In The Know: Episode 71



Finding opportunities with cautious consumers? Learnings from abroad

Announcement (00:00):

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Host (00:14):

This is In the Know, a monthly investment podcast brought to you by Magellan Investment Partners.

Emma Henderson (00:20):

Another interesting debate in sportswear is I'm sure you've seen headlines of challenger brands like On Running and Hoka displacing the legacy performance sportswear brands, say like Adidas or Nike. But I think you only have to look at Adidas dominating all of the recent performance running podiums. On a longer term view, we think the market is undervaluing a very strong brand with competitive advantages that is executing incredibly well.

Host (00:46):

That's senior analyst, Emma Henderson. Welcome to In the Know. Cost of living pressures continue to weigh on consumer spending, but beneath the cautious outlook, some businesses are finding new avenues for growth. In this episode, Alan Pullen, portfolio manager for the Magellan Global Opportunities Fund, is joined by deputy portfolio manager Ryan Joyce and senior analyst Emma Henderson, who share their observations from recent company meetings and investor conferences in the US and Europe.

(01:24):

They explore where consumer demand is proving resilient, why health and wellness is becoming an increasingly important investment theme, and what recent developments in the sportswear sector reveal about the strength of established brands. They also consider how AI is changing the way consumers find and choose products. To kick things off, a welcome from your Host, Alan Pullen.

Alan Pullen (01:50):

Today I'm going to be talking to two of our analysts, Ryan Joyce and Emma Henderson, about some of their recent learnings from trips overseas. Now, we spend the majority of our time sitting in front of a computer, going through 10-Ks, going through expert reports and so on, but we occasionally let our analysts loose.

(02:08):

It is an important part of the process to actually get them over, in front, meeting companies, seeing things on the ground and eyeballing management to combine that work we do of the deep analytical work and the forecasting with a good understanding of what's happening with management, eyeballing them, making sure that we can have trust in what they're doing. So, Emma and Ryan have both been overseas recently. Emma, you've been in Europe?

Emma Henderson (02:33):

Yes, over in London and Germany.

Alan Pullen (02:35):

Nice. And Ryan?

Ryan Joyce (02:36):

I was in Boston and then New York.

Alan Pullen (02:39):

Great. So, obviously these are two experienced analysts been with us a long time. Ryan has spent plenty of time in the technology team and is currently leading our financials coverage as well as helping me look after the portfolio as deputy PM. Emma again has a good history in consumer franchises and is also looking after the industrials that we do. So, we'll touch on a few different topics today, but why don't we first talk to Emma about the consumer?

(03:07):

I think when we're looking at the portfolio, a lot of people are focused on AI trade and that's obviously been a major driver of markets over the past year or so, but we've been looking to make sure we have diversification within the portfolio. We are a bit worried about speculative activity in parts of the data center supply chain and we really need that balance within the portfolio.

(03:27):

So, consumer's going to play a really important role given the steady demand that we see there. So, what have you been seeing in some of the consumer stocks? Because we have seen a little bit of weakness from management in some stocks. What were you finding on the ground across there, Emma?

Emma Henderson (03:44):

Sure. So, I was over in London and Germany attending consumer conferences as well as meeting with various management teams from portfolio and also other consumer companies. I'd say overall, the tone on at least the near term consumer environment is still pretty cautious. Unsurprisingly, consumer confidence is weak, higher costs of living continuing to negatively impact spending and retail traffic.

(04:08):

And the other key concern I think going into next year is ramping cost inflation and how a consumer company is going to be able to offset that with price given the ongoing challenges. But I think stepping back, a key takeaway from the trip is it really isn't as all doom and gloom as these kind of headline concerns suggest. While consumers are still cautious, the employment backdrop is actually still pretty healthy. Consumer credit quality metrics are strong.

(04:33):

And I think both Ryan and I met with a lot of companies in the consumer sector that are still executing really well and delivering solid growth despite some of these challenges on the macro side.

Alan Pullen (04:43):

What are some of the key growth areas that these companies are positioning behind given there are areas of softness in the consumer, the lower end and so on, where are they pivoting to find growth in this environment?

