Quarterly Commentary as at 30th September 2020

MelvilleDouglas
A Member of Standard Bank Group

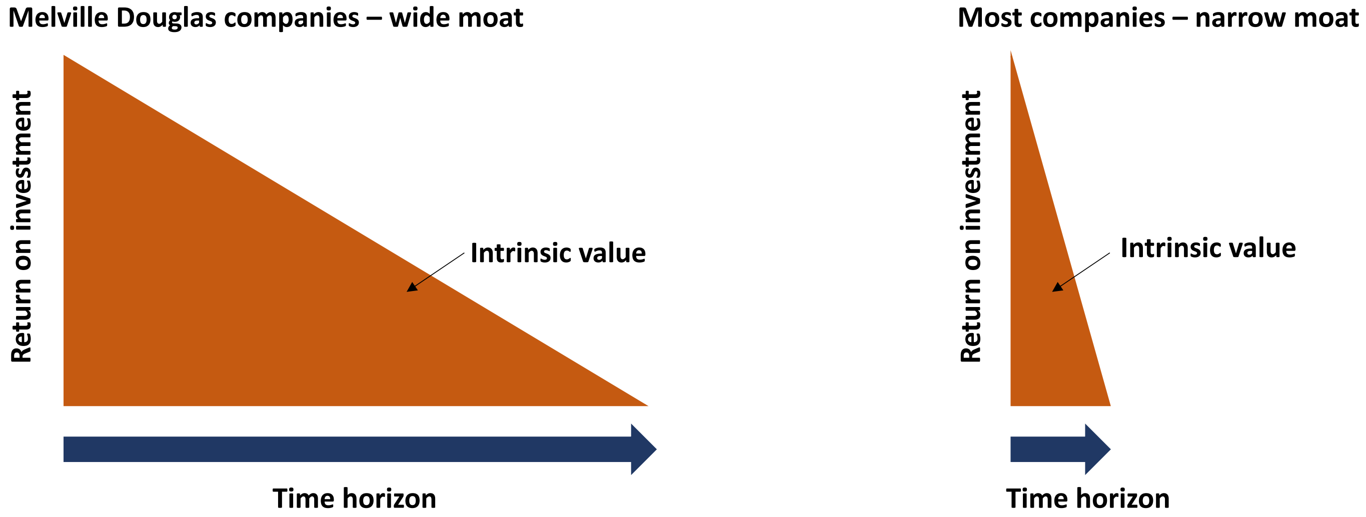
Melville Douglas

Global Equity Fund

Under siege

The Melville Douglas Global Equity fund is domiciled in Jersey. Although this small island is within sight of the northern French coastline, it has been ruled by an English monarch ever since William the Conqueror grabbed the throne in 1066. Over the centuries the French have tried and failed to pluck this little thorn in its side. Their key hindrance was the sea. This natural moat is a treacherous mix of perilous currents and thousands of submerged rocks.

Just as a physical moat has defended Jersey over the centuries, a company can protect profits by building an "economic" moat, or competitive advantage. A basic tenet of microeconomics is that a company earning high returns will attract competitors who also want a piece of the action. Most of the time companies with narrow or non-existent moats will not be able to stop new entrants from taking market share and cutting prices. This dynamic turns a high returning business into a mediocre one. However, there are a very small minority of businesses that defy competitive gravity and enjoy many years of high profits and shareholder wealth creation. These wide economic moat companies are core holdings in the fund.



Source: Morningstar

What can provide moats?

There are many ways in which a company can gain a competitive edge. A low-cost open cast mine with high grade deposits may have a cost advantage. A pharmaceutical company will have patent protection. However, mining depletes finite resources and drug patents typically expire after a decade of commercial sales. To stand still, let alone grow, another huge deposit or blockbuster drug must be discovered. We find more sustainable moats can be built around value-adding brands, network effect and high switching costs.

