How to profit from market myths

In 1962, President John F. Kennedy delivered Yale's graduating class of 1962 a piece of advice that all investors should hold dear: "The great enemy of truth is very often not the lie – deliberate, contrived and dishonest – but the myth – persistent, persuasive and unrealistic... We enjoy the comfort of opinion without the discomfort of thought."

All too often, investors rely on conventional wisdom. Ideas that may have been true one day, which are perhaps not relevant today. For those investors who fail to question the myths they have always believed, danger lies ahead. On the other hand, great investment opportunities can stem from the continual questioning of conventional wisdom and the dispelling of myths.

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The safety of investing in consumer packaged goods

Take consumer packaged goods (CPG) businesses. These are considered highly defensive in nature. And for good reason: they produce the basic goods that humans need to consume each day and are relatively insensitive to economic cycles. From razors to feminine care products, cereals, soups, dairy products and tissues.

For generations, the CPG space has been dominated by large brands. Think of Heinz, Gillette, Kleenex and others. In 1996, Warren Buffett characterised these sorts of brands as "The Inevitables." According to Buffett:

"Companies such as Coca-Cola and Gillette might well be labelled 'The Inevitables.' Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving equipment business these companies will be doing in ten or twenty years… In the end, however, no sensible observer… questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime.[1]"

This conventional wisdom has held true for a very long time. But does it remain true today?

At the 2018 Milken Institute Global Conference, the following comment was made by a participant:

"I'm a terrified dinosaur… I've been living in this cosy world of old brands and big volumes… you could just focus on being very efficient and you'd be okay… we bought brands that we thought could last forever... and all of a sudden we are being disrupted in all ways.[2]"

That participant was Jorge Paulo Lemann, Brazil's richest person and cofounder of investment firm: 3G Capital. 3G is the second largest shareholder of The Kraft Heinz Company. The largest shareholder is Warren Buffett's Berkshire Hathaway.

We question the conventional wisdom of the safety of the major CPG businesses. By dispelling five big myths about the space, we believe we have uncovered a wonderful investment opportunity for our global equity long-short strategy, called Montaka.

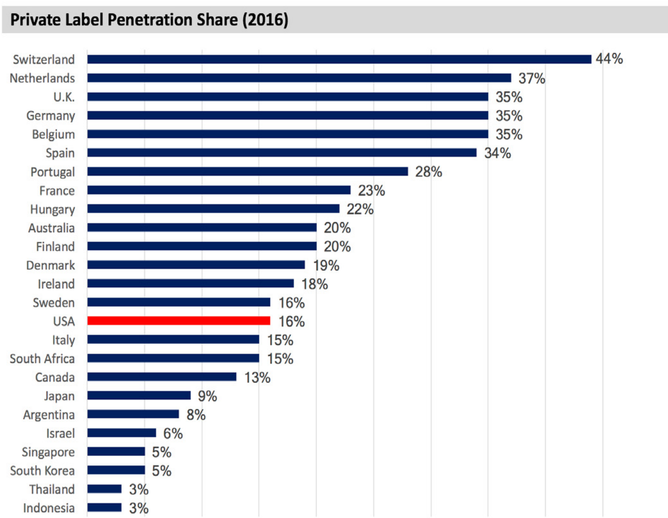
Myth #1 - Big CPGs can afford the best shelf space

Traditionally, the distribution capabilities of big CPG businesses – namely relationships with retailers that allowed these firms to secure prime shelf-space and in-store displays – had reinforced their dominant position. The relationship between big CPGs and retailers was symbiotic: big CPGs needed retailers in order to get their products in front of as many consumers as possible; and the retailers relied on stocking the brands people wanted to maximise foot traffic and sales productivity.

This was the order of the day for many decades, but it is a relationship that has weakened as retailers increasingly promote their own private label products and consumer shopping habits expand online. The motivation for retailers to promote their private labels is threefold:

- Private label brands carry higher profit margins for the retailers;
- Lower-priced private label brands help protect retailers against the competitive threat from hard discounters, such as Aldi and Lidl; and
- Private labels are exclusive and can drive shopper loyalty over time.

In the US, private labels have been gaining market share in recent years. And despite the recent growth of private labels in the US, penetration remains materially lower than many other parts of the world, such as the UK and Europe. This supports the hypothesis that growth in private label penetration in the US will likely persist.