Emma Henderson (04:56):

So, there's probably four growth thematics or areas of growth that stood out to me from this trip. They might not surprise you, but they're value, convenience, affordable indulgences and health and wellness were by far

the standout themes. Within our portfolio, I think we've got some strong exposure to relative value winners, whether that be Dollar General, which is gaining share in the current environment as middle and high income consumers trade in, has a very strong valley private label offering that's doing incredibly well.

(05:26):

We've also got Taco Bell owned by Yum! Brands, which in the US up until recently has been delivering high single digit same store sales growth, offers incredible value and has been capturing a lot of market share in this environment. Convenience has been something I think that in this environment continues to surprise the team in terms of consumer's willingness to pay for convenient products or services despite the higher cost.

(05:50):

You see that in companies like DoorDash still delivering 20% revenue growth or Walmart, which is calling out some pressures in their core consumer base, is still seeing those consumers happy to pay significantly more for 30 minutes sub three hour delivery. So, those fast deliveries in the most recent quarter are up 50%. I mentioned affordable indulgences.

(06:11):

This is a category that we're always looking for in periods of consumer softness, areas like beauty, which remain not an overly expensive price point, but we see consumers continuing to prioritize, looking after themselves. And then finally, health and wellness.

(06:33):

I think this for me was probably the most common trend that I heard across all of my meetings, whether that be consumer companies seeking to develop GLP-1 relevant offerings, protein, longevity trends, running across the board, even under these cost of living pressures, we're seeing consumers prioritize health and wellness. And we met with a bunch of companies that are really leaning into this and driving growth from those areas.

Ryan Joyce (06:57):

Maybe just to add on to that, there's a lot of talk about a K-shaped economy and the lower income, middle income consumer really struggling. I think it's quite interesting that even some of these businesses are seeing that trade down from the higher income consumers. So, while that inflation, those cost of living pressures you talked about are being felt most acutely, I think within those income bands, that choiceful behavior from the consumer is kind of broad based and across the spectrum.

(07:22):

So, the businesses that can benefit from that, like you talked about, are kind of winning at the low end from the value, but also at the mid and the high end, which is quite interesting. And I think part of that, we've seen some softness in luxury. You talked about affordable indulgences. I wonder if we're seeing a trade down from some of these higher ticket items where maybe that middle income consumer, more aspirational luxury consumer traded up for a period into luxury and now they're coming back down into this area.

(07:48):

So, really strong there. Obviously from our perspective, that raises the question, well, what next? Are those luxury companies actually becoming higher quality businesses? You had this temporary benefit from those middle income consumers coming into their customer base supporting sales, particularly through COVID. That tide's receding a little bit. I would argue that makes their earnings quality higher.

(08:08):

You've got more exposure to the high income consumer that's more resilient in challenging circumstances and potential upside should they come back into it. So, I think it's always interesting to think what's happening now, but then also what might happen down the track. Another interesting dynamic or growth driver for some of our portfolio companies I think is emerging markets as well. We're kind of talking about the US consumer here and the challenging environments there.

(08:33):

It's interesting if we go back six months ago or so when this conflict in Iran started out, higher oil prices, the consensus view was that the US would be better off from a consumer perspective. They have more oil within the US, they aren't as reliant on importing and oil is a smaller portion of their day-to-day cost because they're a richer nation.

(08:54):

But what we're actually seeing with the likes of Nestle and Unilever and Reckitt Benckiser is growth in emerging markets has been not all emerging markets, it's been a little bit market by market, but the bigger ones for them, even China where the consumer's facing challenges, but also India been doing really well, I think figuring out the playbook. You talked about looking for different areas to grow and executing.

(09:15):

These businesses do seem to be doing a very good job executing in those emerging markets to find growth.

Emma Henderson (09:23):

We just had Nestle India report delivering 20% revenue growth and not all price that you have to be careful about in emerging markets, really strong volume growth. And I think across the meetings I had, understandably, the consumer companies have become more bearish on China, but where we've really seen them lean in are places like India where incomes are rising per capita consumption of some of their consumer goods is increasing and we're getting to a point with e-commerce and fast delivery and supply chains that the timing is right for these companies to capture more growth in that market.

(09:56):

So, that's been a helpful offset for some of our consumer companies where they are seeing more sluggish demand in markets like the US and Europe.

