The Growing Appetite for Brands

Lindsell Train has never invested directly in emerging market listed companies, but nevertheless accessing emerging markets is an important part of our strategy. In this piece we want to look more closely at the emerging market exposure of some of our holdings and offer an insight into how we perceive their potential. We know that today many people view emerging markets with serious reservations and we hope that we are not too naively bullish about the opportunity they offer. We are well aware that some emerging market countries suffer from inherent problems: they may be beleaguered by corruption and unstable leadership. Crony capitalism and deficits frequently serviced by unreliable hot money only serve to create further instability. We also acknowledge that the spectacular growth in the value of emerging market stocks over the past 15 years – acting as an exaggerated mirror of the underlying economic performance – has proven unsustainable. Between 1998 and 2013 the MSCI Emerging Markets Index grew 8% per annum (or total price return of 235%)[1], far outstripping the MSCI World Index's compound annual growth rate (CAGR) of 2.5% (total return 44%) in the same period. However currency collapses in emerging markets in 2013 resulted in an 11% contraction in the MSCI Emerging Market Index between 2013 and 2015[2], while developed currencies broadly held up over the same period.

The investment attractions of emerging markets have long been understood as being their growing populations and rising middle classes with more disposable income and a hunger for branded goods, coupled with the assumption that these trends will continue. Pessimists might now say that these regions – and therefore markets with them – are undergoing a long overdue correction. Perhaps the *truly* pessimistic might also argue that something has fundamentally gone wrong with the macro case for investment in emerging markets, such as slowing population growth in China or falling commodity prices spelling trouble for African and Latin American countries dependent upon high prices to keep their economies strong. Lindsell Train's portfolios have been stung by these problems, for example when devalued currency in Venezuela hit our portfolio holding Diageo in 2015.

To be clear, we don't anticipate any significant change in the overall conditions in emerging markets any time soon – and yet on a long term global basis we are still optimistic. Broadly we *do* think that over time emerging market populations will grow, as will the appetite of these billions of consumers for branded products, from single use sachets of detergent to luxury handbags and quality entertainment. Across our portfolios, therefore, we have significant emerging market exposure, not via companies listed on local exchanges but on a lookthrough basis via companies based in developed markets, but with a good proportion of their sales to emerging markets. Indeed, as much as 26% of sales by companies in our Global Equity representative portfolio originate from emerging markets (24% in the UK Equity representative portfolio and 13% in the Japan Equity representative portfolio), but no holdings in any account are actually listed on emerging market exchanges. It is worth noting, however, that we are building up a knowledge of some emerging market companies by including ten high quality ones in our global universe – for example Brazilian cosmetics maker Natura or Argentinean ecommerce site MercardoLibre.

Our largest portfolio holding Unilever is a fantastic example of the value that can be created by selling into emerging markets. As an Anglo-Dutch company it is listed in London and Amsterdam, but has 58% of its revenues originating from emerging markets[3]. This is a gratifying enough figure in itself, but we think that the really valuable aspect of this company's emerging market exposure is its long history of selling into certain regions. The forerunner of many of today's brands, Sunlight soap, was launched in India in 1888, followed by the still popular Lifebuoy in 1895, Pears in 1902, Lipton Red Label (as Brooke Bond) in 1903, Pond's in 1947 and Surf in 1959. Lever Brothers India was incorporated as early as 1933, with a soap factory built in Mumbai the following year[4]. Compare this lengthy history with Procter & Gamble, which only entered India in 1964 – and its overall correspondingly lower 40% emerging market exposure[5]. We think that Unilever's years of operation in India and other regions makes its brands uniquely resonant with and deeply ingrained in the daily lives of consumers in these markets, a view shared by the current CFO who notes that often the company's products are perceived by consumers not as global brands but rather local ones[6].

It is similar for Heineken and Diageo, with their equally impressive emerging market pedigrees. Heineken first imported beer to Africa in 1900, co-founded the Tiger beer producing Malayan Breweries in 1932, entered Indonesia in 1937 and then Nigeria in 1946; today 60% of volumes and 50% of revenues come from emerging markets[7]. Diageo's Guinness has an even longer history in Africa – the beverage arrived in West Africa as early as 1827, had reached South Africa by the 1860s, and in 1962 a brewery in Nigeria became the first to produce Guinness outside Great Britain and Ireland. Today Africa contributes 13% of Diageo's overall revenues and emerging markets as a whole account for a not insignificant 43%. Nevertheless, in a recent meeting with CEO Ivan Menezes he stressed that the penetration of spirits in emerging markets is lower than the penetration of other comparable consumer product categories – so there is still plenty of room to grow[8].

