Global Leaders Strategy

QUARTERLY LETTER | FIRST QUARTER 2019

The Global Leaders Strategy invests in a concentrated portfolio of market-leading companies from across the globe. We believe that companies that combine exceptional outcomes for their customers with strong leadership can generate high and sustainable returns on invested capital (ROIC) which can lead to outstanding shareholder returns.

THE PRICING POWER TIGHTROPE

MICK DILLON, CFA
*Portfolio Manager,
Global Leaders Strategy*

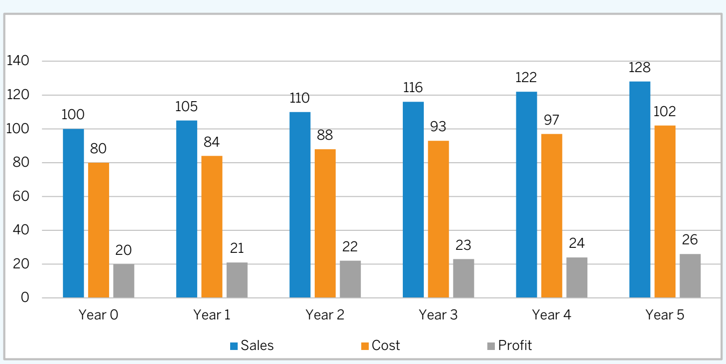
BERTIE THOMSON, CFA
*Portfolio Manager,
Global Leaders Strategy*

'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 by 10 percent, then you've got a terrible business'[1].

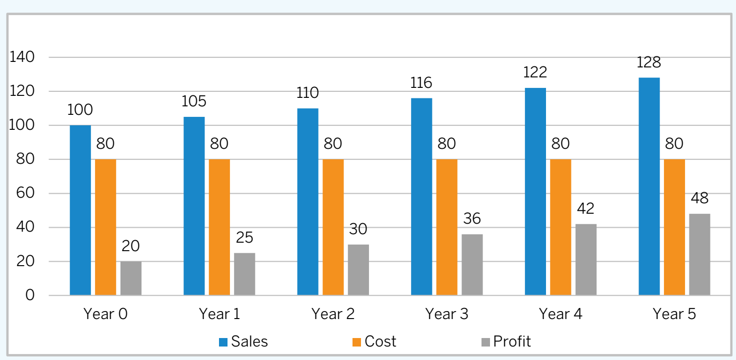
Quality in investment can be a subjective and nebulous concept. We have spent hours of our lives with different investors discussing whether certain companies are high quality or not. The reality is that investment is more art than science and defining quality can be a purely personal exercise. We have put considerable energy into thinking and refining what our conception of quality is (customer outcome, multiple economic moats and durable return profiles). Despite this effort, one of the quality investing fraternity's favourite hobby horses continues to engender much debate on the Global Leaders team. Pricing power is a concept that is lionised by many quality-focused investors, including everyone's favourite Warren Buffett. It centres on the idea that companies that have pricing power have the ability to raise the prices they charge their customers for their goods or services on a discretionary basis. In the real-world Heinz Ketchup, Marlboro cigarettes and Hermes handbags are classic examples of products that have historically exhibited pricing power.

Before we examine the thorny issue of the ethics of pricing power it is important to consider the economic benefits of discretionary pricing that excite the qualitterati. Any examination of pricing power has to include cost as part of the equation – a fact that many investors overlook. As an illustration let's consider a fictional paperclip company, Superclip, that has \$100m of sales and \$20m profit giving a 20% margin (impressive for a paperclip company). Superclip could grow its revenue by either volume (selling more clips), price (charging more for its clips) or a combination of both. In scenario 1 Superclip grows by 5% purely by volume which requires buying more steel and hiring more people to bend the clips. In scenario 2 Superclip grows by 5% purely by charging more for the same number of paperclips (pricing power). Even over a short period of time the results are quite startling. Superclip generates 184% more profit in year 5 by growing through scenario 2 (price) than through scenario 1 (pure volume) (\$48m/\$26m). In addition, the margins in scenario 1 remain flat (20%) but increase substantially in scenario 2 (from 20% to 37%) and profits grow at a compound annual growth rate of 5% vs 19%.

