ASH PARK

Compounding through Consumer Staples

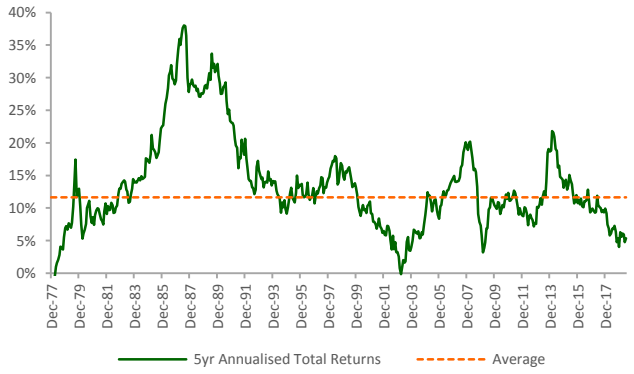
Ash Park on the perfect investment

In our three-year anniversary letter we commented that there may be an opportunity to add value through some slightly smaller companies that we had previously spent less time looking at. Two years on, we added our third smaller company ($3bn market cap) to the portfolio in the most recent quarter, and this process has been instrumental in refining what characteristics are of most importance to us as we look for investments that can challenge the quality of the current portfolio. We continue to scour the world looking for the perfect investment in the knowledge that it probably doesn't exist. If it did, it might have the long-term thinking of Lindt & Sprüngli, the ROIC profile of Estée Lauder, the growth mindset of Clorox, the gross margin focus of RB, the capacity to suffer of Brown-Forman, the capital allocation of Heineken, the ESG integration of Unilever, the diversity of Nestlé and the agility of Campari – with the valuation of BAT.

The Ash Park Global Consumer Franchise Strategy

- Concentrated portfolio of high-quality businesses . . .
- . . . seeking to sustain high returns on capital, underpinned by much-loved everyday consumer brands
- A smart way to access the EM consumer growth opportunity
- No benchmark constraint, significant liquidity
- Low turnover, minimising frictional costs
- Removes reinvestment risk and the need to find the 'hot new' investment theme
- Managed by experts in the Consumer Staples industry and backed by a global network of contacts
- Principals have at least 75% of their investible assets in the Strategy

Global Staples have never lost money in any 5yr period



Returns in US$ for Ash Park Global Consumer Staples index
Source: Ash Park, Refinitiv Datastream

Ash Park Global Consumer Franchise UCITS Fund Returns (EUR, net of all fees and expenses)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	3.5%	5.5%	6.4%	-0.4%	-3.0%	0.7%	2.2%	0.9%	0.3%				16.9%
2018	-2.1%	-6.5%	0.6%	-1.0%	0.8%	2.5%	3.4%	-1.4%	-0.2%	-1.6%	-1.4%	-7.7%	-14.1%
2017	-0.2%	8.4%	1.8%	0.0%	4.4%	-3.6%	-3.5%	-1.2%	-0.2%	1.6%	0.0%	2.7%	10.1%
2016	-0.4%	-1.2%	1.4%	0.2%	2.6%	2.6%	-0.9%	-0.7%	-0.9%	-2.2%	-3.6%	2.3%	-1.2%
2015	9.7%	5.3%	-0.1%	-1.9%	3.1%	-4.3%	6.0%	-7.9%	2.0%	8.8%	3.0%	-3.3%	20.5%
2014										4.4%	3.9%	-1.2%	7.2%

				Cumulative			Annualised		
2019 to 30th Sep	**2018**	**2017**	**2016**	**Year to 30th Sep**	**3 yrs to 30th Sep**	**Since Inception**	**Year to 30th Sep**	**3 yrs to 30th Sep**	**Since Inception**
16.9%	-14.1%	10.1%	-1.2%	4.8%	6.5%	41.1%	4.8%	2.1%	7.2%

The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not a guide to future performance.

