PRIVATE PORTFOLIO MANAGERS

INSIGHTS

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A discussion by Hugh MacNally, Chairman and Founder of Private Portfolio Managers

Rejuvenation of an Icon

The three characteristics PPM looks for in core portfolio investments are: strong financial structure, advantageous positioning in its industry, and attractive stock price relative to the returns that the investment is likely to be able to earn. In the consumer goods industries we have recently written an article on one of our holdings, LVMH, the luxury goods maker, and in this article we look at the other end of the scale – Nestle, the manufacture of a diverse range of branded products.

Nestle is the world's largest food group with strong market shares across developed markets and importantly it is also well positioned in emerging markets. After lacklustre performance over the last 10 years we believe that a process of rejuvenation is underway.

What had been a pattern of reliable growth in revenues and profit over a period of 50 years started to unravel in the mid-2000s. Sales peaked in 2006 and profitability was only maintained at the expense of market share and growth. What had been regarded as a reliable 5% top line growth and 10-12% earnings growth abruptly stopped and went into reverse.

On the surface it might not seem the best prospect. What attracts PPM to the company? Nestle is a company with enormous financial strength, reliable cashflow from trusted and very well established brands, and a low debt level (or net liquid assets if one included the large non-strategic equity holding).

However, the operating performance of business relative to its competitors and historical norms is lacking and significant improvements should be achievable. The company also has a very large opportunity in emerging markets, where other branded consumer goods companies have done so well, and historical norms are lacking. The valuation is attractive in our view, relative to the returns on capital that it should be making and the earnings growth it should be able to achieve.

Another attraction is Nestle's low and falling debt levels. While PPM avoids companies with high levels of debt, Nestle could comfortably take on more long-term debt, which could currently do at extra-ordinarily low rates, very beneficial to the shareholder's return on equity. Additionally, the $30 billion holding in fashion icon L'Oreal offers neither synergies nor strategic benefits. While it has been a good investment there has been pressure from shareholders for it to be disposed of and the funds returned. Further, the rationalisation of the brand portfolio would also be likely to release substantial capital. The amount of capital used in the business is way out of line with the company's historical performance and the current performance of its peers.

A review of the return that is generated by the vast number of brands is overdue, the objective being to increase the rate of growth by refreshing the portfolio and culling the brands that are not achieving sufficiently high returns. The low and deteriorating asset turn suggests that the portfolio of over 2000 products is in need of reviewing.

While there have been significant cost cuts from the business in the last 10 years, the margins have not responded and are significantly below those of competitors. Other operating measures have also deteriorated and compare unfavourably to competitors'.

Nestle has recognised this as a problem and has brought in a new CEO from outside the Nestle culture, a move which has been well received by some of the more critical shareholders. The appointment of an outsider is the first in the company's 130 year history; Ulf Schneider comes with an impressive reputation from his tenure at a German medical devices company, where he was able to generate substantial and long lasting growth. He was both acquisitive but also produced strong organic growth. He joined Nestle in January 2017.

PPM believes Nestle has a very strong brand portfolio however a degree of complacency has developed, resulting in poor operating performance and wasteful use of capital. We believe significant improvements can be made and there are some early signs of this. We expect to see stronger revenue growth, better margins and capital efficiency. The excess capital could be returned to shareholders through buy backs or dividends.

A discussion by Franklin Djohan, Portfolio Manager of Private Portfolio Managers

Waking Sleeping Giants: Timely Revisiting Corporate Strategy

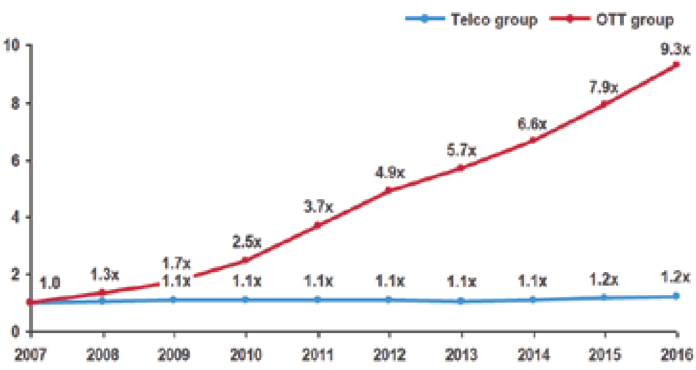
It is not uncommon for large incumbent companies to fall victim to change from external and internal factors, lacking the flexibility and the adaptability to respond to rapid changes in technology and market structure whilst addressing management change and complex operational issues. However, from time to time, industry leaders will rethink their strategy, and make necessary changes to be able to survive and thrive.