Ryan Joyce (10:03):

And I guess just lastly, in terms of companies that we have exposure to some of those thematics that Emma talked about is Amazon actually. Obviously, they feed into that value trend, that convenience dynamic that people are putting more value on. And we're actually seeing the manufacturers, the providers of these goods go to Amazon to seek out that growth. So, we're actually seeing the likes of Estee Lauder put more of their assortment on Amazon.

(10:25):

We're seeing Nike after some meaningful challenges, which we might get to, also bringing more of their inventory onto Amazon because that's where consumers are looking for value.

Alan Pullen (10:35):

Well, a lot to unpack there. There is a lot happening and I agree. I think what's a couple of interesting observations from my perspective, we talk about emerging markets, they obviously provide additional volume growth as they continue to develop and become richer over time. And what's really interesting here is that it is now a meaningful proportion of sales for many of these businesses.

(10:55):

So, Europe is under pressure and we don't expect that to get better anytime soon, but companies like Reckitt, they're deriving the majority of their growth now from emerging markets. So, despite the fact they're listed in Europe, they trade on attractive valuation because of some of the pressures there. We're actually getting really solid underlying growth, which is a little bit masked from that pressure in Europe. So, good opportunities there. I also want to drill in on something you were talking about there.

(11:20):

You said we had recently had very strong growth in Taco Bell. We also own Chipotle, of course, in the portfolio. Something did impact that recently. So, let's get an update on that, Emma.

Emma Henderson (11:31):

Sure. So, for anyone who was fortunate enough to miss these headlines at the end of July and into August, the US had a really bad food safety season over their summer period. The cause of this outbreak was a batch of iceberg lettuce out of Mexico that was sold through restaurants like Taco Bell, which unfortunately became the ground zero for this, but actually reached over 20,000 consumers across the US through grocery stores, through hospital cafeterias.

(12:01):

And we do know from historical instances that a food safety incident is never good. It impacts traffic in the near term, but it's something we spend a lot of time engaging with companies on, understanding their risk management, and it's something that we do see typically has a near term impact. But within around 12 months, brands like Taco Bell, like Chipotle have been able to restore trust with their consumer and consumers do come back.

(12:24):

We took the opportunity this quarter to lean in to both of Yum! Brands and Chipotle on the view that the food safety scandals of the past have been quite a temporary phenomenon and have tended to provide some attractive opportunities to invest in really attractive long-term growth runways with strong brands that have had a track record of rebuilding after these kind of incidents. So, yeah, unfortunately, right up until this incident, Taco Bell had been the star performer in US restaurants, but it's in a period now of rebuilding.

(12:54):

We've seen some positive signs, but yeah, it could be a little bit noisy over the near term as they rebuild back to that growth trajectory they had pre-food safety scandal.

Alan Pullen (13:02):

Yeah, of course. And we do take a long-term view through these things. We want to take into account any potential short-term headwinds, really think could they turn into something structural? And we have seen with Chipotle before where there was in-store safety issues, but this is very much a third party supplier already kind of removed that and improved that supply chain and we expect a fairly quick rebound there.

Emma Henderson (13:24):

Yeah, I think it's actually important to note on the Chipotle side, Chipotle actually didn't stock any of this lettuce, but what we saw was broad-based fear in the market around any kind of cuisine. So, a lot of salad chains went under material pressure, even though they didn't stock this lettuce. So, actually Chipotle hadn't done anything wrong here, but it has been caught up in those headlines.

(13:44):

Unfortunately, only a few weeks after the cyclospora headlines were all over the US press, we did have a second outbreak, which was a salmonella outbreak related to jalapenos, and that was located in a couple of Chipotle stores in some states. It was a very small outbreak, but on top of some already negative headlines, we saw this perfect storm where you just see consumers at that point reset, think about where do they trust eating? Back in 2024, McDonald's had an E.

(14:10):

Coli scandal. We saw the short-term impact, but within a couple of quarters, these are very strong brands that consumers are loyal to, and that traffic does tend to come back.

Alan Pullen (14:19):

Yeah, great opportunity to get into a very high quality company. Now you mentioned health and wellness. We're all seeing this. Protein is everywhere at the moment. Now, is that an opportunity for our companies? Is it overplayed? What is your views?