Source: Ash Park. This table illustrates the returns of the Ash Park Global Consumer Franchise UCITS fund which launched on 14 October 2014. The Ash Park Fund returns illustrated above are the net asset value per share of GBP Class A shares of the Ash Park Global Consumer Franchise UCITS Fund translated into EUR at the relevant daily exchange rate (net of all fees and expenses, all dividends reinvested) up to 24th November 2015, and thereafter reflect the net asset value per share of EUR Class A shares. Past performance is not an indicator or guarantee of future results. The UCITS fund is not available to US investors.

Ash Park on the perfect investment

What is the perfect Ash Park investment?

"Gentlemen, we are going to relentlessly chase perfection, knowing full well we will not catch it, because nothing is perfect. But we are going to relentlessly chase it, because in the process we will catch excellence. I am not remotely interested in just being good." Vince Lombardi.

Figure 1: Vince Lombardi

Source: Medium

In previous letters we have talked about many of the characteristics we look for in investments, but usually within the context of a wider theme. As our Strategy turns five years old, we thought it would be an opportune moment to talk more about how we apply these ideas to our portfolio.

Zeroing in on high-return businesses

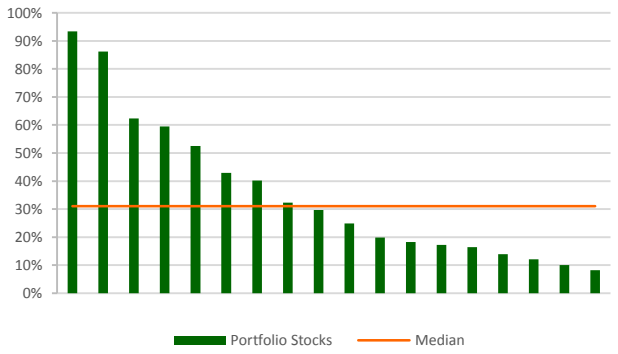
In a 1994 speech Charlie Munger pointed out that "*Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return – even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result*". [1]

We whole-heartedly agree with Mr.Munger – owning companies with high underlying returns on capital is key to long-term investing success. Our portfolio companies have a median ROIC, excluding goodwill and brand assets[2], of 31% - probably around twice that of the broader equity market.

At this point, many discussions of investment philosophies contain in-depth explanation of 'moats' and 'flywheels' in an effort to find those businesses with the sustainable competitive advantage which will enable them to maintain those high returns over the next few decades. We believe that we have made our job simpler. In choosing to invest in high-quality branded Consumer Staples companies, we are picking companies which:

- Are easy to understand – these are products we all use each day;
- Are demonstrably long-lived – many of the largest companies have been around for a century or more;
- Produce products for which there is constant and steady consumer demand – people will always need to eat, drink, wash and beautify themselves; and
- Own brands which enable them to sell everyday, ordinary products at prices which generate good margins, and produce returns on invested capital which are well above the cost of that capital.

Figure 2: ROIC (ex-goodwill) for the Ash Park Portfolio



Excludes two businesses, Imperial Brands and RB, with ROICs well in excess of 100%
Source: Ash Park, company data

Culture eats strategy for breakfast

With around 100 years of collective experience following the Consumer sector, the four of us now have a very clear idea of what we are looking for from Staples companies. We believe that 90%+ of the attractiveness of the industry can be summed up by the graphic in Figure 3 – our version of a relatively common 'virtuous circle of growth'. Strong brands deliver revenue growth, which allows gross margin to expand (fixed cost leverage and/or mix), giving capacity to both reinvest (marketing, R&D, distribution) into additional top-line opportunities but also to modestly expand operating margins.

When companies have the culture and patience to deliver this steady compounding of sustainable growth, the long-term gains can be enormous, even if the headline figures in any one year look unexciting. That's exemplified by Lindt & Sprüngli, whose shares have compounded US$ total returns at 14.8% pa for 46¾ years, that is a 634-fold return (Figure 4).

