QUARTERLY INSIGHTS FROM THE NIKKO AM GLOBAL EQUITIES TEAM

Q3 2018

Needs, wants and winning businesses

How do you react when you see blood; do you swoon or just observe with intrigue? Perhaps conditioned by a recent overdose in crime related dramas (favourites include: 'Killing Eve', 'Peaky Blinders' & 'Better Call Saul'), it was the latter outcome for me after a recent DIY debacle with a saw. I'm not sure whether being relaxed while observing a hand surgeon delving into your self-inflicted wound is a virtue, but the hospital visit was certainly an excellent reminder of the importance of having quality healthcare when required. In financial parlance this was an Economic need being played out.

Economic needs have also recently become an area of interest again within markets, as profit taking has led to quite broad-based declines. The catalysts for this shift in sentiment are both fairly obvious and widely discussed: Quantitative tightening, higher US interest rates, a stronger US dollar, trade wars and acrimonious economic divorces to name a few. With such a backdrop, the willingness to own companies that provide greater certainty due to their focus on delivering economic needs rather than wants, has started to increase.

Investors have become conditioned over previous decades to adopt such shifts in preference, with views on monetary policy often being the catalyst. But is that the right approach today? Maybe we should instead consider whether the era of ultra-low rates, the crutch that supports record levels of indebtedness in the developed world and ensured a plentiful global supply of cheap goods, is over and how this will impact all businesses. Putting the wealth distribution challenge aside, our starting point has generally been an age of plenty.

Hence the question we would consider is less the relative valuations of companies catering for needs (defensives) versus wants (cyclicals), and more the overall ongoing pedestrian rate of growth. With lower growth, profitability will become increasingly key to the delivery of future investor returns. The delivery of profits, and more specifically cashflow, is paramount but suddenly there is a confluence of headwinds. Rising energy prices, rising interest rates, higher sourcing costs resulting from trade tariff implementation, a stronger US dollar and demands from labour all being good examples. The volatility around the recent earnings season in the USA is testament to these challenges.

With the above testing the conviction of equity investors whatever their strategy, it is more important than ever to focus on the discipline behind how you select businesses rather than being influenced by the overdue burst of volatility and profit taking. For us that discipline is to invest only in companies that will attain and sustain superior returns on capital over the next five years and longer. Companies that can do this and ideally with growth drivers that are independent of the general economic cycle are what excites us.

'Cockroach' stocks that keep delivering

Rentokil is a recent addition to our portfolios and offers services no one wants to think about, given pest control is their dominant offering. Just as a hospital trip is a necessity when accidents occur, any 'visit' from unwelcome critters in the food, retail or healthcare industries requires an immediate and managed response.

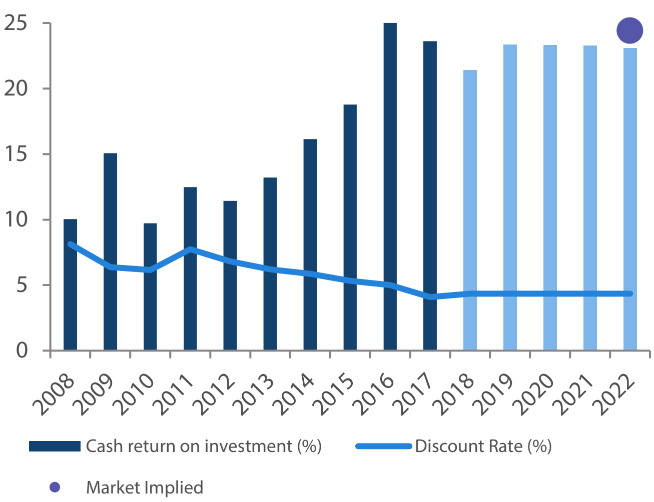
Scientists have worked out that one of the consequences of the reduction of harmful pesticides and cheap global travel, is an explosion in bed bugs. With rising global temperatures added to the mix, unfortunately for us – and not the pests - growth isn't confined to bed bugs alone. Consider the cockroach. They can run up to three miles per hour and hold their breath under water for up to 40 minutes, persistence that is best dealt with by experts. Fortunately for investors, there is a way to benefit from these trends.

In the US, which makes up over half of the global pest market, the industry is highly fragmented. However, that market is consolidating as the three largest players – Rollins (Orkin), Servicemaster (Terminix) and Rentokil – use their scale to roll up the smaller players and drive returns higher. With margins approaching 20%, relatively low capital intensity and organic growth above GDP, these are businesses with sustainable high returns.

Rentokil management focuses on client service and has achieved success using state of the art technology and creating a culture that has led to best in class employee satisfaction levels. Management has also redirected their capital & focus to the high return US business while divesting low return businesses elsewhere. A strong balance sheet and high cash flow returns means that this growth can be self-financed.

And finally they are aiming to grow their US business to a level comparable to that of Rollins today and yet Rentokil trades at half the rating of Rollins. All four of the Future Quality pillars are met and we haven't even talked about mosquitos!