Moat-creating brands cannot just be well known, they must add perceived value. A great example is the cosmetics industry. Estee Lauder can charge massive margins on its premium skincare products as its customers find it more difficult to trade down a perceived notch on their beauty rather than, say, on a tin of baked beans.

Brands also add value if they lower search costs, i.e. the time spent shopping around. For example, many people buy online through Amazon without checking prices elsewhere. This is because trust is even more important online than offline. When buying on the internet you need to hope that you receive what is ordered, your credit card is not compromised, and the seller will take the product back and provide a refund. Amazon's brand has built a second to none moat from this perspective.

A network effect can be very powerful. This is where the service increases in value as the number of users expand. Think of Visa and Mastercard. Each additional cardholder on their network makes their brand more attractive for businesses to accept Visa or Mastercard payments. While each new business that accepts Visa or Mastercard makes the brand more attractive to cardholders. A new competitor network would be prohibitively uneconomic to set up today as it would take many billions of US dollars and decades of intermediary relationships and brand building to replicate.

High switching costs are also a great source of competitive advantage. An example is a Linde-installed and managed industrial gas facility at an oil refinery or blast furnace. There is no benefit to the customer from incurring the huge disruption costs of halting production as a result of ripping out and replacing an embedded part of their process.

It is also important to recognise what does not provide a moat. Having the latest hot gadget or high market share is not a moat. For example, Nokia had 50% market share of smartphones in 2007 but it failed to catch the next big wave. Nor should it be dependent on management skill. Peter Lynch, the legendary fund manager of Fidelity's flagship Magellan global equity fund, once quipped that investors should buy a business that is so good that an idiot can run it, because sooner or later an idiot will run it.

How do you know whether a moat is effective?

Moats generally manifest themselves in pricing power. Once a company loses the ability to raise prices then it is often an early signal of an eroding moat.

To quote Warren Buffet, *"The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price 10%, then you've got a terrible business".*

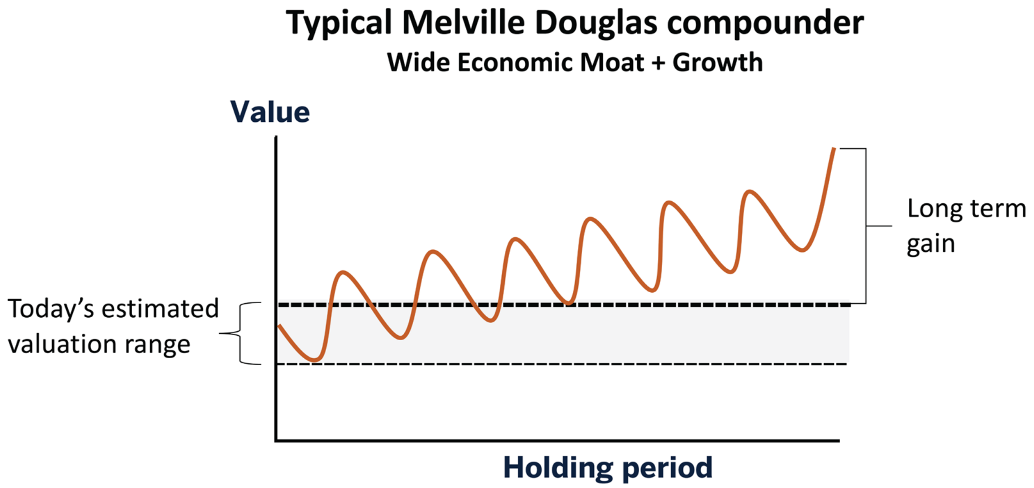
Are wide moats already reflected in the share price?

Surprisingly, often not.

In our day-to-day lives we are prepared to pay up for quality as we know being frugal does not just mean spending less money. It is worth paying a little bit more for a reliable car or for competent legal, medical and financial advice.

