LIONTRUST

Liontrust Global Innovation Fund: September 2022 review

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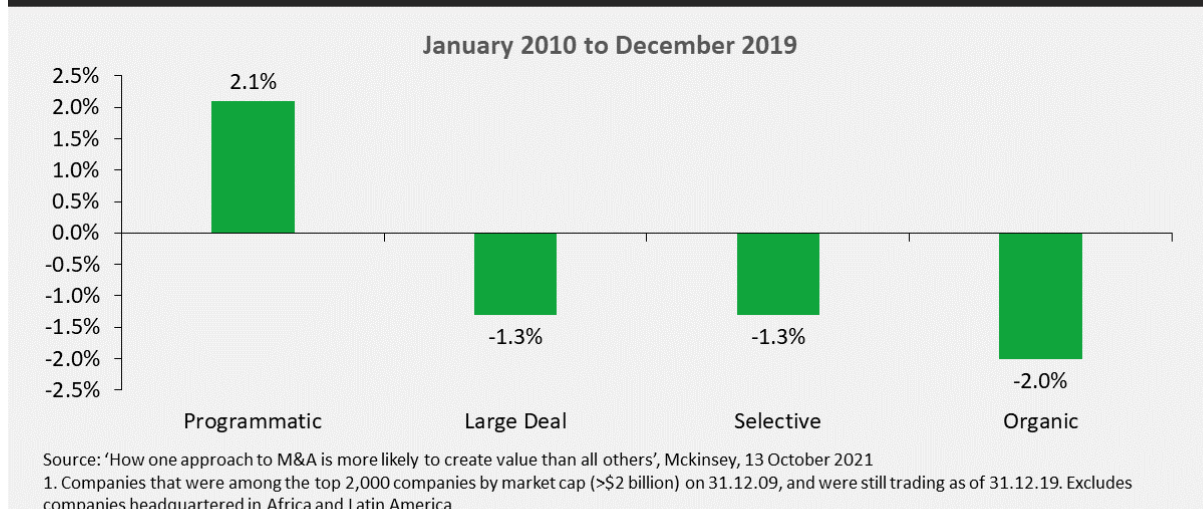
Innovation insight

As we enter a period of slowing growth and high inflation, what does this mean for companies who have M&A embedded in their strategies? Looking back at the great financial crisis of 2008 does not instill confidence: back then, the total value of transactions declined 40-60%. Nor does the fact that the majority of M&A (perhaps as much as 70% of deals) is either value neutral or value destructive, whether done during a recession or not. However, tough times always present opportunities for innovators who can take advantage of them, and we see excellent value creation potential for the most innovative serial acquirers who are masters of capital allocation.

Indeed, one certain type of acquirer was shown to outperform peers in the last recession, and indeed during the past two decades overall. Based on studying 2,000 US public companies, McKinsey has demonstrated that a particular type of M&A – programmatic M&A – is the strategy most likely to create value for companies, with programmatic acquirers outperforming peers by at least 20% in total shareholder returns since 2010. What does McKinsey mean by programmatic acquirers? They are similar to serial acquirers in that they pursue numerous small deals, but their purpose is to materially add value by building businesses. This makes them interesting for us in the Liontrust Global Innovation team, wherever such acquirers purchase and enhance the building of innovative businesses.

Global 2,000[1] excess total returns to shareholders by program type



Source: 'How one approach to M&A is more likely to create value than all others', Mckinsey, 13 October 2021
1. Companies that were among the top 2,000 companies by market cap (>$2 billion) on 31.12.09, and were still trading as of 31.12.19. Excludes companies headquartered in Africa and Latin America

As a reminder, we define innovators as companies which create customer value, whether through driving down prices or enhancing the quality of their offerings. This requires a degree of closeness with the customer, which can be challenging for a typical acquirer owning a sprawling web of operating companies, each with their own customer network. The key, therefore, is decentralisation.

Allowing operating companies the autonomy to innovate preserves entrepreneurship in business divisions, agility in catering to customer needs, and crucially allows a holding company to scale with ease, unincumbered by bureaucracy (the company essentially becomes a platform with attractive capital-light economics). A number of holdings across our two funds fit the description of decentralised programmatic acquirers – Danaher, Halma, Lifco, Diploma, Roper Technologies and Constellation Software.

These are not household names, yet we interact with them more than we may think. When we exit a shop, it is likely BEA (a Halma company) sensor technology that opens the door for you; if you visit a dentist in the Nordics, chances are that its equipment and materials are supplied by one of Lifco's dental wholesalers. The unifying theme here is niche market expertise, which creates a powerful barrier to competition. Since the growth rates and size of these niche markets are not eye-watering, this dissuades new entrants, allowing the niche market leader to retain high levels of profitability and customer retention levels. Dominant companies in such niche markets therefore have the potential to expand the whole size of the market, the hallmark of innovation.