Emma Henderson (14:33):

Yeah, I might let Ryan start with this. He was over in the US, and I think they tend to embrace these trends slightly different to the rest of the world.

Ryan Joyce (14:40):

I think the reminder for me going over there was just that US does things bigger. You think there's a trend that's in place. I feel Australia's relatively moderate. You go over there and it's like every single food has protein added to it and not just a little bit of protein, a lot of protein. Coca-Cola has a dairy brand called Fairlife that's called Core Power Elite. I think I know who they're targeting. It has something like 50 grams of protein in a little thing of milk. So, they're going very hard on it.

(15:10):

It's kind of this interesting dichotomy as well because you have this clean living health and wellness trend going on, which protein is part of, but then to get the protein into that food and make it still taste good, you actually need to add a whole bunch of other things. There's a few companies called Flavor and Fragrance Companies that are responsible for that. And they're doing fantastic because they're having to reformulate, add all these other things. So, it's an interesting dichotomy going on there.

Emma Henderson (15:36):

And I think on my side through restaurants coverage, I am typically quite skeptical about some of these health and wellness fads, but I do think protein relative to some other fads of the past does have some more kind of durable structural drivers behind it. We've seen chicken within QSR outgrowing the rest of the industry for a very long time. That's been a long-term trend, but it does seem to have accelerated.

(15:58):

McDonald's only in September held their latest investor day and they tried to frame up the addressable market here. So, they noted that today there's around 30 million Americans that are on GLP-1, but then you have 60 million Americans that are actively seeking to increase protein in their diet. So, I think it's no surprise that at that scale, you've really seen companies lean in.

(16:19):

In restaurants earlier this year, we saw Chipotle release its high protein menu with plenty of options for consumers to double the amount of protein in their meals in even releasing their first ever snack item, which was the high protein cup, which in all candidness is just very clever marketing for some chicken in a cup. I think also then if we look then on the sports and the fitness side, we're actually hearing very consistent messages from companies in that space as well.

(16:46):

Across multiple meetings while I was in Europe, I heard from companies from sportswear to alcohol that something the industry's grappling with at the moment is the younger consumer and different patterns of behavior, specifically that this cohort of younger consumers are increasingly finding their sense of community in places like fitness gyms instead of bars and clubs. And so, clearly that's presenting opportunities for some, but challenges for other parts of the consumer sector as well.

Alan Pullen (17:12):

Yeah. So, health and wellness, definitely a key factor going on here. And the other side of that has been alcohol. We've had a position in the portfolio that we've actually exited Diageo on concerns that these health and

wellness trends were going to be proving more structural than cyclical. And you've touched on some of those then. Ryan, what's the kind of latest on alcohol and are there some opportunities there or do we just need to avoid that space?

Ryan Joyce (17:37):

Yeah, I think it's interesting. Whenever a company goes through a little bit of a tough patch, there's always this cyclical versus structural debate that comes out and the structural debates tend to come out more for at that point in time. I think here, there's a mix of both. There are cyclical factors going on. We talked about cost of living pressures. The alcohol companies had been quite aggressive, I would say, expanding their pricing ladders and pushing pricing up, which is now a headwind for them.

(18:03):

But I also think there are some structural factors there that Emma alluded to in terms of the health and wellness and influencers doing there. But I think what for me was an interesting part is also what it means for the industry going forward and the level of competition, because we also talked about convenience as being a bit of an on trend thing, and I think that works against some of these spirit companies where people used to spend a lot of time maybe mixing up their favorite cocktail.

(18:29):

At the same time that people are now happy to pay Uber or DoorDash to have things delivered, they're kind of reaching for that ready to drink beverage, whether that's beer, wine, or maybe a ready to drink cocktail. And that's introducing new competitors into the market. So, you can have the beer companies come in and do it. You can have potentially Coca-Cola come in and do it. They've already got distribution, they've got relationship with the retailers.

(18:50):

So, I think we're going to see increased competition in that space and it also devalues the brand. So, one of the things we liked about the alcohol companies is that the brands of the spirits themselves, Johnny Walker, for example. But if you're mixing that in a ready to drink beverage, that's something a bit fun, it's marketed, it's less about the taste of that spirit or the brand of that spirit.