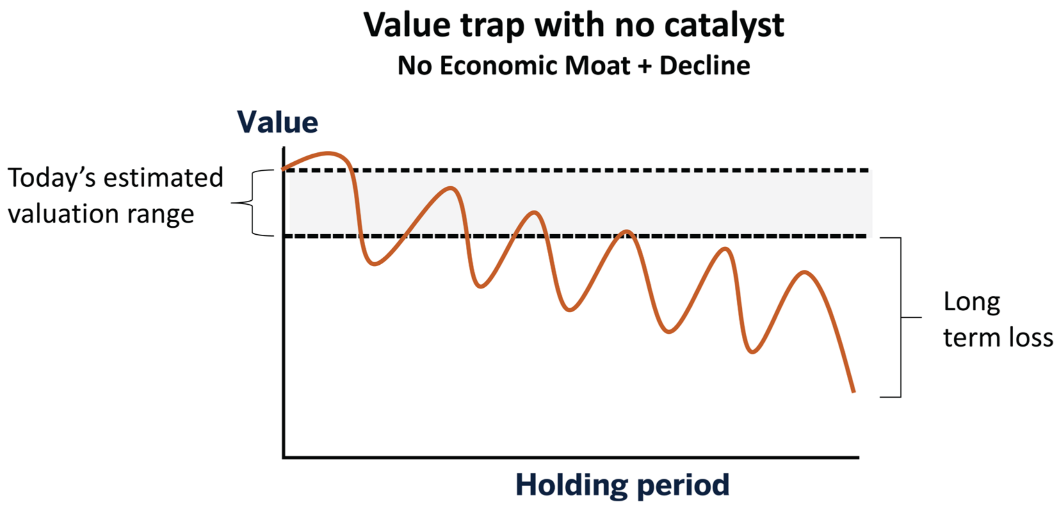
But in the investment world economic moats are often not fully priced into share prices. This is because a high component of stock market trading is made up of short-term investors who place more weight on the here-and-now. Will a company beat earnings expectations next quarter? How long will the recession last? By doing so they end up underestimating the enormous magnifying power of compound returns over the years and decades derived from wide moat businesses.

This time-horizon induced anomaly provides a repeatable and lucrative opportunity for long term investors. A wide moat compounder is a forgiving stock to own even if an investor pays a full price at the outset. As illustrated in the chart, so long as you are a patient holder through the ups-and-downs of business cycles the intrinsic value per share will eventually grow above the initial price paid.



Source: Melville Douglas

By contrast, a seemingly cheap stock could end up becoming a value trap if there is no economic moat. Time is a foe rather than a friend. An example is bricks-and-mortar US department store Nordstrom. A year ago, the shares were trading at a lowly 11x price-to-earnings ratio. The coronavirus pandemic has accelerated the eCommerce pressures on the business, resulting in the share price plunging -70% over the past 12 months. Are the shares even cheaper? No. The price-to earnings ratio is still 11x based on 2021 earnings.



Source: Melville Douglas

Adapt or stagnate

The final point is that an investor cannot simply buy and forget. Moats can quickly dry up. Competitive advantages are rarely permanent, particularly amidst a fast-changing competitive landscape. The next Airbnb, Uber or Amazon will always be around the corner to upend the status quo. As such we have a healthy sense of paranoia that today's winner might be tomorrow's value trap. Testing the strength of a company's defences is an ongoing task. The saving grace is that although the names may change in the fund, we are clear about what we want to own.

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From our Fund Manager's Desk

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund to articulate what we find compelling. This time round we have chosen Linde.

Plucking money out of thin air is not just a trick played by sleight-of-hand conjurers. Industrial gases companies have done it for decades. This note elaborates why we like these modern-day alchemists.

What are industrial gases?