Source: Euromonitor; Morgan Stanley

1 (Berkshire Hathaway) Chairman's Letter, 1996
2 (Brazil Journal) Jorge Paulo Lemann is a 'terrified dinosaur'. But he is not lying down, May 2018

On Walmart's Q1 2019 earnings call, management made a comment that signalled these private label pressures could intensify for CPG companies: "We have really stepped up our focus on private brands…We think there's an opportunity to gain extra share of wallet as a result of providing quality private brands.[3]"

For CPGs, the rise of private label creates a significant competitive headwind. The continual loss of market share to competing private label brands – typically priced at a 20-30 per cent discount – results in ongoing downward pressure on the revenue lines of branded CPGs. And at some point, the pressure becomes too much. Last year, for example, Gillette effected price cuts on their razor blades by as much as 20 per cent.[4]

For years, crowding out the competition by securing coveted shelf space worked well for the big CPGs. Now, not only is private label product taking more of the traditional shelf space, but the world in which shelf space is finite has all but disappeared. As shoppers move online – for browsing, reviewing and purchasing – the shelf space has become virtually infinite. The once-strong barriers to entry for competing products have now been reduced thanks to the emergence of e-commerce and the shifting consumer shopping habits to online channels.

Nowadays, CPG businesses must not only keep a stronghold on distribution, but they must also dominate online search, a task that is arguably more difficult.

Myth #2 - Big branded CPGs are the best marketers

For generations, the largest CPG brands have enjoyed an almost impenetrable scale advantage relating to their marketing spend. By outspending competitors, brands like Heinz, Gillette, Kleenex and others could drive dominant market shares in their respective categories. These privileged market positions allowed these brands to command the best shelf space at retailers and continually push prices up, inch by inch over time. The additional revenues helped fund more marketing and the cycle was perpetuated.

That these scale advantages are impenetrable has been the conventional wisdom believed by many for years. But does this conventional wisdom hold true today?

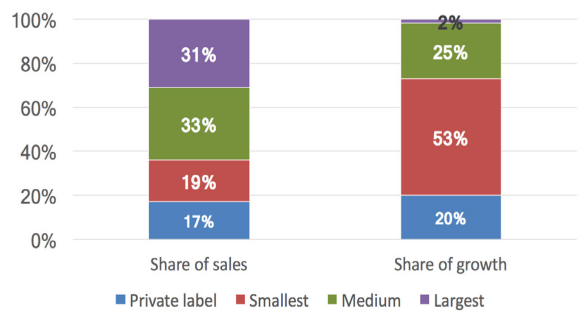
Previously, the retailer was the CPG's customer. Today, the retailer is often a competitor, offering their own lower-priced private label brands. And in many instances, retailers would not allow CPGs to cut their prices – even if they wanted to. This dynamic forced traditional CPGs up the premium spectrum, driving even greater pricing gaps to private label brands.

In years gone by, the largest CPG marketers would explain the benefits of their products and innovations with authority. Gillette, for example, typically spent about US$1 billion every seven or eight years to develop a new razor system (at higher price points, of course).[5] Today, consumers gain authority from online peer reviews rather than TV ads and large billboards.

According to a branding strategist for a major global CPG business we interviewed: "Consumerism used to be about choice. Now consumers have too much choice. This has created distrust between big business and consumers. Being anti-corporations is mainstream. And this favours new start-up brands.[6]"

We can see evidence of new start-up brands punching well above their weight. In 2017, more than half the growth in US food and beverage sales went to the smallest brands, including start-ups. By contrast, the large brands made a negligible contribution to industry growth.

US Food and Beverage Share of Sales and Share of Sales Growth in 2017



Source: Nielsen, Redburn

The success of new start-ups has even resulted in the major global CPGs literally throwing out their brands and starting again. Last year, Kellogg's Australian division described to investors at a conference how they launched a new snack for Australian consumers, the packaging for which not only omitted any Kellogg branding but even omitted Kellogg's Australian address. When did multi-billion dollar brands become so toxic that even the postal address on the packing would impair sales?

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3 Walmart) Q1 2019 Earnings Call (May 2018)
4 (WSJ) Gillette, Bleeding Market Share, Cuts Prices of Razors, April 2017

5 (WSJ) Rather Than Add More Blades to Its Razors, Gillette Trims Prices, November 2017
6 (Interview) Branding Strategist, October 2017

Myth #3 - Big CPGs have scale in production

Economies of scale is the concept which describes the unit cost advantages that accrue to firms as they increase their production volumes. It stands to reason, then, that the big CPGs should have the most efficient and low-cost production capabilities, with their vast manufacturing scale providing a wide moat that is difficult for smaller competitors to assail without significant capital investment. While this may have been true decades ago, today the outdated technology, changing consumer preferences and availability of contract manufacturers have turned the big brands' legacy manufacturing facilities into cost drags.