(19:10):

So, again, just kind of chips away at the competitive advantage at the same time that you're losing a bit of volume as well. You contrast that with beer companies. I think they're much better positioned. That non-alcoholic beer I think tastes quite good. They can push into the spirits category potentially and kind of take some share there. It was quite nice at the consumer conference where you could go to the meetings at lunch and have a non-alcoholic beer when you're meeting with Heineken. So, some interesting dynamics there.

Alan Pullen (19:37):

Yeah, it's an area we don't have exposure to at the moment in the portfolio, but historically has been very defensive. So, when markets are in trouble, beer sales have been fairly resilient historically. So, an area we're going to continue to keep an eye on to see if we can get some attractively valued exposure as long as we get confidence around these longer term growth trends. So, not yet, but we're always looking for parts of the market which have high quality companies which may be oversold at some point.

(20:06):

So, one area we are positioned in, we still quite like is sportswear. Adidas is a good size position within the portfolio. So, I think you're across there at their investor day, getting some really good insights. Emma, how's Adidas positioned at the moment?

Emma Henderson (20:21):

Sure. So, this has been a pretty interesting year for sportswear and I'd say it's been really a tale of two halves. So, you've got to recall these companies produce, I'd say two types of products. You've got performance product, which is the technical product supported by innovation, which is intended to use for running, for football, for basketball, and then you have the sports inspired lifestyle business.

(20:44):

And really, if you look at both of those businesses, they've been on a completely different trajectory this year. So, starting with the positives, I think we've seen some pretty incredible execution on the performance side. And we mentioned before, in a challenged consumer environment with cost of living pressures, there's been some remarkable growth delivered from some of these sportswear companies.

(21:04):

Adidas grew almost 40% year-on-year in its performance sport business in the most recent quarter. And yes, there's the World Cup tailwind, but you have to dig through those numbers and see that they're also delivering over 30% growth year-on-year in performance running and strong growth in other fast-growing sport categories like training, like motor sports.

(21:23):

Another interesting debate in sportswear is I'm sure you've seen headlines of challenger brands like On Running and Hoka displacing the legacy performance sportswear brands say like Adidas or Nike. But I think you only have to look at Adidas dominating all of the recent performance running podiums or to hear from them in their investor day that if you separated out Adidas's running business as a standalone business, that would be the fastest growing business in the market today.

(21:50):

And I think you missed that given some of the challenges on the fashion side, which we can touch on later. Even Nike that is experiencing severe challenges on its lifestyle fashion side, it's still delivering high single digits performance growth in a market where the consumer's under pressure. So, I think strong evidence that health and wellness and the importance of sport are still durable consumer tailwinds and that the largest brands that have got strong competitive advantages in innovation in a huge endorsement portfolio are still relevant today.

(22:20):

So, where we are seeing challenges and what has been the most material negative drag on this segment and impacting valuations has been on that fashion lifestyle side. Ryan mentioned the cyclical versus structural debates we're seeing in other categories. There's definitely an element of macro pressure here. There is a large part of the sneaker purchasing population that is low to middle income consumers.

(22:43):

So, it's not surprising that we are seeing some weakness, but I think the more important and idiosyncratic dynamic that's going on here has been a very disruptive and prolonged turnaround from Nike, which is the largest player in this category and is over two years into a turnaround where it's had a large amount of highly discounted product out in the marketplace and unfortunately with not many green shoots yet appearing.

(23:07):

So, interestingly, this is dragging down growth and it's weighing on sentiment for other brands like Adidas, like On Running that have both seen share price pressure over the last couple of months in response to this. But if you look at where the weakness is concentrated, it is really in developed markets, lifestyle, footwear. And if you look at other categories, so say apparel or say lifestyle and emerging markets, which Adidas over indexes to relative to Nike, we're seeing really strong growth there.

(23:32):

So, I was over in Germany at Adidas Investor Day for a couple of days in September, and the focus of that event was really around product strategy and execution and really highlighting that Adidas has a very broad range of products that are resonating very well with different drivers in different markets. And I really came away with

more conviction that they have a very diversified growth portfolio and they are being disciplined in this environment where Nike is discounting and causing pressure.

