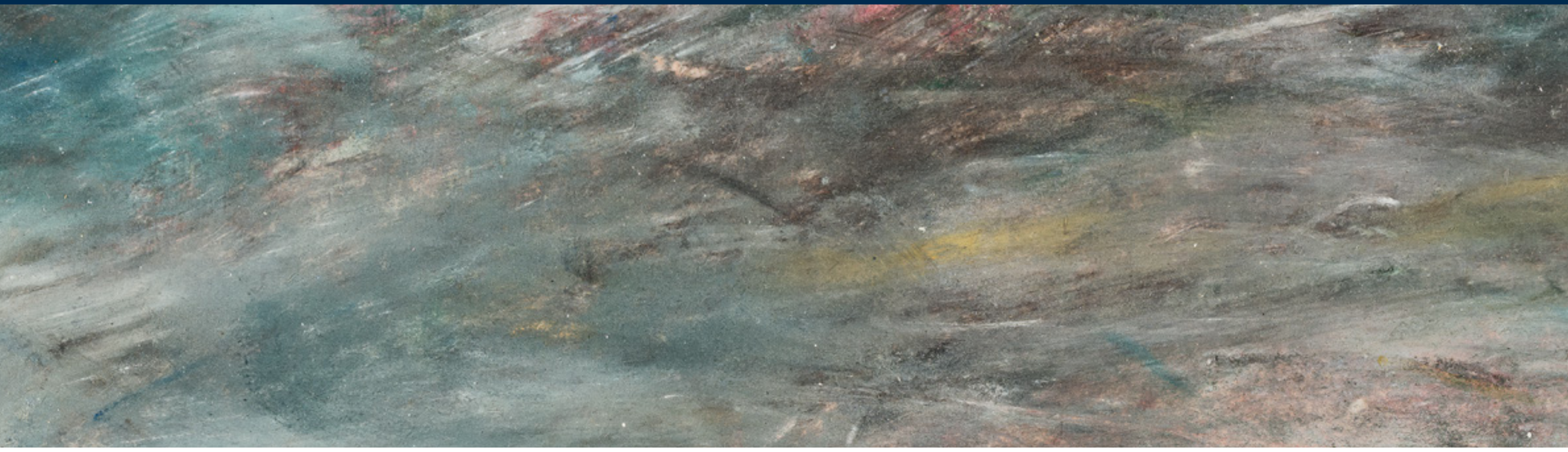

VIEWS FROM THE SOUTH

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Against the backdrop of continuing rising interest rates, banking turmoil that risked contagion and ongoing geopolitical wrangling with China, our trip to the US in late March was certainly a timely one.

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Over two weeks, we had 21 company meetings and five site visits across five states and seven cities, from Miami, Jacksonville, Atlanta and Nashville through Springfield, Missouri to Dallas and Austin. As always, meeting with companies is a vital part of our research process. On this occasion, it provided additional value in hearing from businesses and their customers as to how the current major macroeconomic factors were having an effect, if at all, so far.

INTEREST RATE JITTERS

Whilst the potential banking crisis sparked concerns in the sector globally, US markets were more jittery about the impact of interest rate rises on the domestic economy. In particular, the rapid hikes have, once again, exposed unexpected weaknesses in the US financial industry.

At the same time, supportive fiscal policies like the Chips Act and Inflation Reduction Act (IRA), designed to boost the US manufacturing industry for semiconductor chips and reduce carbon emissions, lower healthcare costs and increase tax revenues respectively, have begun to take effect.

BANK CRISIS NOT YET A CRISIS

Although the demise of Silicon Valley Bank (SVB) and Signature Bank could have serious ramifications in the sector and have captivated the media on both sides of the Atlantic, it was surprising how little it came up in our conversations with companies. Perhaps that speaks to the nature of the businesses that we were meeting, many of which were consumer facing, but, based on these conversations, it doesn't feel like a re-run of 2008.

As a firm, we have long been wary of the banking sector's levels of leverage, its operational and balance sheet opacity, increasing competition from non-traditional bank models, and its predilection for risk-taking and management missteps. That said, of course we regularly meet with banks and other businesses in the industry.

"Beyond the banking turbulence, the broader macroeconomic picture in the US is mixed"

On this trip, we visited Jack Henry Associates, which provides core banking software to small community US banks. Meeting with management at the company's headquarters in Springfield, they were fairly sanguine on the recent situation. The CEO suggested that SVB and Signature were very specific cases – badly managed banks with niche, concentrated exposures – and he does not believe this is reflective of endemic risk-taking in the wider community banking sector.

Jack Henry's customers include circa 950 commercial banks and savings institutions, and circa 700 credit unions. Its largest customers account for between 50-100bps of revenues and these banks typically have a $35 billion balance sheet (versus SVB's at $200 billion). Jack Henry believes this diversification will help to insulate it from current developments although contagion could be a possibility.