From rocket fuel to filling up balloons for children's parties, industrial gases are used everywhere. They are a key input in a multitude of heavy manufacturing processes. In steelmaking oxygen is blown through molten pig iron to lower the carbon content. In refining hydrogen is used to desulfurize gasoline to ensure emission standards are met. Going one step further, hydrogen is increasingly displacing petroleum-based fuels by acting as an energy carrier in fuel cells. Industrial gases can also be found in the kitchen, where inert and safe nitrogen gas is used in food packaging to help preserve freshness and provide padding to reduce damage.

What do industrial gases companies do?

An industrial gases company produces nitrogen, oxygen and argon by capturing the air we breathe. Air is liquefied via cooling and pressure and then each component is separately distilled at their various boiling temperatures. Other gases (e.g. carbon dioxide, helium, hydrogen and acetylene) are usually sourced from other industrial processes as by-products.

An industrial gas company, such as Linde, sells and distributes gases to its customers depending on the volumes involved. For heavy consumers Linde would build their own gas production facility on the same site as their customers' operations where it can be physically integrated. Linde also ships gases in bulk by specialised trucks on the road or sells smaller amounts in the cylinders you would see used by welders or in hospitals.

High switching costs is the secret sauce

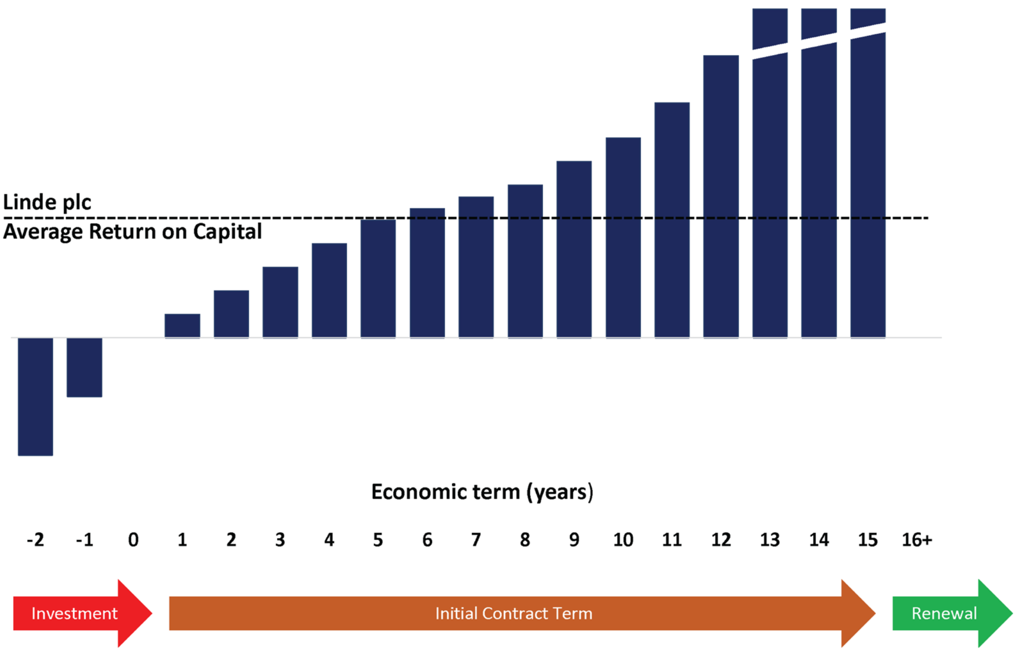
Industrial gas companies are highly cash generative businesses that avoid much of the feast or famine suffered by other commodity producers. How do they manage this feat when they are selling a processed version of a free and abundant commodity (i.e. air)?

The answer is very sticky customer relationships. Linde receives premium prices and can lock into long term contracts because the switching costs for its largest-volume customers are high. The Big Three industrial gas companies tend to dominate market share for the big on-site commissions as a result of their technical expertise, scale and reputation (clearly, an accident with oxygen and hydrogen can do a lot of damage). The number one priority for high volume customers is a regular, safe and reliable supply of a vital input to their production process. For example, hydrogen represents only about 1% of a refiner's cost of production. Why quibble about the cost of something that is effectively a rounding error compared to its overall expenses?