(24:00):

And I think they're acting in a way that is important to protecting their momentum and brand health going forward. So, overall, pluses and minuses in this sector, but if we step back, we think this is a company where the market is very focused on negative near-term headlines. And on a longer term view, we think the market is undervaluing a very strong brand with competitive advantages that is executing incredibly well.

Alan Pullen (24:25):

And they delivered really strong results in the first half of the year, off the back of the World Cup a little bit. So, I think people are expecting something of a slowdown into the second half, and that near-term concern has left the valuation really undemanding. So, what kind of near-term valuation in terms of price earnings? We're normally focused on three to five year type returns are you expecting out of Adidas?

Emma Henderson (24:48):

Yeah, so the valuation, as you said, is undemanding. We're floating around the mid to even low teens one year forward earnings multiple, which is at well below the company's history. We see over a three to five-year view, over 20% total shareholder return here. I think we have to acknowledge that in the near term, there's some risks. You still got a promotional environment, you still have a choppy consumer environment, but on a longer term view, we see a really attractive valuation.

(25:14):

And for patient investors, we see a great value creation opportunity here.

Alan Pullen (25:18):

Well, they're dominating the podiums, as you said, and that does bode well for performance running. So, one, we've got a decent sized position in given that longer term opportunity that we have. Now, we haven't talked about AI yet, which is remarkable on a investment focused podcast, but when we think about these consumer stocks and we think about, well, how might AI impact them?

(25:38):

It's really about discoverability of their products and how people take the journey from top of funnel, as we call it, into finally purchasing the product. What are you seeing AI and how it might impact some of these consumer brands like Adidas?

Emma Henderson (25:52):

I think the key learning from the trip is that this is a very rapidly changing environment that consumer companies are finding themselves in. We heard from companies across the board around the need to rapidly adapt marketing and SEO strategies to remain visible and relevant. I think one of the key learnings that companies have expressed so far is that having brand scale isn't enough in an AI world. That needs to be backed up by quality data, science and technical explanations, professional endorsements being incredible media.

(26:24):

So, we are looking for companies that are proactively investing behind this opportunity and making sure that they are relevant in this very fast-changing world. I think a good example of a consumer company tackling this well is L'Oreal. They've shared that they've set up multiple tasks for us both in the US and Europe to constantly analyze and understand where LLMs are driving their responses from, what criteria they're looking at, and how their products are ranking relative to competitors.

(26:52):

The feedback on the ground was this isn't just a weekly exercise, things are changing by the hour and how your products can present to the consumer can be completely different from one LLM to another. So, it's definitely creating a challenging environment and you're looking for companies that are being quite dynamic and addressing this head on. Similarly, when I was with Adidas in Germany, they highlighted a lot of investments in AI search and LLM discoverability.

(27:20):

On sportswear, I mentioned there's some technical innovation, so they're making sure that that is being surfaced well and that they are incredible media placements like the right running magazines, for example, so that they are being surfaced. Then the next here, which I think is the opportunity, is not only just focusing on are you visible, are you being discovered, but how can you now use AI personalization in e-commerce shopping?

(27:42):

So, I think that's something we're going to be hearing a lot more from consumer companies about going forward.

Alan Pullen (27:47):

Obviously AI is changing kind of everything for all of our companies, some more so than others. We think a lot of these consumer companies, we really like them because they're really disruption proof, the strength of their brands and so on, but they are still going to have to adapt to what's changing out their environment.

(28:02):

And the good thing about the companies we have is that they have the strength, they have the capabilities, the marketing to adapt to those changing conditions and the enduring source of their economic moat is typically not being impacted, whether that's distribution, whether that is scale, whether that is the brands that those companies operate. So, we're backing them to be able to manage this transition and still return great money to shareholders over time.

(28:28):

All right, we've heard a lot about Europe and consumer. We should really get more of Ryan on this. I feel like he's been a little bit left out. So, tell us a bit more about what you were seeing in the US. Of course, financials is leading the coverage there. What insights have you got, Ryan?

Ryan Joyce (28:43):

Yeah, I think the one notable takeaway was it really did feel like this Main Street versus Wall Street dynamic that you hear about where I started at the consumer conference. We talked about the companies being quite defensive talking about navigating that challenging environment. And then you go to the financials conference and the companies were upbeat. They're delivering strong numbers and they're optimistic about the future. And that's not super surprising.