From our conversations with industry consultants, we understand that not only are many CPG companies burdened with legacy manufacturing technologies dating from the 1970s and 1980s, their production facilities are also severely underutilised. For example, on the Kraft Heinz merger call, Heinz CEO Bernardo Hees disclosed that Heinz utilisation rates were down in the low 40 per cents prior to 3G ownership[7]. Capacity underutilisation is unsurprising, as companies that invested in capacity on the expectation of sustained GDP-plus growth have instead typically faced declining sales and shrinking volumes.

In response to changing consumer preferences, particularly the shift away from packaged foods and big brands, many CPG companies have aggressively rationalised capacity to improve utilisation rates and invested in new production technologies for organic foods. This comes at a cost, however. For example, Campbell Soup saw its adjusted gross margin contract by 390 bps in its 3Q 2018 results, due in part to higher manufacturing costs and lower manufacturing yields at its Campbell Fresh business.[8]

Finally, the widespread availability of high-quality contract manufacturers has enabled private labels and small, niche brands with asset-light models to compete effectively with the big CPG companies. Dollar Shave Club, the US subscription razor startup acquired by Unilever for $1 billion, sourced its razor blades from Dorco, a South Korean manufacturer of private label razors.[9]

As Jorge Mesquita, the Chairman of Johnson & Johnson Consumer put it: "It used to be that manufacturing assets, large plants was a moat, a barrier for entry. But again, you see today across the world, that small companies, new entrants can access excellent contract manufacturing in just about every region.[10]"

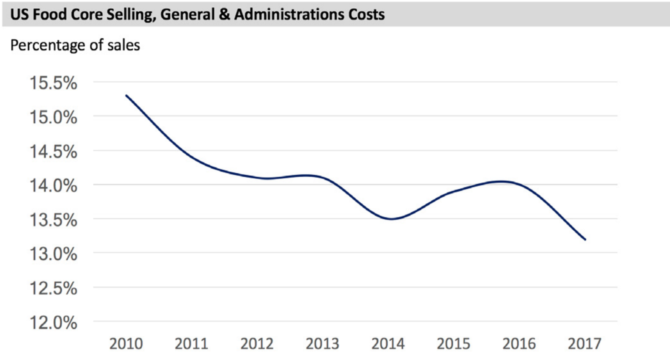
7 (KHC) Merger Call, May 2015
8 (CPB) Q3 2018 Earnings Call, May 2018
9 (NYT) $1 Billion for Dollar Shave Club: Why Every Company Should Worry, July 2016
10 (JNJ) 2018 Consumer & Medical Devices Business Review, May 2018

Myth #4 - CPGs can reduce costs to boost margins

In recent years, the CPG space has experienced numerous and intensifying revenue pressures. In response, CPG companies have turned to cost cutting programs in an effort to preserve profit margins. With no end of the challenging sales environment in sight, it has become widely accepted that the large branded CPG companies can and will maintain their profitability by… doing more of the same. This does not seem easily achievable in our view.

For the better part of the last decade CPG companies actively worked down production and operating costs. To begin with, CPG managements instituted large scale productivity programs, and then repeated them year after year. Yet all the effort to reduce production costs (by consolidating manufacturing plants, streamlining supply chain processes, and the like) has been to no avail: across the CPG industry gross profitability has barely budged. What productivity efforts have given, persistently declining volumes have taken away.

At the same time, Morgan Stanley research shows CPG company profit margins have benefited from structural "cost out" initiatives and more radical approaches to cost management, including "zero-based budgeting." Since 2010 core Selling, General & Administrative (SG&A) expenses at US packaged food companies declined by around 2 per cent of company sales, respectively.



Source: Company Data, Morgan Stanley

Today it is likely these companies have little excess fat left to shed in order to boost margins. As an industry consultant commented to us: "Most of the companies have, whether its Kraft-Heinz or General Mills, to a greater or lesser extent played a lot of those cards multiple times now…they have all gone through these big cuts."

Worse, it seems as though many of them have cut too deeply – cutting into the "muscle" of the organisation. Far from cutting costs to boost performance, many CPG companies require new investment just to maintain the existing sales and profitability levels. Any costs that come out of one area of the business look likely to reappear in another.

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CPG companies now face the need to invest in new product and production methods, as well as higher SG&A spend to promote product innovation and support iconic brands. This message has been uniform across substantially all the CPG companies we follow. Higher spend is no longer a differentiator, instead it has become the cost of entry to play in a crowded marketplace.

