Events, Dear Boy, Events

The brutality of recent events makes it hard to know what is "really" going on in markets– i.e. what level securities would be without Japan and the Arab Uprising. But we have to assume conditions in the investment markets will eventually return to normal. When they do we expect the following recent events, facts and quotes from the world of business to provide a true perspective on what may, indeed, really be going on.

LVMH's agreed acquisition of Bulgari, after its 2010 swoop on part of Hermes, is an eye-opener for several reasons.

First, at 28x EBITDA (note, not 28 times earnings, but 28 times EBITDA!) this is by some margin the highest valuation ever put on a luxury goods business – even if Bulgari's revenues and margins are temporarily depressed. Now, it is possible that Monsieur Arnault has taken leave of his senses - although the wealth he has created for owners of LVMH, by his policy of snapping up luxury goods brands wherever and whenever they come available suggests he knows these assets better than the stock market. And assuming Arnault's head not turned by Bulgari bling, the rest of us can do little better than recognise how few of such brands remain available to portfolio investors and those that are left are probably still cheap. We have been twitchy holders of Burberry for the last £3, having tagged it with an £8 price target a couple of years ago. However, three things made us revise that preliminary target. The unexpected quantities of cash the company has begun to generate, swinging from debt to net cash, the purchase of its minorities in China – accelerating growth in that market. And the sight of Arnault putting a higher premium on comparable assets than we would have dared to do. We wouldn't buy or add to Burberry today, but £1 or £2 lower and we will want to remind ourselves that the heritage and global resonance of this brand is unique, extraordinarily valuable and that we should do what Arnault would do.

Next, what LVMH has done is to act on the implications of the following quote. This from the CEO of Henkel, Kasper Rorsted in an interview for the FT, coincidentally on the same day as the Bulgari deal. Henkel is a consumer product company, with extensive interests in Emerging Markets and this is the lesson learned from that experience:

"If you look at what consumers are striving for in emerging markets, actually it's not the local brands, it is the global brands. They're striving and buying up into the chain rather than down."

Of course, Bulgari is rather higher up the aspirational chain than most of us care to crick our necks for, in emerging economies or no. But it won't be lost on LVMH that compared to a depressed European jewelry market, Bulgari's China sales were up 40% last year. And it shouldn't be lost on Western investors that some of the inflation pressures mounting on developed world consumer branded goods companies are mounting because of this new marginal demand for their products from the developing world. These "new" sales will go some way to mitigate the profit margin squeeze, which has afflicted our holdings in Diageo and Unilever so far in 2011.

In passing, it is worth noting too that developed world FMCG companies are much more cheaply valued than their Emerging Market counterparts. Reckitt Benckiser recently paid 8.2x revenues and 30x EBITDA for Paras Pharma, an Indian OTC drug manufacturer, double or treble Reckitt's own valuation and a rating few Western even ethical drugs companies can dream of these days. Meanwhile, there is Unilever, with half of its sales in Emerging Markets valued on a lowly 1.5x those annual sales – but its Nigerian, Indian and Indonesian subsidiaries command 2.2x, 3.9x and 6.3x respectively. Unilever is either very cheap, or those Emerging Market assets overvalued.

Rorsted had something interesting to say, too, about China – a geography where Henkel is treading carefully. "It's an extremely diverse market with a lot of local suppliers, with very, very low profitability, 1-3%." This is a useful corrective to complacent optimism about all remote Eldorados, but it also puts another aspect of Unilever's business performance into perspective. The company has E1.2bn revenues in China – by no means trivial – that have grown at a CAGR of 18% these last five years. Those sales though, are only mildly profitable and Unilever has had, as it recently admitted, to get itself into the position of being the #2 advertiser in China just to get this far. The prize from all this brand building investment for Unilever shareholders is considerable, nonetheless. One reason why that Unilever Indonesian subsidiary trades on 6.3x annual sales is that its sales there have grown at a 16% CAGR over the past decade, with super-profitable margins of 20%, because of the high branded personal care content. Whatever, Unilever must be one of only a handful of companies on the planet with the existing scale to take on a challenge like China.

I now have a final, wholly different perspective on the LVMH/Bulgari transaction. This deal, declared Reuters, this deal was the 4,171st corporate takeover or merger to be announced around the world in calendar 2011. Presumably this includes quoted and unquoted companies and some pretty small fry – but well over 4,000 combinations before mid-March is an impressive tally. What's certain is that both the scale and the quantum of the deals are increasing. Their accumulated value stands at $413bn, up over 30% on the same period of 2010.

And I say, when your clients ask you what's going on in the world today and are expecting an exegesis about Libyan tribal politics or US monetary policy, instead tell them that over 8,000 profit seeking entities (it takes two to tango), run by rational allocators of capital have decided that combining their operations makes sense, in order to take advantage of the tremendous business opportunities around the world. It is thematic too, that several of 2011's business combinations involve stock markets themselves – with LSE/Toronto most relevant for us. The enthusiasm for putting regional exchanges together is a clear demonstration that Capital is becoming increasingly global in its behaviour – requiring a global response from corporations. We argue further that there is useful information embedded in all these deals. This willingness to combine suggests that it remains cheaper to buy stock market assets, than to build new ones from green field – an important signifier that stocks remain cheap.