(29:07):

We talked about credit quality remaining healthy, employment is still strong in the US. We've seen markets are healthy. I'd say there's been a healthy amount of volatility, which is also good for a lot of the financial market participants. The affluent customers that are kind of the bigger sources of revenue for the wealth businesses and things like that have been doing okay, even if being a bit more choiceful. And a lot of talk about product innovation.

(29:30):

So, things about perpetual futures, leveraged products, GPU-backed securities, which I would say makes me a little bit nervous, makes me think a little bit of the go-go times and a little bit late cycle. It'd be interesting to see what the mood is now, maybe six weeks later. We've had a few large IPOs pushed or pull. We've had interest rates move up and some question marks on these AI financing deals as well, which they've been key players in.

(29:56):

One of the things that I was looking to investigate while I was over There is the outlook for the large alternative asset managers. They've had a great, call it five years of growth. More recently, that growth has really been driven by private credit and infrastructure investment. That infrastructure investment is increasingly AI. So, I wanted to get a sense of what's going on there. The takeaways from me were that the space is becoming more competitive.

(30:21):

So, the bigger players are doing better and that's not surprising, but they've all pushed into the same space. And you're seeing the traditional banks also push into private credit as well, and you're seeing a proliferation of products there. And in one meeting, they were talking about annuities, which is kind of like private credit. Asset managers offer both private credit funds, but also annuities that they then invest in some of their private credit.

(30:41):

And these things are, the rates are adjusted hourly in the day and the distributors of those products change very quickly, which provider they're going with. So, there's very low switching costs on that new flow. And of course, these are products that pay out weekly. So, it is something where you need to keep refilling the pool. And some of the big players that are more disciplined, so they have advantages in scale and origination and other things, but they're just stepping back because they're saying it's too competitive for us.

(31:07):

We don't think we're getting the returns here that is commensurate with the risk. So, I think that was a little bit of a cause for caution from my perspective. In terms of the actual private credit flows as well, over there, there's a lot more institutional flows into those funds. They've been okay. The retail flows have been softer. There's still redemption queues. The redemption queues are starting to get a little bit lighter, but there's still people waiting.

(31:32):

And that was before we saw the rise in interest rates in September. So, we may see another step change there, which we'll be keeping an eye out for.

Alan Pullen (31:40):

Yeah, that's interesting because I mean we've previously invested in Brookfield, of course, who plays in a number of these areas, but some very high quality companies and private assets have been growing as part of investors' portfolios. And investors here in Australia have probably seen private credit offerings or private asset offerings coming to market more and more, but you're a little bit cautious in this space at the moment. Is that the takeaway?

Ryan Joyce (32:06):

Well, I think relative to future growth expectations. So, I think it's a good asset class when managed well, but you got to be realistic about your growth expectations. It's actually an interesting dynamic because we saw coming out of COVID when interest rates started going up that this asset class attracted a lot of funds because all of a sudden you could get quite good returns, fixed income rates were going up. And we're arguably in a similar period.

(32:29):

Again, I do think that people that are deploying capital well in this environment into alternative assets, unlisted assets, credit probably will do well over the medium term. The challenge the alt asset managers have is that they deployed a lot five or seven years ago and they're not getting as much liquidity out of those products because the market valuations aren't there, because interest rates have gone higher and they've leveraged up a lot of those assets.

(32:55):

So, a lot of the time, the funds that they're looking to raise are funds that they're returning to their investors and then getting reinvested, but they haven't been providing the liquidity that those customers were looking for. So, there's a bit of a challenge there in turning over some of that. They're trying to fix that through secondaries and other means, but whilst the opportunities are attractive, I'm not sure they have as much ability to go and deploy.

Alan Pullen (33:19):

Great. Now we spend a lot of our time doing deep research into stocks we don't own. As you can hear, we don't actually have any exposure to the alternative asset managers at the moment, but it is important to be constantly testing for new stocks that might make it into the portfolio. We love the positions we have. We think there's a very high quality companies, typically in that 25 to 30 positions.

