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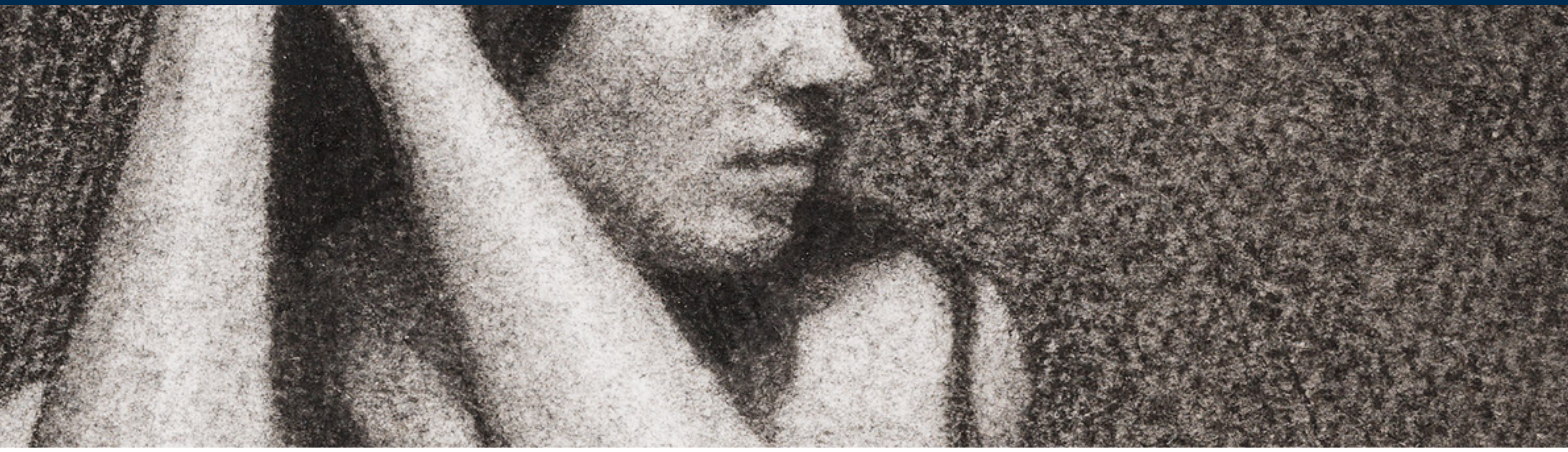

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PODCAST TRANSCRIPT

TALKING RESEARCH – Q2 2023 UPDATE

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Katie:
Hello and welcome to Talking Research. My name is Katie Boyce. I'm an investment writer at Walter Scott, and this podcast is an opportunity to hear first-hand from members of our Research team. Today I'm delighted to be joined by Alan Lander, Investment Manager and Co-Head of Research and his fellow Investment Manager, Lindsay Scott. During the course of this episode, we're going to talk about what has been a busy second quarter both for markets and Walter Scott. Then we're going to move to talk all things luxury as it's

been an extraordinary time for the sector, with LVMH the first European company to hit the $500 billion mark and Hèrmes' margins surpassing 40%. Lindsay's just back from Paris, where she met with a number of these businesses, so it'll be fascinating to get her thoughts.

But before we get into all of that, Alan, welcome! It's great to have you here given some of the recent evolution with respect to the leadership of the Research team. Now, you've been at the firm for 17 years, so perhaps you could give us some background to your career at Walter Scott.

Alan:
Thanks Katie. I'm delighted to be here today. I joined Walter Scott back in 2006 and have spent my entire career here, having joined as a research trainee. Over the course of those 17 years, I've spent time on each of the regional teams within Research and currently sit on the Asia-Pacific team. And, for the last two years, I've also been co-heading the Research team alongside Alex Torrens. He is moving to Boston later this year, heading up our North American presence and, at that point, I'll be taking on sole responsibility for heading the Research team, asking some of the more senior members of the Research team to support me in that role going forward.

Katie:
And one of those senior members of the team is also here with us today. Lindsay, hi.

Lindsay:
Hi, Katie.

Katie:
You've been at the firm for almost 20 years so a similarly long-term career.