So why are we bullish on these companies' prospects right now? Their nimble playbooks mean that capital can be deployed at ease. Small private business valuations have fallen significantly this year, and since our serial acquiring companies buy up companies for the long-term, retain management and help them build their business, selling to a Lifco or Halma is more attractive for an entrepreneur than an asset-stripping private equity house. Put simply, these companies are adept at deploying capital at attractive rates of return (shown by strong incremental returns on invested capital), and market turmoil throws opportunities their way.

Added to which, these companies operate in industries where demand is sticky, through good times and bad. Whilst Lifco's dental equipment, Halma's sensors, Danaher's life science consumables and Roper's radio frequency technologies are not the most exciting products in the world, they are deeply embedded in their customer's workflows, and/or mission critical. A high proportion of revenues are therefore recurring or highly predictable, leading these companies to exhibit defensive characteristics in recessionary conditions.

Company News

Does inflation derail innovation? The answer is absolutely not; in fact, the opposite is the case. Innovation drives down prices for customers, which, during a cost-of-living crisis such as we are currently experiencing, is a godsend for consumers.

There is no better example than Costco. Costco's deceptively simple, non-tech, business model innovations have meant that it is a cheaper option for households than even Walmart (ASDA here in the UK) or Amazon. To name just three of its innovations, focused on relentlessly lowering prices: Costco fixes its mark-up on everything it sells at 12-14%, compared with the over 20% typical for ordinary supermarkets. This is because it effectively makes its profit margin on its c.119 million annual membership subscriptions instead. The upshot for you and us as customers is that while Tesco or Sainsbury's would prefer to sell us a £10 bottle of wine for £11 if they could, Costco is perfectly aligned with its customers and would actually prefer to sell it to us for £9, grow its membership base through

better customer value and achieve even better economies of scale in the future. This is a structural driver of lower and lower prices over time.

Second, Costco essentially welcomes its members directly into its warehouses to buy in bulk, driving revenues per square foot around three times those of Walmart and over four times those of Target. Just one small but eye-opening factor behind these superior revenues per square foot is 90% lower losses from theft owing to selling only difficult to steal bulky multipack items.

Third, Costco achieves strong bargaining power with suppliers through its limited product range of fewer than 4,000 stock-keeping units in its stores compared with Walmart's c.120,000, which creates intense competition for inclusion among suppliers. So, when items become too expensive due to inflation, Costco just replaces it in the store and sells something else.

When innovation structurally lowers prices like this, it is not just a great thing for consumers, but investors too because it increases demand and market size, driving high long-term shareholder returns. Today, Costco is the second largest retailer in the world with 839 stores, continuing to expand both in the US and increasingly internationally, having grown revenues steadily at an 8% compound annual growth rate over the past two decades and consistently achieved an industry-leading return on invested capital of close to 18-20%. It has compounded shareholder value at 16.5% per year over the 36 years since its IPO in 1986.

In current turbulent times, however, with double-digit consumer price inflation we are seeing consumers rely more than ever on Costco. Indeed, we shop there regularly ourselves and have never seen it as busy as in the past few months. Its Q2 2022 results announced in September showed 38% revenue growth over the past 3 years compared with a 20% industry average. In the last quarter, 1.2 million customers upgraded to its Executive membership to access better price deals − the largest rise in a decade − and renewal rates rose to 93% in the US and 90% internationally, both all-time records.

The "Louis Vuitton of sportswear", **Lululemon Athletica** has generated c.20% compound revenue growth over the past decade and has an industry-leading 57% gross margin, driven by exceptional apparel quality and an attractive lifestyle brand built over the past 24 years on its yoga and female-first heritage.

Looking ahead, we believe the company has a big growth runway based on five drivers. First, we expect significant catch-up growth in menswear, where sales are currently about one-third of the size of womenswear but are growing at a 30% compound annual rate. The men's product range has now expanded to over 300 items, around half the breadth of the women's range, led by product innovations such as high-quality lightweight running shorts and Lulu's recent expansion into golf-wear.

Second, the company is catering for both men and women in capitalising on the major consumer shift towards casual workwear, supplying high-quality and comfortable solutions like the popular "ABC" trousers. Third, underpinned by significant consumer-led product innovation, Lulu launched its first own footwear collection this year, a major revenue generator for other sportswear companies like Nike and Adidas. Fourth, Lulu is scaling up its long-existing community of in-store and larger-scale yoga, running and other fitness events, and in doing so incorporating at-home exercise via its recently acquired Peloton alternative, Mirror. It is early days, but it is initially monetising the overall offering

through a $39 a month Lululemon Studio membership subscription. Finally, Lulu has huge scope to expand internationally, with consumer brand awareness in Europe (3%) and China (7%) currently an order of magnitude lower than in the US (25%) and its home market Canada (48%).