(33:39):

And we only have room for another three to five companies typically every year, given we have a long holding period. We want these companies to grow over time. So, we're constantly testing a lot of companies to see where they can make it in. It's a tough team to get into, essentially is what we want this portfolio to be.

(33:57):

So, I guess one last question for each of you, on the back of these trips or research that you've been doing, what's the one company not in the portfolio that you think is most likely to interest you or one thing you'd like to push to make it into the portfolio going forward?

Ryan Joyce (34:14):

One company that is kind of high up on the watch list for me at the moment is Marsh. It's an insurance broking and consulting firm in the US. It's the largest provider of insurance broking to businesses, not to individuals. So, this is corporate insurance. They've come under some selling pressure, both higher rates or interest rates, but also a little bit of AI concerns.

(34:34):

But we've also seen a very soft insurance pricing market that higher rates means that the insurers are getting higher earnings on their investment incomes, and we've also seen relatively limited large storm losses or cat losses for the insurers. So, they're going through a depressed period of growth because of that. And I think you're getting pretty attractive valuation on pretty low growth of mid-cycle earnings.

(34:57):

So, I think if we can get confidence that they can navigate AI and turn it to its advantage and leverage their scale and invest in that area, and then you can sit patiently and wait for that insurance pricing cycle to turn, that could be a nice opportunity.

Alan Pullen (35:10):

Yeah, interesting one to call out. We've actually covered these companies for probably a decade and they've never actually made it into the portfolio in any size, but we know them well. We're waiting for our opportunity and maybe that's coming up now. Interesting because they're actually very defensive companies as well, which could be useful from a portfolio perspective. They don't actually take insurance risk as you've noted.

(35:32):

They simply are the connectors between the primary insurers and the clients. So, quite low risk companies as well. So, an interesting one. What have you got for us, Emma?

Emma Henderson (35:43):

So, mine's also in the interesting defensive bucket. One area that I'm finding really interesting at the moment, have been doing work on and met with management teams when I was away is pest services. So, typically this would be quite a boring industry, but it's unfortunately ended itself up in the AI loser bucket. And we've seen the share prices of some of the leading providers globally fall almost 30% this year.

(36:07):

So, these companies provide pest services to residential customers, also to commercial customers and provide termite services and other ancillary work. A portion of their business has ended up in the AI disruption debate. It's the new customers in residential pest services that they obtained through digital channels. These companies have provided more volatile than usual earnings results this year, and part of that has been attributed to LLMs.

(36:33):

And what we're seeing here, and I guess what it remains an open debate in the industry, are LLMs pushing pest services customers firstly either to DIY solutions rather than to the professional channel, or are we seeing LLMs preference local players over national brands using metrics such as proximity, strong local reviews or price? So, at the end of the day, these are typically been very defensive companies.

(36:59):

They have very attractive economics, recurring revenue streams, and I think this could be an interesting area for us to dig into. I think there's probably an element of some cyclical risk going on here. We tend to see consumers defer potentially a recurring pest service if it's not essential. So, that might be overemphasizing the AI risk.

(37:19):

And then similar to the consumer companies that we spoke before, I think this is a particularly dynamic environment that brands are navigating, but ultimately these companies have a lot of scale to invest behind and optimize their marketing strategies to maintain relevance in an AI world. So, if we can get conviction that this is a fixable problem rather than a structural change to the competitive structure in that market, it could be an interesting diversifier for the more despensive sleeves of our portfolio.

Alan Pullen (37:46):

Yeah, that's fascinating. My first pick for AI disruption would not have been Cockroach Services, but interesting that it has been impacted to such a high degree and really goes to that conversation we had earlier about consumer discovery and understanding the importance of how AI might impact all our companies because it might come through in somewhere that is not immediately apparent. So, thank you for that. We'll be doing more work on that sector.

(38:11):

We'll be doing more work on insurance brokers, looking for those next great opportunities to drive those long-term compounding returns. Thank you, Emma. Thank you, Ryan.

Host (38:21):

That was portfolio manager Alan Pullen in conversation with senior analyst Emma Henderson and deputy portfolio manager, Ryan Joyce. We trust you've enjoyed this episode. For more information on previous episodes, visit magellaninvestmentpartners.com/podcast where you can also sign up to receive our regular investment insights program. Thanks for listening.

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