Lindsay:
Yes, I joined in 2004. A lot of Walter Scott's Research team have come straight from university. I trained as an accountant at what was Zeneca, now AstraZeneca, and then worked in the City during the tech bubble. Much like Alan, during my time here, I've rotated around all the different geographical teams. I'm currently sitting in the EMEA team hence my trip to Paris last week to look at both companies that we've already investing in and companies that we could potentially invest in.

Katie:
Well, it's wonderful to have you both here. Thank you. Moving on, we're halfway through 2023, and it's been another interesting period for markets. Alan, perhaps you could share your thoughts on the year so far?

Alan:
It's certainly been an interesting start to the year. As always, there's plenty of macroeconomic uncertainty to contend with. If you look at Europe and the US, I think inflation has been stickier than many people expected coming into the year. And some of those core elements of inflation now appear to be well embedded. That's a bit of a headache for central banks as they try to engineer that soft landing, so to speak – taming inflation whilst not disrupting the employment picture too much or tipping the economy into recession.

In that context, it feels like interest rates are going to have to be higher for longer and, with that, the associated ramifications for consumers and for businesses. We've been seeing some of that in the US financial sector in particular over the course of the first half. And then, in Asia, we've got China emerging from Covid finally. It had that long period of lockdown in 2022 and then the big spike in Covid cases but China is now emerging and reintegrating with the global economy. That's also proving more unpredictable than many had anticipated. There was a lot of early enthusiasm about a rapid recovery there, now that's maybe starting to ebb a little bit in terms of the market dynamics.

Katie:
Despite that, markets have been moving higher. Why is that?

Alan:
From a corporate perspective, and that's certainly how we look at the world, we continue to see very robust fundamental performance certainly, with respect to the high-quality, resilient businesses in which we invest. For example, the consumer sector has been a strong driver of performance over the course of the year and fundamentals there have been holding up better than expected. I think employment remained strong. We've had good levels of household savings which have been deployed post-pandemic and the result has been that consumption has been resilient. I think the question now is whether that's going to continue or whether we've got something of a Wile E. Coyote moment here and we're already over the edge of the cliff.

Katie:
So that's markets but what's been happening with you and the team over the last few months?

Alan:
This time of the year is always busy for the Research team because a majority of the companies in which we invest have financial year ends in December so we're seeing the annual reports from those companies being released and we're going through the analysis associated with those annual reports. Then, members of the team are re-pitching those stocks in research meetings. We're discussing and debating the merits of those investments on an ongoing basis.

On top of that, this quarter, it's been a period packed with research travel. Members of the team have been to Switzerland, the US, France, Spain, Italy and, more recently, two team members went to Taiwan and China. Lindsay's been visiting a Scottish whisky distillery in the Borders and we

had one of the team down in Newcastle in northern England last week meeting Greggs the UK bakery store.

Katie:
In May, we also hosted our client conference here in Edinburgh: two and a half days, 30 speakers – company management, academics, authors, scientists. What were the highlights for you?

Alan:
I think, from my perspective, whenever we hold these client conferences, the highlight tends to be the discussions with company management. At this particular conference we had a great line-up in that regard. We had executive management presentations from companies such as Fastenal, West Pharma and WuXi Biologics, Hang Lung, LVMH, Novo Nordisk; a fantastic line-up of leadership from some really successful businesses and quite a privilege to hear from those members of management first-hand.

Katie:
And talking of LVMH, let's now turn to luxury. Lindsay, you interviewed the company's CFO at our conference, and have a lot of experience in the sector as a stock champion for a number of luxury names. You've also just returned from a week in Paris where you met with Hèrmes and Kering. Really, you couldn't be better placed to comment on the sector so, what has been happening with these businesses?

Lindsay:
Over the Covid years, it's been really interesting to watch these businesses. They've had quite strong growth throughout the pandemic for a variety of reasons. And, clearly, we had all the store closures and lockdowns, which had a big impact on the businesses, but they very quickly pivoted to their local consumers.

Jean-Jacques Guiony, the CFO of LVMH, was talking a little bit about this at the conference. In particular, he mentioned their Chinese consumers. Typically, in luxury, around a third of your sales are to the Chinese cohort but a lot of that is overseas travelling and in Europe specifically because of the price differential that you would see. However, that obviously disappeared and what they saw was really strong repatriation of that spend back into China.

