Liontrust Global Dividend Fund: September 2022 review

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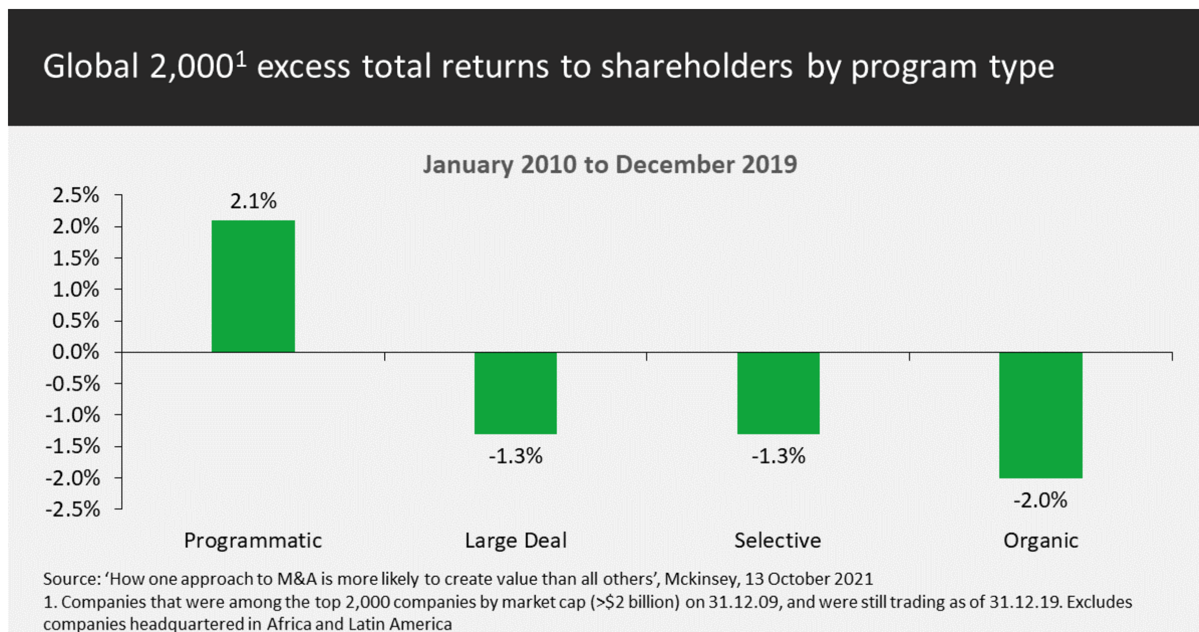
Innovation insight

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.



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.

Buys

DIPLOMA PLC

The market sell-off opened an entry point into one of the UK's highest quality compounders, **Diploma** (down c.30% year-to-date), which has an exceptional track record of creating shareholder value – compounding total shareholder returns at 27% for the past decade. Yielding under 2%, yet growing its dividend at an average of 14%a year, Diploma epitomises the type of income stocks we look for in the Global Dividend Fund.

The company distributes essential products to industrial and healthcare companies (controls, seals, consumables for life sciences and diagnostic instruments), which are typically sourced from niche manufacturers. But Diploma does not simply buy stock and distribute. Its unique customer proposition is its high-touch sales approach where products are customised for the end user, bundled together to form tailored kits, or applied with bespoke packaging. This is how the company adds customer value.

As a distributor, the company is asset light. As a customer-focused innovator, the company has high and stable profit margins underpinned by multi-year customer contracts for many of its products. As

a serial acquirer, it has proven to be a highly scalable platform (given its de-centralised model,) which still has a significant runway ahead given under penetration of key markets. Much of this acquisition-fuelled growth tends to be discounted by the market, given the complexity and uncertainty surrounding M&A forecasting. Management's strategy is all about consistency – a focus on sustaining double-digit growth with KPIS centred around high returns and cash generation. Impressive returns on invested capital (16% over the past 5 years) demonstrates the competitive barrier the company has created through its niche market strength.

Have you ever wondered what goes on behind the scenes when you order your dinner at a restaurant? World leader in professional cooking technology and new holding in the Fund, **Rational,** is on a mission to improve the efficiency of its customer base of chefs, meaning we all don't have to wait so long for our food to arrive. The company has about half of the global market share for professional ovens, achieved by an obsession with making its customers more productive through innovative solutions.