Figure 1: Rentokil - Cash Return on Investment



Source: Nikko AM as at 30 September 2018

Another recent investment is Ecolab. Ecolab is all about safe food, clean water, energy production efficiency & a healthy environment. For instance, their products 'touch' 25% of the world's food supply, help clean 1 billion hotel rooms, clean 1 trillion litres of water & make safe 45% of the world's milk supply.

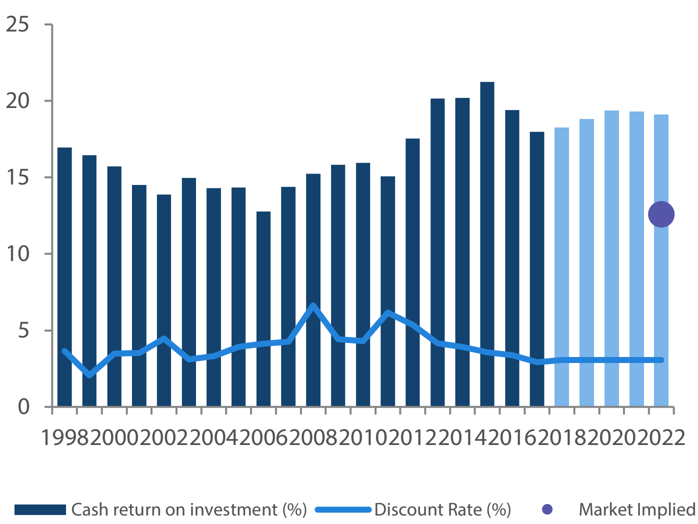
Their products and services save their clients' money and they share these cost savings, (retaining 30c of every $1 OPEX saved). This alignment of Ecolab's interests with those of their customers drives very close customer relationships and very high brand loyalty (with a client retention rate percentage in the "high 90s").

Pricing power is strong too and comes from the fact that they are only a tiny part of their customer's cost to operate but their products have a disproportionately high impact on their brand equity / license to operate. Recent food safety scandals in China speak to the need for their products in that area and think how often you would stay in a dirty hotel room or eat in a restaurant where the dishes came complete with the leftover residue of a previous diner's meal.

Another important driver of Future Quality here is Ecolab's scale advantage. Their Research & Development budget dwarfs that of smaller peers and – with 26,500 sales representatives – these new technologies have a far greater chance of finding their end customers.

With structural growth opportunities, minimal risk of disruption by new technology and a significant scale advantage, Ecolab's profits look much more future-proofed than most.

Figure 2: Ecolab - Cash Return on Investment



Source: Nikko AM as at 30 September 2018

The race to adopt the cloud has just started

Back on the subject of economic wants, investors will no doubt start to question the willingness of companies to undertake capital expenditure as uncertainty again starts to dominate decision making. The United Kingdom's shift to a laggard status globally in GDP growth terms following the prolonged Brexit uncertainty, would suggest that such concerns are indeed justified. We share these concerns and hence have been focused on finding growth drivers that are more independent of the broader economy. This has led us to the key economic need for all corporations today – upgrading technology solutions to compete in the era of the cloud.

In many ways the digitalisation of analogue assets is the new arms race. With only modest economic growth, market share is everything. Companies that embrace technology to collect more data, improve efficiency and create better solutions for customers are typically the winners. The rapid substitution of old-fashioned cash with services such as Apple pay or Wepay is a good example of these rapid shifts.

We have embraced this theme for some time, and within the area of technology this is one that we think will be persistent for many years to come and is still underestimated by investors. As this letter is being written Red Hat, a holding in the portfolio has been bid for by IBM at a significant premium. Clearly the long-term attributes of software companies enabling the growth of the cloud are sufficiently good for other technology players to pay a large premium to re-enter the race with a competitive solution.

Within portfolios this is far from the only company whose long-term growth is being driven by these trends. We would highlight Accenture as a global consultant specialising in technology implementation and Hexagon a provider of geospatial and industrial solutions to collect and manage data for a wide array of businesses. The provision of public cloud services is a key driver of growth for holdings such as Microsoft and Amazon. Several key divisions of Sony, such as CMOS sensors, music and gaming, have growth being driven by the use of sensing to digitalise the world or the use of the cloud to deliver better services.

Reflections on the journey so far

As a team we have been together since 2011 and sometimes it is worthwhile to stand back and reflect on what we have delivered for clients and how. We will leave the reader to judge the returns we have achieved, but our self-reflection is focused on how we got here and whether the journey was fun. Put simply, getting the human stuff right is **the** most important factor and whilst excelling in this area is a constant challenge there are many things we think are key to succeeding in a collective effort such as ours. As an ethos this entails believing you have no monopoly on wisdom, being willing to admit mistakes, keeping your ego in the box and embracing the collective wisdom of teams. We thank everyone from colleagues to clients who help us maintain such an environment and do what we love – finding long term winners.

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