CHANGING CONSUMER HABITS

Beyond the banking turbulence, the broader macroeconomic picture in the US is mixed. The higher interest rates are yet to hit the consumer too hard. Employment remains exceptionally strong and consumer balance sheets healthy but there are signs of demand slowing from pandemic peaks. Tightening credit conditions are likely to lead to a weakening economy later in the year.

From our discussions with Dollar General, the discount grocery retailer, it's clear that customer behaviour is changing. Unlike the Global Financial Crisis, customers currently still have their jobs but people are feeling the pinch, choosing private label goods and shopping more regularly in "Value Alley", the company's one-dollar aisle (where comparable sales are up 30% year on year in the fourth quarter).

Management was keen to emphasise that, as was the case back in 2008, Dollar General would be expected to be a major beneficiary of down-trading in any deflationary environment. Long term, the company believes it can continue its long-term ambition of opening more stores. Dollar General works with surgical precision in analysing zip codes with incomes, population density and competition positioning to ensure the right locations. Growth is underpinned by white space opportunity but also broadening its offering with different formats, such as more chilled and fresh produce which attracts customers in higher income brackets too.

RETAILERS' RESILIENCE

Two other seemingly unassuming businesses with impressive customer insights and the resilience to withstand a weaker environment are O'Reilly Automotive and Tractor Supply. O'Reilly is a specialty retailer of automotive aftermarket parts, tools and equipment, with almost 6,000 stores in 47 states and 42 in Mexico. (You can read more about O'Reilly here.) Chatting with the CFO at the company's headquarters (also in Springfield), he acknowledged that, in their experience, consumer reaction to economic shocks tends to result in short-term deferrals. Whilst the end customer may delay their planned work, they quickly realise the importance and financial benefits of maintenance over buying a new vehicle.

O'Reilly's extremely strong customer-focused culture is also an advantage. Added to this, the company has a sophisticated inventory system that keeps track of customers' preferences and sales trends to get the right products where there is demand.

On our tour of an O'Reilly distribution centre, we were able to witness this competitive advantage first hand. We had a similarly positive experience visiting a Tractor Supply store in Tennessee, where we saw real examples of the company's emphasis on its culture. It is the largest retailer of farm supplies in the US, operating in 49 states. On our visit, the store manager took the time to stop and speak to numerous customers who he clearly knew well, including the owner of a pet goat, which was there for its regular shampoo session. This was definitely the most bizarre and probably memorable moment on our trip!

Talking with Tractor Supply's CEO and CFO, it was interesting to hear how market growth over the last three years has been driven by higher rates of pet ownership and rural/interstate migration. These trends have brought new customers to Tractor Supply and represent an ongoing annuity stream going forward. Hence why they are comfortable that, whilst growth will slow (relative to recent years), there shouldn't be a sudden drop off. Over the long term, they believe the market should grow at around 2% and Tractor Supply should be able to outgrow this materially, via same store sales of 4-6%.

> *"No longer is cost the single focus but diversification and security of supply are now critical"*

INTERSTATE MIGRATION

On the topic of interstate migration, we saw for ourselves how the south and south-eastern states are booming, with the appealing combination of warmer weather, lower taxes and a more business-friendly environment leading to inward relocation of people and investment. Visiting Tesla's Gigafactory in Austin was a prime example of this. The sophistication of automation in action was impressive – although there remains a meaningful amount of human interaction in the process too. Currently, Tesla employs circa 8,000 people at the site but this is expected to increase to 15,000 when the site is fully finished.

As the largest distributor of heating, ventilation and air-conditioning systems in North America, it was unsurprising to hear from Watsco that the company has seen increased air-conditioning unit sales with the migration to the Sunbelt. It's also a beneficiary of improved efficiency regulations, and now federal and state level support via the IRA, which will incentivise consumers to install more energy efficient units. Watsco has been investing through the pandemic in distribution, inventory management and price management technology which they should be able to leverage in coming years.

RE-SHORING IS FOR REAL

Probably one of the biggest talking points of the trip was, unsurprisingly, around supply chains and the re-shoring/near-shoring developments taking place in the US. Undoubtedly, supply-chain challenges brought about by Covid-19 have changed corporate mindsets. No longer is cost the single focus but diversification and security of supply are now critical. Government support in the form of the IRA and the Chips Act is incentivising businesses to make the necessary changes.

Whilst the broader trend for re-shoring will be positive for US industrial activity and manufacturing, the offset will inevitably be inflationary. Management teams know that it's not necessarily the cheapest way to design a supply chain but the improved security of supply is deemed to be worth it. Looking ahead, the spike in interest rates is evidently having a real impact and it's likely that tightening lending standards will continue, which doesn't bode well for growth generally. However, based on our discussions in the US, we returned to Edinburgh with a real sense of optimism. Regardless of the challenging environment, there are still plenty of high-quality businesses with strong brands, robust balance sheets and the ability to innovate. These businesses are not simply surviving but exploiting the current inflationary environment to their advantage.

FURTHER INSIGHTS

- *Industrial-strength culture in the Midwest*
- *O'Reilly Automotive stock story*

IMPORTANT INFORMATION

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The information provided in this article relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

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