Lulu's Q2 2022 results announced in September were strong, underpinned both by the core part of the business, women's apparel, and the above growth drivers. It delivered an 18% beat on adjusted EPS driven by both sales and gross margins. Looking forward, we expect some potential short-term challenges from inventory build as consumer demand weakens. However, we note the likely relative resilience of spending in a recession by Lulu's high-income demographic and Lulu's high core product-component of inventories, reducing the risk of inventory falling out of fashion should it need to sit for longer than planned. As compensation for this short-term risk, at 1.7x Lulu's shares currently trade below their historical range of 2-2.5x the S&P500's forward P/E multiple.

NETFLIX

Netflix announced that it "estimates its ad-supported tier will reach 40 million viewers by late 2023". If achieved, this could have sizeable implications for the stock as it implies its new offering (to be rolled out in 2023) could boost subscribers by around 10 million in just three quarters of launching.

We learned about the company's intention to offer a cheaper ad-supported subscription in April, and it recently indicated that the cost could be as low as $7-9 a month (almost half the price of its current $15.49 plan). This is meaningful value creation for customers. The overwhelming majority of customers leaving Netflix cite the rising cost of subscription as the top reason (40%, which compares to about 20% for other reasons regarding content or competitor offerings). On the flip side, for customers thinking of joining or re-joining the platform, price reduction is consistently the number one factor driving this decision. So, there is a strong demand-led opportunity behind a lower-priced ad-supported offering.

The key question is whether Netflix can capture that value. We believe it can based on its barriers of scale, network effects and IP (content). Competition has certainly been intensifying in streaming, but Netflix has advantages stretching back to its roots in 1997, when it disrupted the DVD rental market by successfully counter-posing Blockbuster. Counter-positioning is one of the seven barriers we look for in our companies, but occurs rarely. As defined by Hamilton Helmer, it is when 'newcomers adopt a new, superior business model which incumbents do not mimic due to anticipated damage to their existing business'[1] (i.e.. cannibalisation).

Blockbuster was the incumbent in this story, and failed to respond to the competitive threat posed by Netflix's DVD postal rental offering since − as per classic disruption theory − it targeted only a consumer niche within the market. There was uncertainty as to whether a subscription service would prove to be a viable business model, added to which if Blockbuster adopted Netflix's approach, this would serve to legitimise it. What this enabled Netflix to do, having got a foothold in the market, was pioneer the first streaming service to customers in 2007. Others followed suit but lacked the pre-existing customer base of Netflix who were already used to a monthly subscription model.

[1] 7 Powers, The Foundations of Business Strategy, Hamilton Helmer

This history lesson is informative because it firstly confirms that innovation is embedded in the DNA of the company, secondly, that it has 15 years of streaming media experience (which has over time led to predictable operations and costs, in comparison to many new entrants whose streaming divisions are not profitable), and finally, that is has a large customer base built over many years. Today, four out of five Americans subscribe to Netflix. Now, the average American does subscribe to four or more streaming service... but a staggering 70% use Netflix the most (HBO is the next most used platform, but only 10% use it the most). The fact that Netflix has maintained its leadership amidst a proliferation of streaming services speaks to its ability to provide continued customer value. Customer loyalty may be fickle in streaming, but that is where Netflix's content delivery network comes into play.

The company has invested heavily in exclusive rights and originals over the past decade, spending $17bn on content in 2021 – a level we will continue to see over the coming years. Stranger Things and Squid Games are but a few examples in the rapidly growing and popular Netflix original library, but importantly this IP provides operating leverage: owned content spend is a fixed cost, so as subscriber volumes increase, the cost per user declines. $17bn is a hefty sum for competitors to match.

Since a significant majority of Netflix's current viewing is on content that does not require additional licensing negotiations for Netflix to start running ads on, an ad-supported offering should not dent the company's operating margin expansion trajectory. Nor should it diminish its unit revenues.

As such, there is potential for a meaningful revenue acceleration (over $1bn in incremental revenue by 2024) from its ad-offerings, added to which the company is clamping down on password sharing. Of Netflix's 65 million US subscribers, 20 million of these accounts are shared, implying considerable paying subscription potential.

Down 60% year-to-date and trading on a reasonable 2023 p/e of 21.7x, the market is not ascribing much value to the company's budget subscription plan, but it could be a game-changer.

Discrete years' performance (%), to previous quarter-end:**

	Sep-22	Sep-21	Sep-20	Sep-19	Sep-18
Liontrust Global Innovation C Acc GBP	-24.3%	19.5%	29.9%	2.0%	16.5%
MSCI AC World	-4.2%	22.2%	5.3%	7.3%	12.9%
IA Global	-8.9%	23.2%	7.2%	6.0%	11.6%
Quartile	4	3	1	4	1

****Source: FE Analytics as at 30.09.22. Quartile generated on 07.10.22**

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For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Investment in the Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The Fund may invest in emerging markets/soft currencies or in financial derivative instruments, both of which may have the effect of increasing volatility.

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