Telstra, Woolworths and Microsoft are recent examples of large incumbents where management has had to revisit and revitalise the companies core corporate strategy to 'wake the sleeping giant'. The results of which are starting to show.

At PPM we think that Telstra, one of Australia's leading incumbent Telco providers, strategy change is finally 'ringing home'. As evident from the investor day on 2nd November 2017, company management has finally 'answered the call' to provide a much needed clarification of strategy.

The company's large mobile business is facing increasing competitive pressure in a dynamically growing market. One must ask how a company with only two competitors (soon to be three) operating in a sector so central to everyone's daily life is not able to command a greater share of their customers wallet? However, Telstra's problem was not unique as illustrated by the chart below. The top three global telco's also missed out on monetising the explosion of data that was picked up by companies like Google and Facebook. The question for Telstra's management is what are they going to do about it?

OTT company revenue has accelerated since 2007, wile telco revenues have remained flat



Source: Telstra Investor Day PDF, available from www.telstra.com.au/aboutus/investors/financialinformation

Telstra management finally came to the realisation that they had to adapt their strategy in order to grow.

One of the key strategies management has highlighted was for the company to start tapping into the Over the Top (OTT) market. This initially sounded an alarm—that the company was going outside its core competencies, as OTT is dominated by technology companies like Google, Facebook, and Netflix not Telcos, and these technology companies are very agile and able to innovate, something that is not in Telstra's DNA. However, Telstra is aiming to monetise something closer to home, the visibility and data it has from its network infrastructure.

One of the examples of this new venture is in the Cyber Security space, something that is very crucial in the hyper-connected world we live in now. Telstra's Cyber Security space, something that is very crucial in the hyper-connected world we live in. Telstra's Cyber Security Offering is more of a managed service, made possible since it can monitor any abnormal activity going through its network, a logical move for the company. Management has also refocused and revisited several other initiatives, which we believe, will if well executed put Telstra back onto a more competitive path.

There are other examples where companies were able to re-energise their business by enacting a reinvigorated strategy. The strategy can either consist of small iterations to the previous one, or be vastly different, as seen at Woolworths—this large incumbent grocery retailer was 'caught sleeping at the wheel', and let Coles and the emerging Aldi take market share. New CEO, Brad Banducci, was tasked to turnaround the business. His strategy was about going "back to basics", and doing all the small things right from the bottom up. He brought the attention back to the customer, having the right products at the right price and, good store presentation, to name a few. Although it is still early days, the indication so far has been positive, with same store sales starting to pick up and Woolworths taking back some market share off its competitors.

Microsoft is another example of a large incumbent that has refocussed its corporate strategy with ongoing success. At Microsoft, revenue used to be highly dependent on its customer replacement cycle, hence unpredictable. To combat this, Microsoft implemented a subscriptions based business model. This allowed for more predictable earnings and control of the company's product-lines to ensure they were always up to date.

Obviously having a sound strategy is only part of the story. While many factors contribute to the success and running of a robust business the importance of refocusing on your strategic plan cannot be underestimated.

Image: Yngve Martinussen

Environmentally Friendly Coffee Cups

PPM is proud to announce that we have moved away from paper/plastic cups, aiming to save over 4500 cups from landfill each year. Come and join us for a coffee in one of our environmentally friendly cups!

Seasons Greetings

On behalf of everyone at PPM we would like to wish you a happy and safe festive season. We have many exciting events and publications upcoming in 2018 and we look forward to working with you in the new year!

For further information about PPM's services, please contact either Sally Humphris or Adam Griffiths on 1800 463 359 or email ppm@ppmfunds.com.

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