraine in particular are causing the US companies with exposure here to speak more cautiously. We remain focused on finding high quality companies, which can grow earnings over the long term and have strong balance sheets to withstand the challenging economic environment ahead.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au