Mind you, I was disconcerted to hear Xavier Rolet compare the unfolding Natural Resources boom to the Internet, as a justification for putting London and Toronto's resource-biased boards together. Doesn't he remember what happened to NASDAQ once the New Economy bubble burst? NASDAQ fell 75% and has never fully recovered. We support the LSE's strategy, but no doubt the combination makes the new group even more leveraged to the commodity price cycle.

In fact, the NASDAQ, as a proxy for global technology has had a decent few years, up 2.4x since its lows in 2003, outperforming the S&P500, which is up 60%. We expect more outperformance as tech fundamentals continue to improve.

Here is a nice slew of facts to support that contention. Last year, according to a Bloomberg story, American adults spent on average 660 minutes a day consuming Media via one medium or another. Those 11 hours were 1.5% greater than the previous year (650 minutes), which in turn was 2.5% more than in 2008. Eleven hours is already a significant proportion of every American's waking hours, but the gradual increase seems to confirm a long-held Lindsell Train investment proposition – that the world will never be bored of being informed or entertained. It is no surprise, though, that the devices used to consume all that media are changing. The time Americans spent reading newspapers fell again in 2010, from 33 minutes a day to 30. Meanwhile, Internet browsing rose 6% to 155 minutes a day and Mobile devices sucked up another 49 minutes of US life, more than 25% longer than the previous year. Interestingly TV viewing was down only marginally, at 266 minutes a day, still up on the 254 minutes spent in 2008. TV and Internet are converging rapidly – very soon they will both be delivered into the family home over the same device and, for investors, it doesn't do to underestimate the value that TV brings to advertisers and its owners (as illustrated by the renaissance in ITV's shares and Murdoch's pursuit of Sky). TV – a 75 year-old technology - is still generating its own new records. For instance, this February's Super Bowl drew the largest audience ever for a single broadcast, 111m, up 5m on 2010. Not surprisingly, advertisers flock, willing to pay $3m for each 30-second slot, still up 40% on 2001's levels, despite the recession and purported demise of free-to-air TV.

There are terrific investment ramifications – money-making opportunities - from this increase in not only consumption of Media, but in the number of devices delivering that content. A couple of examples, from many, that are relevant for Lindsell Train. Those 111m pairs of eyeballs, fixated on the sports thrills of the Super Bowl, are one reason why Thomas DiBenedetto and James Pallotta are taking a gamble. DiBenedetto is a Boston Red Sox executive and Pallotta a US hedgie made good and together they are part of a consortium that has put in a bid to buy Italian soccer franchise Roma. Italian football is in a mess – in part, as Stephen Julius, former owner of Vicenza, puts it, because it's "business model is decades behind". But that means the clubs are cheap. Roma and Juventus (the latter of which we hold a modest investment in) are valued at around 1.0x their annual sales. Americans know that US sports franchises and even UK football clubs swap hands at 3.0x sales or more. The temptation to take control, update the business model - thereby growing the depressed sales base, then benefit from a rerating, from 0.8x (for Juventas) to 3.0x, is, well, tempting. Although we must agree with Stephen Julius, that owning any part of an Italian football club is a "challenging and unusual investment", especially when it transpires that amongst our fellow investors in Juventus, 7% is owned by the Libyan State Investment Fund!

More mainstream, did you see the growth rates in the digital part of Pearson's business, now 30% of the whole and up 25% year-on-year? I was most impressed by the numbers of students signing up for Pearson's online education platforms, 56 million in 2010, up from 42 million in 2009 and more than double 2008's tally. That growth in the "virtual" delivery of education is having tangible benefits for Pearson's business economics. Working capital as a proportion of sales fell to 20%, from

25% the previous year – as an increasingly digital company just deploys less physical stuff. Profit margins in its Education division were up another 100 basis points last year, to 16.4%. Better margins mean more cash, with operating cash flow up 16% pa over the last 5 years. More cash allows higher dividends, with last year's 9% hike the fastest for a decade – this from a company that has grown its dividend ahead of inflation every year for the last 17. Pearson looks more and more like one of the great growth companies of the next decade – still only valued on 1.6x its annual sales. How about 3.0x sales 50% higher by 2015? That gives a Pearson share price target of £29. Crazy? Perhaps, but remember this share was as high as £22, as long ago as 2000.

I want to conclude with a final fact – one that relates to Lindsell Train, but leads to a question we have about our industry. LT is now a decade old and that means a number of our mandates are lapping 10-year track records. The first to do so was Finsbury Growth & Income Trust, to which we were appointed advisers in December 2000. Finsbury's PR adviser wondered and discovered how many other investment trusts had had the same nominated individual as manager for 10 years or more. And, according to the AIC, there are 531 trusts or investment companies in its universe and, of these, 65, or 13% meet the criteria. Not so many, but probably still a higher proportion than in OEIC-land. Why is this so? Who gets bored first – the investment manager, his employer or the clients? Whatever, the relatively high manager turnover is bad business, or at least a missed opportunity. It's the guys (including the gals) with the longest records that get the biggest asset pools built around them. That's good for the clients and good for the asset managers. Here's to LT's next decade at the helm of Finsbury Growth and the Lindsell Train Investment Trust.

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