Air separation units are often built by the industrial gas company onsite and embedded with their customers' operations to minimize transportation costs and ensure reliability of supply. To reassure the industrial gas company will get a return on this initial hefty investment customers will agree to 10- to 15-years "take or pay" contracts with cost pass-through clauses. "Take-or-pay" contracts help to insulate industrial gas company earnings from downturns as they require customers to purchase a minimum amount of product from their plants. The advantage of the cost-pass through clauses is that it links the largest input costs (electricity and energy) to inflation, which secures and stabilises the industrial gas company's profit margins.

This all adds up to a fantastic deal for industrial gas companies. As shown below, the cash flow on such projects is negative for the first few years through the investment phase but becomes very cash flow generative thereafter. Renewal rates for these onsite contracts hover around 95%, i.e. winning a contract can create a customer for life.

Linde net cash flows on a new project



Source: Praxair, Melville Douglas

Scale begets scale

Big onsite operations bolster the rest of the business as they create regional monopolies based on scale. The first company in a locality secures a big advantage because often there is only one such customer within a 250-mile radius and transportation costs are onerous beyond this range. The large customer typically consumes about 70% of the annual output, enabling the industrial gas company to piggyback this scale advantage and sell the remaining product locally to smaller customers, such as oxygen for welding or healthcare, via cylinders or via trucks that fill large storage tanks.

The Big Three major multinational producers (i.e. Linde, Air Products and Air Liquide) dominate the market with approximately 75% market share. The remaining market share is made up of numerous smaller regional players who benefit from the very local nature of business. With high technological, capital expenditure and incumbent onsite barriers to entry, the status quo is unlikely to change soon. Linde management have told us that market dynamics are relatively rational. When competing for contracts, typically 25% of the time there is no bid from another player due to incumbency position, 25% of the time there is one other competitor, 25% of the time there are two others and only 25% of the time there are more than two.

Multiple avenues for growth

Demand for industrial gases increases roughly in line with industrial production growth in developed economies and up to one-and-a-half times industrial production growth in emerging economies. Growth areas include energy, environment and emerging economies. For example, oxygen demand is driven by its greater usage in industrial processes to improve efficiency and healthcare demand as populations age. An exciting opportunity is the rapid growth in hydrogen as a fuel for transportation and heating. As well as offering their engineering experience, the Big Three industrial gas companies have a competitive edge because they operate most of the hydrogen transmission pipelines and are setting up distribution networks as new hydrogen refuelling stations proliferate.

Linde-Daimler-Total hydrogen refuelling station on the German autobahn

Proof is in the pudding

The fund has been a long-term shareholder of Linde, the world's largest industrial gas company. In addition to benefiting from compelling industry dynamics, Linde is well diversified across customers, geographies and end markets. Its management team is regarded as the best of the Big Three producers.

All these advantages have resulted in a business that has managed to grow its dividend by 15% per annum since the company was publicly listed in 1992. Given rock-solid competitive advantages and growth potential, we expect the business to deliver steady profits and dividend growth. This is something to be prized amidst a disrupted world. The share price may zig-and-zag, as share prices do, but over the long term it will reflect the underlying dividend stream paid to shareholders. The stock is a shareholder wealth compounder and remains a core holding in the fund.