Since its invention of the first combi steamer in 1976 (which fundamentally transformed the industrial-scale food preparation process, as the devices replace around half of conventional cooking appliances), it may be surprising to learn that the Rational has only launched 9 products since. The company is not interested in producing umpteen products, preferring to 'be the Michael Schumacher of catering equipment and excel in our own area of expertise' in the former CEO's words.

Today, the company sells just five products, because it actively pursues a strategy to make its own products obsolete every seven years or so when it drives an industry-transforming innovation. In other words, this continual innovator has carried out multiple successful self-disruptions.

The most recent wave of innovation came in 2020 with the launch of iCombi (an intelligent combi steamer that can recognise the food its cooking and optimise cooking methods with pinpoint accuracy) and iVario (an intelligent cooking system). The customer benefit is enormous in terms of labour savings, efficiency and quality. Using iVario, your roast beef can be cooked 4 times faster than using conventional technology, and uses up to 40% less power consumption. At a time when energy costs are soaring and hospitality labour is thin, efficiency gains have never been more important for restaurants, hotels and canteens.

Strong customer demand was evident in an ad-hoc release from the company at the end of September, raising guidance for the year as it anticipates another record quarter in Q3. At the same time, supply chain disruptions are easing, supporting margins. With a significant untapped total addressable market (TAM) (c.4.8million potential customers for iCombi alone, with c.75% still using traditional cooking technology) and dominant market position fuelled by scale economies and process power, we see an alluring growth runway ahead for this highly cash generative global leader.

Universal Music Group, a new holding in the Fund, is the largest recorded music company in the world, providing unparalleled value for its artists through development and distribution based on its unrivalled network and resources. Discovering new artists and keeping them happy is key to dominating a market where content is everything.

Taylor Swift, Justin Bieber and Drake are but a handful of the artists whose recordings Universal Music Group (UMG) holds the rights to. The ownership of such content (over 3 million recordings) is a truly unique asset which UMG can monetise across multiple revenue fronts and for many years, and towers in comparison to peers − UMG dominates the $26bn recorded music market (a 3 player oligopoly), with 31.2% market share (c.10% above the no. 2 player). At the same time, no individual artist counts for more than 1% of UMG's revenues in any given year, ensuring UMG's ability to capture value for shareholders.

Since content is a fixed cost, this scale creates phenomenal fixed-cost leverage which the growth of streaming serves to exacerbate; unlike the sale of a CD (for which UMG would pocket c.1/3rd of the retail price on each unit sold), streaming via a platform (think Spotify) on a subscription model means that UMG generates its share of revenue every single time one of its artists get played. The richness of UMG's content catalogue is hard to overestimate – products 20 years old still account for near 20% sales today, creating a flywheel where the combination of IP ownership and scale enable further investment in future content, underpinning future revenue generation.

Its last quarterly results showed continued progress on bringing innovative monetisation initiatives to market, including an expanded platform deal with META, which builds on recent greenfield expansion efforts in areas such as social media, gaming and fitness and demonstrates UMG's ability as an innovator to create expand new markets. Ownership of song rights and sheer scale mean that bargaining power firmly lies with UMG over distribution and social media platforms, resulting in strong incremental profit generation.

Sells

To make space for these new names, we sold **Morgan Stanley** and **Rio Tinto**, which both hit our price targets, as well as **Howden Joinery Group** on exposure to the slowing UK housing market. The recent mini-budget has upended mortgage markets and has concerning implications for mortgage affordability in the years ahead. Whilst we continue to admire Howden's business model, there are better opportunities on our watchlist with more attractive upside.

Company news

Nike reported Q1 2023 earnings which sent the stock price down over 10%, mainly on concerns over inventory build. We increased our position. The 44% increase in inventories year-on-year is a short-term headwind that will dent gross margins (since discounting will be required to clear excess inventory), but the explanation is logical and rooted in the exceptional circumstances of the here-and-now – supply chain disruptions have meant delivery lead times have increased, and retailers are getting their orders in earlier before Christmas trading. Underlying customer demand is still very strong, and we think the ability to grow revenues 4% (above expectations and 10% on a currency neutral basis) is impressive given weak Chinese demand (representing c.17% of the business) following intermittent lockdowns.