Similarly, in the US and Europe, they said that they spoke to their sales assistants in all the regional stores and said, you have a list of consumers, locals, let's work with them and let's try "to clientele" a little bit (that's the language they used). It's really selling directly to your local consumers and it worked very well.

The other thing that we've seen during this period is that the strong brands have just gotten stronger. They've had more firepower to spend on appropriate marketing and that's really paid off in dividends in terms of the sales growth that we've seen.

Actually, to further that conversation, two of my colleagues have just come back from Taiwan and China. They were in Shanghai at one of the biggest malls, which is owned by Hang Lung called Plaza 66. Tom was just telling me it's actually one of the highest sales-density stores globally for a lot of these big brands and he was blown away by how busy these were. The size of Dior, Louis Vuitton, and Hèrmes stores over multiple floors and really thriving.

Currently, clearly there are a few question marks over the short-term sustainability of this luxury consumption that we've seen. There are question marks over the US spend. A lot of it has been through the stimulus money, and LVMH and Hèrmes can see that in where they're selling with a lot of it in more regional stores a lot of it is online, it's in smaller leather goods, the lower price points. There are question marks over how sustainable that will be.

At the same time, you've got travel returning. Now, we're still about 25% below 2019 levels in terms of travel spend but you've also got the Chinese, who've been in lockdown for the last couple of quarters, returning to stores. There are lots of puts and takes in the short term that we're watching out for. Tom and Des came back from their trip very optimistic about what they were seeing on the ground in China.

Katie:
And Lindsay, although your meetings in Paris around luxury were very well timed, it was part of a wider research trip, wasn't it?

Lindsay:
Yes, I travelled with Michael Scott, who is no relation of mine, and neither of us are related to Walter Scott, just for clarity, because that was a question that we got everywhere we went! Michael's ambition is to meet the whole of the CAC40 index. Therefore, he was out there for three weeks, Fiona MacRae joined him the first week, I joined him in the second week and Jamie Zegleman went out for the third week.

It was very much a typical Walter Scott research trip where you'd have four, five, six meetings in a day. You could go from Sanofi (pharmaceuticals) to Credit Agricole (bank) to Hèrmes (handbags) and then finish off in an industrial business. You've got a mix of companies to meet and discuss and get a nice picture of what's going on across different sectors. Some are companies which we invest in, some which we don't, some which are definitely potential candidates that we'll do more work on, others which are more just for background macro, but you take something from every meeting. These are mostly global businesses, and there are a lot of learnings across sectors that you can get. I think this is one of the quite unique things about the way that we exercise our philosophy, that we all travel and meet with a multitude of different companies.

We've definitely got some work to do now, some interesting meetings that we will follow up on. At the same time, some confirmation from the meeting with Hèrmes, for example, that they are still in a very strong position with their business model, the way that they make bags to demand. And it's not a sort of supply push, there's very restricted production. We had a meeting with them and a tour of one of their stores in Paris, which used to be an old swimming pool. It was a great trip.

Katie:
Alan, coming back to you, another consumer discretionary name that's been strong this year is Inditex. And you visited the company's headquarters in Spain recently for the fifth time in 11 years. How has it changed over that time?

Alan:
It's a really intriguing place. Tucked away in Galicia in the northwest corner of Spain, it's not necessarily where you'd expect to find the headquarters of one of the largest fashion retailers globally. It's certainly a long way from the catwalks of Paris. However, having been and visited the company here many times over the last decade, I'm always struck by the culture of the business and its growth mindset.

And that mindset is really evidenced when you visit by the growth of the Zara (the main brand which Inditex operates) operation. In A Coruña, the operations have just expanded for Zara over time. On every visit, there's a new building that's been added to support that growth. On this visit, there was a huge new building of 70,000m², erected during the pandemic to house the online departments for Zara. On the original trip I did here back in 2012, there was a very small corner of one of the floors devoted to online. I think it was 400m² at that point in time. And now we're talking about a building which is 70,000m² in size. So that gives you sort of an idea of the growth of the business over time. Today, about 30% of revenues come from the online business. Given the size of this building, it certainly suggests they're far from done.

Katie:
And what's been driving the performance of late?