The CFO of Edgewell Personal Care, the maker of Schick razors, summed it up well when speaking about cost saves on the 2018 Q2 earnings call: “It is expected that the savings generated will be used to fuel investments in strategic growth initiatives and brands, offset operational headwinds from inflation and other input costs, and improve the overall profitability of the Company.” With so many calls on the savings, we think it is unlikely that the residual impact on profits will be a positive one.

Even President Trump’s corporate tax cuts appear unable to help the profitability of the CPG businesses. Rather, management teams have indicated (again almost uniformly) that they will be investing tax savings back into their businesses, thereby increasing the cost base, depressing operating margins, and limiting any benefit to shareholder earnings.

Myth #5 - A Strong US economy should boost earnings

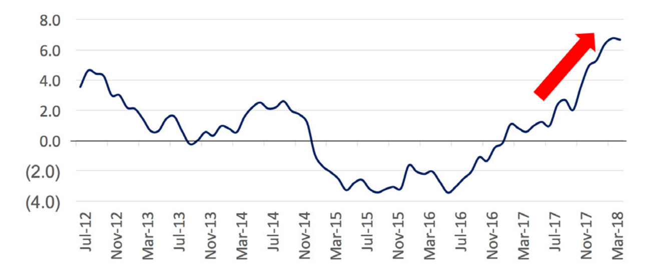
The US economy has not been this strong for more than a decade. US unemployment is at its lowest level in 20 years, industrial production is growing strongly and interest rates remain at historically low levels. Against this backdrop, the conventional wisdom is that CPG business earnings must grow… Not so fast. You see, while strong economic growth is a tailwind for industry revenues, it can also create significant cost inflation.

Analysing CPG supply chains, we uncovered the significance of freight transportation to a CPG’s overall cost structure. Not only is the CPG business responsible for trucking the raw inputs to its manufacturing facilities, the major retailers also typically force the CPGs to bear the cost of trucking the finished products to the stores (or the distribution centres).

The problem is, demand for freight is significantly outstripping the supply of freight (trucks and drivers); and rampant cost inflation is the result.

Producer Price Index — General Freight Trucking

Percentage change (annual)



Source: Federal Reserve Bank of St. Louis

The lack of freight supply is worth further comment. While trucking has traditionally had limited pricing power, no barriers to entry and extremely low margins, it served the post-war, baby boomer generation well who represent the core source of labor. Following a sustained period of post-war economic growth in the US with sharply rising living standards, younger generations have shunned the long-hours, poor lifestyle and meagre remuneration the trucking industry offers, creating a dearth of employees.

Furthermore, overworked, sleep deprived and poorly policed, the trucking industry faced sweeping regulation at the hands of the government to improve public safety with the implementation of the Electronic Logging Device (ELD) Rule in December 2017. The rule requires truckers to install a digital device (ELD) which records driving time. This move forced compliance with the federal hours-of-service law that limits driving to no more than 11-hours per day within a 14-hour workday, followed by 10 consecutive hours off-duty. Given this rule was rarely adhered to by the trucking community, the imposition of hefty fines, licence suspension and electronic monitoring created the environment for a labor squeeze (i.e. cost spike) in a market that was already short on labor options.

The impact of the dramatic increase in freight costs was clearly articulated by Campbell Soup after the company slashed guidance on its 2018 Q3 earnings call, sharply missing consensus and sending the stock tumbling by 15 per cent over the subsequent two trading sessions. The CEO unexpectedly resigned the morning of the earnings call leaving the CFO to relay the challenges the business was facing: "We are updating our full year guidance to reflect lower expectation for gross margin performance, with the two primary drivers being the performance of Campbell Fresh and the inflationary impact of higher transportation and logistics costs.[11]"