Furthermore, one of the reasons management is stepping up discounting activity (which is mostly limited to apparel, less than one third of sales) is to clear inventories to make way for new product innovations around the corner. This reminds us of Nvidia's last quarterly print, which was similarly received poorly by investors, yet now as then we see little that impacts our investment case. Nike's digital customer experience is thriving: Nike digital had its highest net revenue quarter ever, growing 23%, with record app traffic and the newly launched Nike app in China becoming the number one brand shopping app. Gen Z demand in China is particularly healthy, boding well for the company's next leg of growth in which China is key.

We invest in Nike because of its industry leading approach to connecting with customers and relentless focus on product innovation. Nothing about the Nike innovation machine has broken. Consumer responses to recent innovations have been constructive and the company continues to push the boundaries of novelty – the recently launched Air Max Scorpion is the first product to be entirely created using 3D VR software, machine learning, and computational design, which allowed for just an 18-month turnaround (markedly shorter than industry norms). The biggest apparel overhaul in 30 years (the Nike Forward platform) and a refresh of its basketball line are but a couple of innovations in the pipeline.

Looking through the immediate issues of inventory, logistics and FX, the key drivers of value creation for the business are performing strongly: product innovations continue apace and direct-to-consumer ecommerce sales (which are both higher margin and more capital light) continue to grow as a portion of the business. The company is trading below pre-pandemic levels, yet its digital business – the engine of future growth − has almost tripled since 2019. We do not think the opportunity to buy the stock at 84c will come around many times again.

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.

Adobe announced it has entered into a definitive merger agreement to acquire Figma, a leading web-first collaborative design platform, for approximately $20 billion in cash and stock. The combination of Adobe and Figma is said by Adobe to "usher in a new era of collaborative creativity".

This acquisition builds out Adobe's ability to enhance its digital tools and platforms, with the company choosing to buy rather than build out an emerging market of collaborative design tools. This new toolkit enables designers to move seamlessly across interactive mobile and web applications to collaborate in real-time, its design systems are sophisticated, and this drives a rich and extensive developer ecosystem.

Why is Figma so great? Very simply, its photoshop product works across multiple screen sizes. Originally designed for a desktop computer, Adobe's Photoshop is not made to be pulled and squeezed across Android, iPhone mini, iPhone Pro, shared on teams, iPad and so on. The tool has to change,

because the problem changed, but Photoshop can't change, because so many people rely on its current format.

Figma's other great advancement over Photoshop is that the canvas is expansive and open, whereas Photoshop keeps everything constrained to a single page. These may seem trivial to us only concerned with the final result, but not to photoshop designers trying to solve a problem. These nuances reduce the switching costs of migrating from Adobe photoshop across to Figma.

Many digital creators praise Figma's real-time in-browser collaboration capabilities as being unique. While often used for UI/UX design, it can also be used to create presentations and simple docs. This versatility allows Figma to reach a much larger pool of non-creative pro users. Cross selling into Figma (collaboration) from the core Adobe product (creative work) is therefore complementary.

As part of Adobe, Figma's web-based, multi-player capabilities will accelerate the delivery of Adobe's Creative Cloud technologies on the web, making the creative process more productive and accessible to more people. Figma's total addressable market is $16.5 billion by 2025. The company is expected to add approximately $200 million in net new ARR this year, surpassing $400 million in total ARR exiting 2022, with best-in-class net dollar retention of greater than 150%.

The key details of the transaction include a deal comprised of approximately half cash and half stock and upon closing of the transaction, Dylan Field (CEO) will continue to lead the Figma team, reporting to David Wadhwani who is the president of Adobe's Digital Media business.

So, what do we think? Adobe paid an eye-watering price for a new collaborative software platform where the true value of the acquisition will not be apparent for at least three years. However, the way Figma delights customers (shown by a net retention rate above 150%) means that we prefer to back management on this acquisition, rather than be too quick to judge – just like the market did when Facebook first acquired Instagram.

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

	Sep-22	Sep-21	Sep-20	Sep-19	Sep-18
Liontrust Global Dividend C Acc GBP	-5.8%	21.2%	8.1%	15.7%	12.4%
MSCI World	-2.9%	23.5%	5.2%	7.8%	14.4%
IA Global Equity Income	-0.6%	21.6%	-3.9%	7.0%	7.0%
Quartile	4	2	1	1	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. Do remember that the value of an investment and the income generated from them can fall as well as rise and is not guaranteed, therefore, you may not get back the amount originally invested and potentially risk total loss of capital. The MSCI World Index and IA Global Equity Income sector are comparator benchmarks.

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.

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