Superclip Scenario 1: Volume-Led Growth



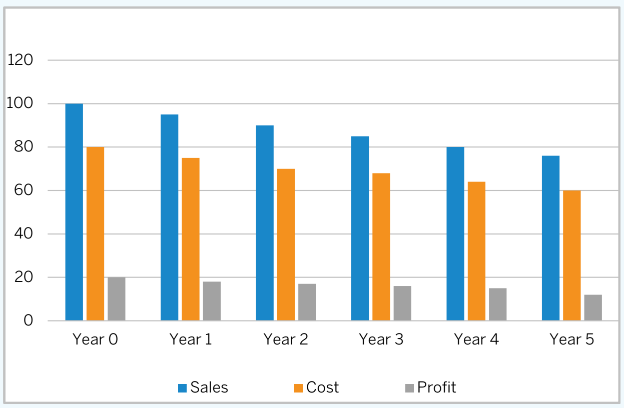
Superclip Scenario 2: Price-Led Growth



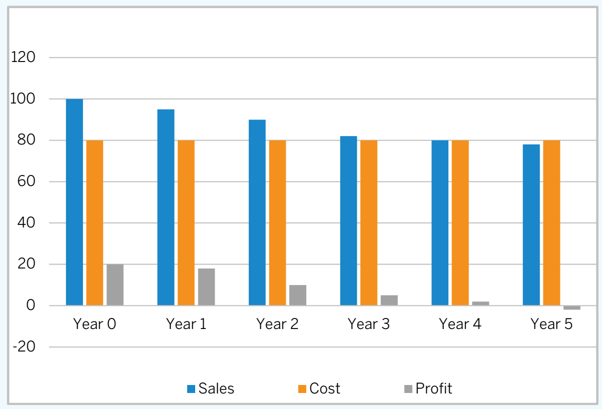
[1]Source: Warren Buffet, *Financial Crisis Inquiry Commission*, 2011.

Of course, this example is overly simplified – in the real-world volume growth rarely comes with costs that are perfectly correlated with volume. Likewise price growth rarely comes with costs that are completely fixed. What the example does show is that if a company has the ability to charge more for its products without putting in extra cost the economic benefits can be substantial. Undoubtedly this is one of the key attractions of companies with pricing power – they should be able to grow their profits and cash flow faster than revenue as long as they can grow their costs at a slower pace than revenue. In simple terms these businesses should see high margins and rising returns if their capital bases are also leverageable. All of this can be a powerful tailwind to compounding. Interestingly the converse is true for companies exposed to the opposite of pricing power, deflation, if costs reduce at a slower pace than revenue. Let's return to Superclip and consider two additional scenarios. In scenario 3 Superclip's business faces demand erosion that sees its sales decline by 5% a year as demand for its paperclips shrink. In this scenario the company buys less steel and lays off workers so that costs decline by 5%, inline with volume, resulting in a 5% decline in profits annually. In scenario 4 Superclip produces the same volume of products annually but its customers demand a 5% reduction in price annually. In this instance the company has to buy the same amount of steel and employ the same number of people to bend the steel into clips. The impact of deflation is pretty startling in scenario 4 – Superclip becomes loss-making by year 5.

Superclip Scenario 3: Volume-Led Revenue Decline (-5%)

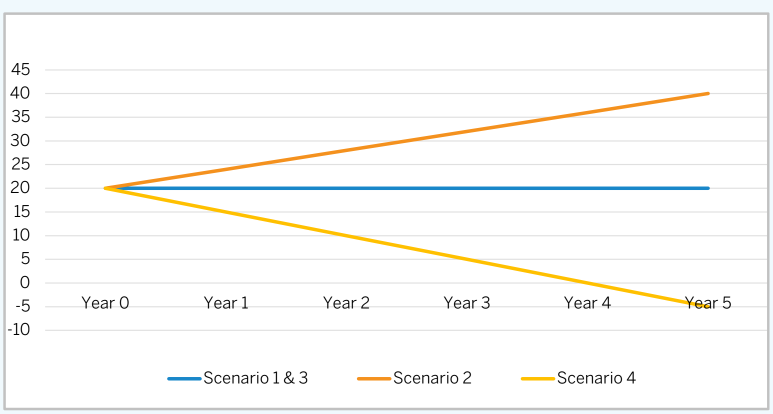


Superclip Scenario 4: Price-Led Revenue Decline (-5%)



The divergent outcomes of each four scenarios can be seen in Superclip's margins below. What might sound like small differences actually have big impacts over time. 5% pricing power (scenario 2) and 5% deflation (scenario 4) result in expanding margins at one extreme and losses at the other extreme. In scenarios 1 and 3 margins remain flat as we have assumed that all volume-based costs are variable.