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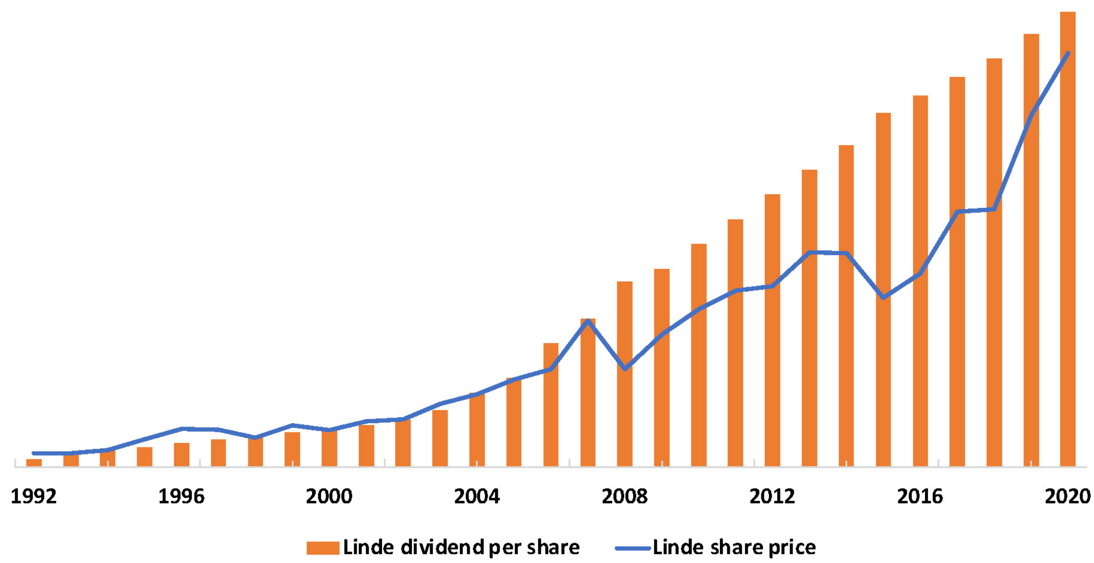
Follow the money – higher dividends, higher share price



Source: FactSet, Melville Douglas

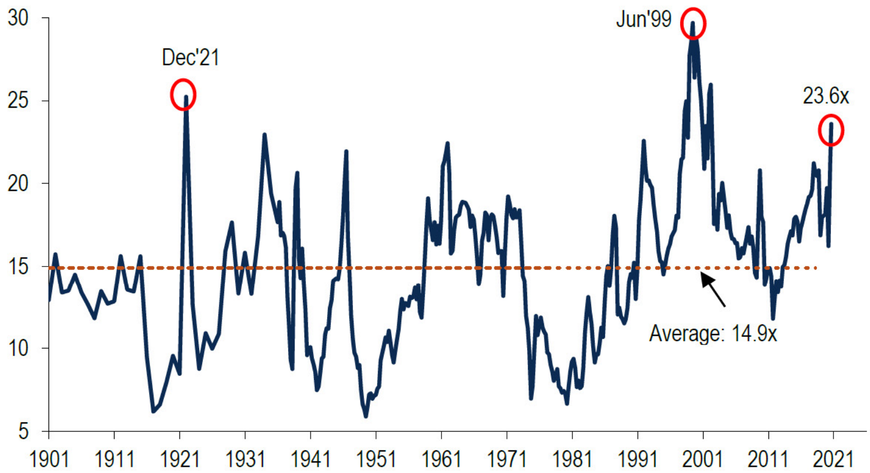
Castles in the sky

"And those who were seen dancing, were thought to be crazy, by those who could not hear the music"
Friedrich Nietzsche

Nietzsche's quote encapsulates today's varying perspectives. We are all sharing the same experience, but some are happy to dance with the market resurgence whilst others believe it is all in their heads.

Those not dancing to the market tune point to price-to-earnings ratios at nose-bleed levels, particularly on Wall Street. The S&P 500 price to earnings ratio (P/E) based on current profit levels is at 24x. This level has only been surpassed by December 1921 (25x) and June 1999 (30x).

S&P 500 price-to earnings ratio is the highest since 2000 and 1921



Source: Bank of America

However, extreme valuations have not always presaged doom. Let us examine the two higher P/E peaks: 1921 and 2000.