Alan:
Well, there are lots of factors that have been driving the excellent performance of late. And to give you an idea, in the first quarter of the year, Inditex grew its sales at a 15% rate year on year in constant currencies. I think, ultimately, it comes down to differentiation versus peers. There's no doubt that today the level of differentiation between what Zara offers and what the competition is offering is as wide and as compelling as it's ever been. Historically, we've talked a lot about the differentiated business model that Inditex employs and the fact that it has that differentiated supply chain that allows the business to be more flexible and produce on-trend fashion in its stores more readily than peers. During Covid times, that business model has been more relevant than ever as other retailers have struggled with a lack of supply chain flexibility, Inditex has just had great products in store, so that's certainly been one of the factors that's been driving performance.

Another is a very proactive evolution of the store base at Inditex, and this has been ongoing over the last six or seven years. They call it their store optimisation programme. It's essentially making the store base fit for an omnichannel world. It has closed thousands of stores over the last five years or so and the stores it's been closing have been smaller stores, which were originally placed for convenience. That convenience is now afforded to customers through the online channel, so closing these smaller stores and opening fewer, larger flagship stores that offer a much more premium experience and display the products in a better light. What's more, these larger stores then have greater economies of scale and are able to support technology and infrastructure investments. Again, that further enhances the consumer experience. For example, when you go into one of these larger Zara stores, you'll likely find a robotic click-and-collect silo. You're starting to see the rollout of self-checkout kiosks, and that's all been enabled by RFID [radio frequency identity] labelling of products, which is another technology-based investment that the company has been making over recent years.

I could go on with respect to factors that differentiate Inditex today. But, suffice to say that we believe that Inditex is now in a position where it can really capitalise on its scale and differentiation over time.

Katie:
And Lindsay, Alan mentioned earlier that you had been visiting Diageo's Scottish sites. I think a whisky distillery may have featured in the tour. Perhaps you could tell us a bit about that?

Lindsay:
It was quite unusual to have a capital markets day in my hometown. Scotch is obviously incredibly important for Diageo. They are really driving the growth that we're seeing in the Scotch category as the biggest player, and they had organised a three-day trip to various parts of the business around Edinburgh.

The first place they took us was Cameron Bridge, which is just south of Leven and it's on the river. This is where they make what's called the "new make" grain whisky. It's kind of the base of all the blends and they produce two million litres a week. It's a huge industrial plant and it's a continuous process.

Then, in contrast to that, the next day they took us to a little distillery

in the Lowlands called Glenkinchie. They make 1.2 million litres a year versus two million a week – so very different. And if anyone is coming to Edinburgh, it's about an hour's drive away. I would highly recommend a trip. It's a lovely little distillery. About 10% of the volumes that they produce go into a single malt and the rest goes into Johnnie Walker blends. Again, very different, producing a malt whisky to producing the new make grain whisky. One of the things that struck me from the Diageo trip was the whole sustainability aspect of it. They call it "Society 2030". They're very conscious of the water that they're using, of making sure that their environmental footprint is as minimal as it can be, particularly given the huge expansion plans that they have for the business going forward. Even though I'm not a Scotch drinker, I learned a lot and understand how they plan to grow this business and grow the market share that they have with Johnnie Walker in particular, plus all the single malts that they have.

Katie:
And it ties in quite nicely, doesn't it, to the luxury discussion we've been having and the premiumisation of some of their brands?

Lindsay:
Absolutely, a really strong theme with the whisky is about premiumisation. For example, when you go up through the different levels of Johnnie Walker, they have a business that they call the "ghost and rare" business and this is the very premium stuff. A ghost distillery is one that shuts, so they've got whisky lying down. They blend that and make these very specific premium brands. That was all quite exciting and that's a part of their business that they're looking to do more with.

Katie:
On that note, it sounds like an appropriate point to call it a day. Alan, Lindsay, thank you both very much for your time today. And of course, to our listeners, thank you very much for tuning in. We've covered a lot, so if you've got any questions on what's been discussed, please do get in touch. Also, as Lindsay mentioned, Des and Tom were recently in Taiwan and China, and I'm looking forward to chatting to them about that trip on a future episode very soon. Thank you very much.

IMPORTANT INFORMATION

STOCK EXAMPLES

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