The danger of defensives

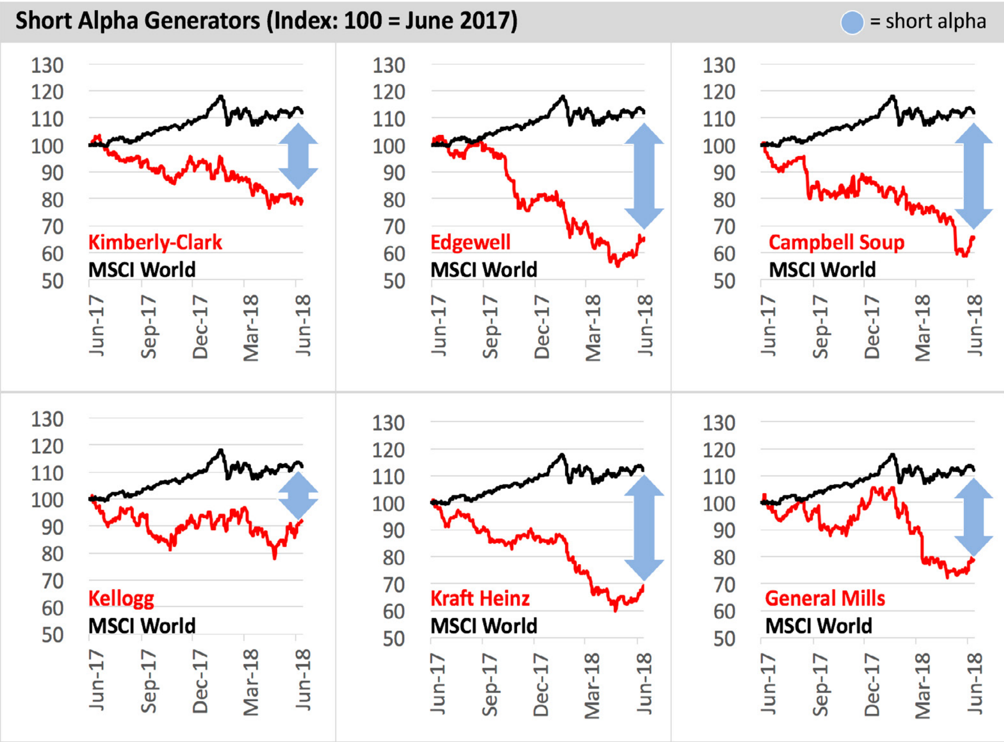
For years, the conventional wisdom has been that investing in big CPG businesses is safe. Recession-proof demand drivers, consumable products, large scale production distribution and marketing advantages – what is not to like? And in a low interest rate environment, the belief has been that these businesses represent equity-like returns and carry only bond-like risk.

In many cases, we believe the opposite is true. Investors in many CPG businesses today are actually taking equity-like risk to deliver bond-like returns (at best). The market-implied expectations built into many stock prices imply growing revenue lines and expanding profit margins. Whereas in reality, revenue lines are under pressure from changing consumer preferences and disruption from lower-priced private labels; meanwhile, the cost-savings being pursued by all will need to be reinvested for (attempted) future growth. At the same time, bond yields are increasing, reducing the opportunity cost of owning less-risky bonds.

11 (CPB) Q3 2018 Earnings Call, May 2018

This dynamic can be observed clearly by a selection of CPG businesses that Montaka was short at the time of writing this whitepaper. As illustrated by the chart below, the CPG businesses that were selected for Montaka's short portfolio have declined in absolute terms – and have significantly underperformed the global equity market.

In the same way that long portfolio value-add (or "alpha") can be measured as the return over and above the equity market index; short portfolio alpha can also be measured as the degree of underperformance relative to the equity market index.



Source: Bloomberg

Profiting from myths

In a world of aging populations, rising interest rates and the late stages of one of the longest bull markets in equities on record, it will likely be the case that future average equity returns will not be as high as they have been over recent decades. And in a lower-returning average equity environment, the implication is that stock-specific alpha that is generated by a high-quality active manager will be a higher share of the total return (i.e. relatively more valuable to one's overall portfolio).

The case for a high-quality, global equity long-short strategy, such as Montaka, is particularly strong in the current market environment. In addition to Montaka's high-conviction long portfolio of high-quality global businesses that are materially undervalued, Montaka manages a short portfolio of individual businesses that are deteriorating, misperceived and ultimately overvalued. By questioning conventional wisdom, as we have done in the CPG space, we can profit from dispelling myths in Montaka's short portfolio.

Over the period during which this whitepaper was being drafted, news emerged of the passing of American writer, Philip Roth. Here is one of Roth's great observations to which we believe investors should take heed: "All that we don't know is astonishing. Even more astonishing is what passes for knowing."

Learn more about the Montaka strategy

Investing with Montaka provides investors the opportunity to benefit from both the value created by extraordinary businesses purchased at discounts to intrinsic value, as well as the decline in value of deteriorating businesses and industries. The result of this combination is reduced Net Market Exposure which may also provide greater capital protection when markets turn down.

The Montaka Global Fund was established in July 2015 and the strategy was made available to retail investors in November 2015 through the Montaka Global Access Fund.

Over the June quarter, the Montaka Global Access Fund returned investors 6.82 per cent, net of fees. And since its inception (01/11/2015) has returned 19.30 per cent. Importantly, it has achieved this with an average Net Market Exposure of 47 per cent.

If you would like more information on investing in the Montaka Global Access Fund, please click visit: https://www.montinvest.com/mga

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