It was actually a great time to invest in 1921 as the market almost doubled over the subsequent five years. P/Es were high because earnings were depressed by a recession in 1920 and 1921. The Spanish flu pandemic of 1918 to 1920 had also just ended. Earnings powered ahead on the back of a period of rapid technology led growth due to electrification of homes and workplaces and the expansion of the middle class opened markets for new technologies, such as radio sets. There was a productivity boom and proliferation of automobiles. The Roaring Twenties was just starting, and the 1929 Great Crash was still eight years away.

P/Es were high in 2000 due to frenzied buying of dotcom stocks. The subsequent crash meant Wall Street was still below 1999 levels five years later. Some commentators are drawing parallels with 2000 and today's rally in big technology companies. However, on closer examination there are a lot more differences than similarities. First technology valuations were far higher, with the average technology stock P/E ratio at 85x in 2000 compared to 29x today. Second, on almost every measure investor sentiment was euphoric compared to today's deep sense scepticism about the rally. Third, central banks have our backs. The Federal Reserve started tightening monetary policy in the spring of 2000 to reverse the excess liquidity it had created ahead of the Y2K bug. This time round the Federal Reserve will not increase interest rates until the US reaches full employment and inflation moderately exceeds 2% for some time. According to their own forecasts, core inflation will remain below 2% until 2023.

Another way to look at valuations is relative to what you can also buy. As shown below, the gap between the yield on the S&P 500 and investment grade US corporate debt is almost at parity. This level of valuation harks back to the 1950s. The nuance is that the dividends paid by large cap equites will likely grow in excess of inflation whereas the fixed coupons on bonds will not grow. A relative mispricing is clearly afoot if you are prepared to experience a bit more volatility over the short-to-medium term.

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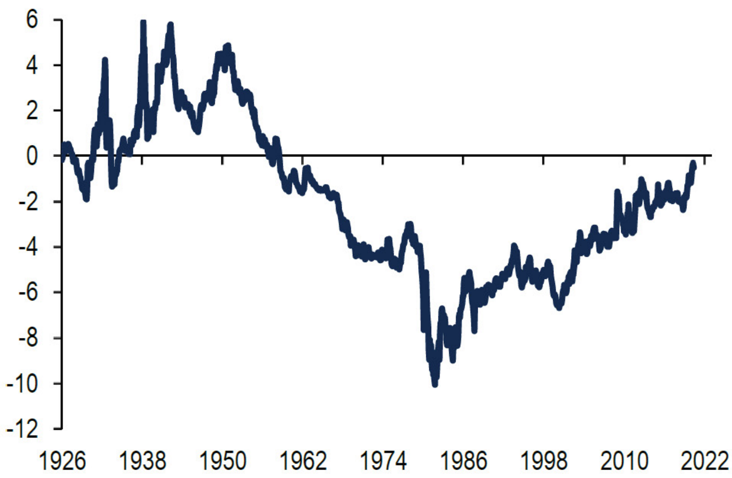
Growth for free? US dividend yield minus AAA corporate bond yield at parity



Source: Bank of America

Putting this all together, although the US market is looking pricey as a result of a Big Tech rally, we do not see enough parallels with the dotcom boom-bust. Equally, although artificial intelligence might drive the next quantum leap, the jury is still out on whether we can capture the type of productivity improvements that helped to power the 1920s boom in the US.

Over the short-term there are a multitude of reasons that could upset the apple cart. There is no imminent rollout of a COVID-19 vaccine amidst second wave infections in Europe, job assistance programs are winding down and there is a lot of policy uncertainty ahead of the November elections.

But we need to remind ourselves that the emotional rollercoaster that drives stock market volatility is usually temporary, whilst the rising cost of living is permanent. Over the next decade a global equity portfolio has a far more realistic chance than cash or bonds of delivering inflation-beating returns even at current valuations.

At times we will sit out a song, but we hear the music.