Superclip Scenario 1-4 Margins



As mentioned cost and price are inextricably linked in business economics and deflation can be incredibly damaging whereas pricing power can be incredibly helpful in a world where costs (especially people) for most companies rise over time. Indeed pricing power provides some insulation against macroeconomic volatility as discretionary pricing provides a natural hedge against inflation. One important nuance here is whether a company has real (above inflation) or nominal pricing power. Conversely companies that experience regular price deflation have to continually reduce costs to protect their profits and cashflow. Most automotive component suppliers face deflationary pressure from powerful customers and are permanently on the cost reduction treadmill. There are however some businesses where absolute costs actually shrink as volume increases which can offset deflationary forces. In our experience these businesses are the exception rather than the rule but, like everything in investment, it is important to evaluate price and cost on a case by case basis.

If pricing power can be helpful for certain companies then the obvious question is – what conditions need to exist for pricing power to be possible? The godfather of strategy, Michael Porter, defines a set of conditions where customers are not sensitive to price in his seminal book '*Competitive Strategy*'.

[2]**Buyers are not sensitive to price when:**
1) The cost of the product is a small percentage of the buyer's costs.
2) The penalty for product failure is high.
3) The effectiveness of the product can yield major savings.
4) The buyer seeks a customised product.
5) The product contributes to a high quality strategy.
6) The buyer is very profitable and can pass on the cost.
7) The buyer is poorly informed.
8) The motivation of the decision maker is not just the cost of inputs.

Although written nearly forty years ago Porter's criteria still holds much truth. Indeed the last condition is one reason why luxury goods companies are able to raise prices for products made out of a commodity like cow hide in leather goods. Elsewhere the third condition is one reason why our Swedish industrial holding Atlas Copco is able to charge higher prices for its range of compressors as they are more efficient than the competitors' and yield material savings to their customers in the form of lower operating costs. Although fine in theory we would add that pricing power is also most likely to persist in industries that have benign competitive environments and barriers to entry. Even if the buyer doesn't care about pricing it doesn't mean that a new competitor won't try and disintermediate the relationship that the incumbents have with their customers in a competitive industry with negligible barriers to entry. Human beings are entrepreneurial by nature.

Porter's criteria raise another point that is at the core of any transaction – the idea of value. Commerce centres on the idea that customers transact because they see value in the goods or services they are purchasing. As many of our readers know we look for companies that deliver a superior outcome to their customers – special goods or services that foster a special relationship between the company and the customer. This relationship is built on trust – the trust on the part of the customer that they are receiving a product or service that they value. This trust is called into question when companies raise prices to the point that price overtakes value. This can result in the customer being taken advantage of and abused through price gouging as egregious management look to extract excess economic rent. This can create numerous business risks. Firstly, price gouging incentivises customers to switch to another company at the first available opportunity. In addition excessive price gouging can, in some extreme cases, actually damage the customer to the point that their finances are so depleted that they can no longer transact. Lastly the practice can attract the attention of regulators who can intervene and redress the balance. Of course we shouldn't be surprised that this practice

[2]Source: Michael Porter, *Competitive Strategy*, 1980.

exists as it is a product of one of our core emotions in business — greed. The reality is that whilst there can be short-term gain, price gouging can seriously damage the long-term health of companies. Arguably the best examples of this type of customer abuse in recent years come from the pharmaceutical industry. Notably in 2007 US drug manufacturer Mylan acquired the rights to allergy product EpiPen as part of its acquisition of Merck's generics business. Over the next seven years the company hiked the price of the product by nearly 600%. The action resulted in regulatory scrutiny, congressional hearings, a hefty fine for misclassification of the product and the eventual launch of a lower-priced generic version of EpiPen by a competitor.

As long-term investors that focus on compounded returns we would be exposing our clients to heightened risks if we invested in companies that practice predatory pricing despite the attractions of lofty near-term margins and returns. Whilst we appreciate the economic benefits of pricing power we are also acutely aware that a fine line exists between inflationary pricing power that is a tailwind to compounding and customer abuse through price gouging. Indeed latent real (above inflation) pricing power can provide significant optionality but it has to be used sparingly in a manner that respects the customer relationship. We feel that discretionary pricing can be both a negative as well as a positive force for investors – a realisation that is not always shared by other quality-focused investors. We hope that you are having a prosperous 2019 so far and that our thoughts on this topic were useful. We look forward to updating you on our progress in the next quarterly letter as the strategy enters its fifth year.

The Global Leaders Team