Years of experience in often volatile areas mean that Diageo, Heineken and Unilever all understand the necessity of continuing to invest during periods of economic weakness, enabling them to weather and even take advantage of the periodic economic crises that occur in these regions. Dismissing local competition as poor quality is of course short sighted, but in severe downturns smaller local players often lack the expertise or balance sheet firepower to handle the situation in the same way as an established multinational. Heineken, for example, has built several new breweries in Nigeria, Ethiopia and Cote d'Ivoire during recent periods of economic weakness,

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and in our meetings with Unilever and Diageo they have emphasised the importance of maintaining promotional and infrastructure investment during crisis periods. Unilever highlights the fact that its Argentinean business has grown stronger after every crisis, and Diageo contrasts the excellent results of maintaining investment in Latin America with the deleterious effect of its policy of scaling back from some Asian markets during the 1997 debacle.

Pepsico and Mondelez are two further LT holdings with meaningful emerging market exposure, at 35% and 40% of sales respectively. These companies demonstrate that the world has a growing appetite for soft drinks, salty snacks and chocolate. There is a strong correlation between income per capita and amount of money spent on impulse categories such as snacks, so income growth in emerging market regions should boost sales of these products. Branding is also of paramount importance within the snacking category: consumers in both developed and emerging markets favour familiar, branded treats, which creates strong barriers to entry and limits private label's ability to erode prices.

Another key point is that both Pepsico and Mondelez benefit from the economies of scale that derive from the ease with which their products can be globalised and adapted to local tastes. A can of Pepsi is a can of Pepsi the world over, as is a packet of crisps (borne out by Pepsi's #1 share of salty snacks in Russia and Latin America, the latter with around 60%)[9]. So Pepsico can use the same supply chain to make the basic product and then vary the flavourings, which are added at the end of the process, for each market. A bag of Walker's salt and vinegar crisps purchased at the local corner shop near our offices here in London is really much the same as a pack of Lay's Numb and Spicy Hot Pot crisps on a Chinese supermarket shelf! The packaging is also flexible, as the air in the bags allows the amount of product inside to be adjusted in line with commodity price fluctuations without having to change the size of the bags.

Mondelez's Oreos were launched in China in 1996 and have become the biggest selling biscuit in the region with a 16% overall market share[10], making it the second biggest market (after the US) for Oreos. A global $2bn brand, Oreos are as versatile as Pepsico's salty snacks because they are also easily adaptable for local markets both in terms of tailored flavourings (Green Tea Ice Cream Oreos, anyone?) and also packet size, as smaller serving sizes are the norm in much of Asia. Gum has also been a success story for Mondelez in China, achieving a 13% share of the overall gum market from virtually nothing a few years ago. Elsewhere, Cadbury (owned by Mondelez) has been in India since 1948 and today enjoys a 65% chocolate market share in the region, which has been a helpful way to introduce other Mondelez products, such as branding Oreos as "Cadbury Oreos".

Just as there exists a global appetite for sweet drinks, chocolate and salty snacks, we see a global appetite and growing demand for compelling entertainment, which is good news for our holdings Disney and WWE. It seems to us that these companies' really "must see" content shares some features with Pepsi and Mondelez's products, in the sense that the core content has universal appeal with just a few adjustments needed for local audiences. Disney has an overall low percentage of revenues from emerging markets (just 5-10%)[11] but a closer look at the theme parks reveals the extent of Disney's appeal in China: both Hong Kong and Shanghai boast Disneyland parks, with the latter having had over 5.6m visitors since its opening on the 16th June 2016. Both parks are also good examples of Disney's sensitivity in adjusting its content to local tastes: both have Chinese food offerings and Shanghai features a "Garden of the Twelve Friends" with characters such as Remy the "Ratatouille" rat and Tigger as animals of the Chinese Zodiac. The Disney channel is another powerful asset, with 108 global channels and new penetration into large markets such as Turkey, Russia and India.

WWE's two biggest markets are the US and UK and its revenues from emerging markets are still small, but India, Mexico, Brazil and even China are increasing in importance. The WWE network, a subscription-based video streaming service first launched in 2011, has now been introduced to every relevant country except China, and in all cases WWE will invest more into localisation, both in terms of language and using local stars to engage audiences. According to WWE, wrestling is India's third most popular sport (admittedly the scale is small compared to the enormously popular cricket and football) and with a total population size of 1.3bn, the prospects for expansion are good – especially as WWE are at least 20-30x bigger than their US competitor TNA. We also point to the spate of Chinese companies taking stakes in European football clubs as evidence of the country's overall growing appetite for sports content and rights. Within the last two years Chinese holding company Suning has taken a 68% stake in Inter Milan (which works out as a substantial 4.4x enterprise value to sales multiple) and a Chinese consortium has purchased almost 100% of AC Milan on a 3.7x multiple; separately, other Chinese organisations have taken a 13% stake in Manchester City and a 20% stake in Atletico Madrid.

China is also an important region for two of our Japanese names, consumer goods company Kao and cosmetics maker Shiseido. We consider the latter to be the only global luxury brand with an Asian provenance, and its impressive heritage and reputation for Japanese quality has made it the #2 high end cosmetics company in China after L'Oréal. The region is important enough for Shiseido to come up with two dedicated Chinese labels, Aupres and Urara, as well as the prestige global Shiseido brand. Kao's Merries nappy brand has been incredibly successful in China, where the growing middle classes are willing to spend more on quality Japanese made baby products. Merries is now the #1 premium nappy brand with a 30-40% market share; within the overall nappy market the same brand has a 12-13% share. As of 2016 baby nappies have an overall estimated penetration of just 60% or so in China (compare this to 90%+ in the US, Europe and Japan), so we think there is huge potential for development – and increasing premiumisation. The Chinese government's recent abolition of the one-child policy should also provide an additional boost.

The slowdown in China has challenged two of our luxury holdings, Burberry and Rémy Cointreau. In some ways the Chinese success of both brands had stemmed from the negative side of emerging markets – corruption and bribery, as well as economic growth partially prompted by unstable government initiatives – and when the former two came to an end with the state-wide anti-corruption initiative combined with currency woes, Burberry's sales

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were hit hard in the key regions of Hong Kong and mainland China, sending the share price falling from its all-time high of £18.72 in February 2015 to a low of £10.41 in June 2016. Our funds felt the pain of this but we were nevertheless happy to buy more Burberry into this weakness. Events took a similar turn at Rémy Cointreau, where the same anti-corruption push and subsequent decline in cognac consumption affected investor confidence and by early 2015 the share price fell to around €52 – the same levels as 1990 – at which point we initiated a holding. We don't expect China to return to its boom years soon, if ever, but we take the view that in the long term China's appetite for cognac hasn't disappeared entirely, and other parts of the world continue to be strong – especially the US.

Top quality branded goods companies with products that resonate globally are always of interest to us, and we consider their ability to sell into emerging markets a compelling element of their operation. To sum up, I'll leave you with the words of Unilever CEO Paul Polman, who articulates the opportunity – "80% of the population of the world will be outside the US and Europe in 30 years' time. Ask yourself, do you want to invest in a company that is well represented in the part of the world where 80% of the population could be, or not?" We do.

Madeline Wright, Portfolio Managers' Assistant - March 2017

Footnotes:
1. *Dec 1998 to Dec 2013*
2. *Bloomberg total return analysis*
3. *https://www.unilever.co.uk/about/who-we-are/about-Unilever/*
4. *Sources: Unilever and Hindustan Unilever websites (https://www.hul.co.in/about/who-we-are/our-history/)*
5. *Source: Euromonitor (http://blog.euromonitor.com/2015/10/fmcg-companies-emerging-market-slowdown.html)*
6. *Source: LT meeting with CFO, January 2016*
7. *Source: Heineken*
8. *Source: LT meeting with CEO, January 2016*
9. *Source: Pepsico CAGE presentation 2016*
10. *Source: Euromonitor*
11. *Source: Disney*

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