[1] *A lesson on Elementary, Worldy Wisdom As It Relates to Investment Management & Business* – Charlie Munger, USC Business School, 1994

[2] We regard this as the best measure of underlying returns, otherwise the ROIC of a company will largely be driven by how many acquisitions it has done.

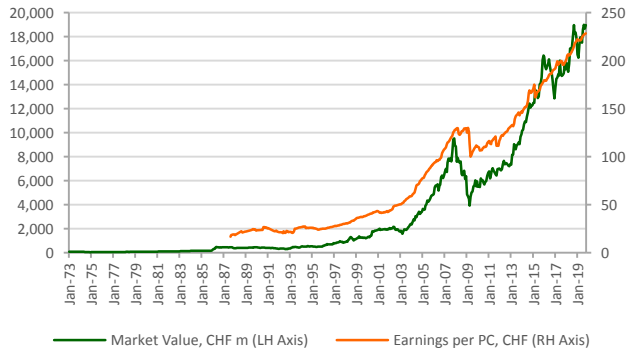
Figure 3: Ash Park's virtuous circle of growth

Source: Ash Park

When this process goes into reverse it can be costly and time-consuming to escape. Jim Kilts, the former CEO of Gillette, called the process of a sales shortfall and ensuing brand support cuts the 'Circle of Doom'[3].

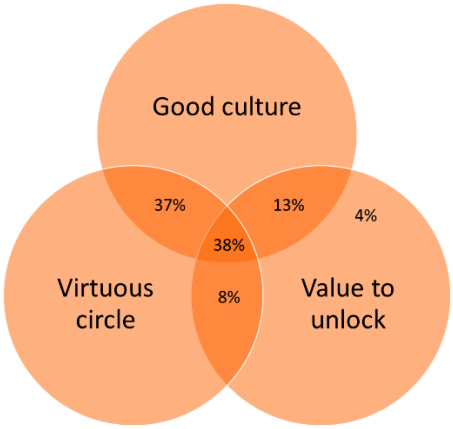
If a company is in the virtuous circle of growth and has the sort of culture to avoid looking for short-cuts or to pull the various levers of growth too hard, it is likely to be a candidate for the Ash Park portfolio. Indeed, 83% of the current Ash Park portfolio (Figure 5) is currently in the virtuous circle of growth (the 17% that isn't, is temporary in our view) and has what we would deem a good culture. Of that 83%, about one half also has what we refer to as additional 'value to unlock' beyond the compounding of long-term growth, either in the form of unnecessarily low margins, M&A optionality, or an exceptionally depressed valuation.

Figure 4: Lindt & Sprüngli – decades of steady compounding



Source: Ash Park, Refinitiv Datastream, in CHF

Figure 5: The Ash Park portfolio make up



Source: Ash Park

With that as a base, we have set out ten (non-exhaustive) characteristics that we look for in potential investments, many of which overlap and intertwine with both the virtuous circle and a good culture:

- Volume and mix-led sales growth
- Ability to grow in 'ex-growth' markets
- Gross margin focus
- Capacity to suffer
- Long-term thinking
- Integrated approach to ESG factors
- Agility and entrepreneurship
- Diversity of country and category exposure
- Effective capital allocation
- Valuation

We discuss each of them briefly below.

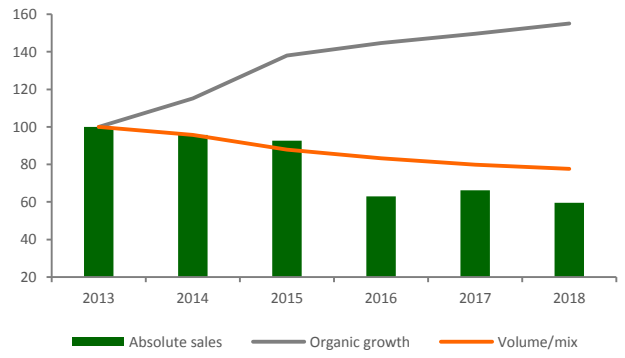
1. Volume and mix-led sales growth

You can't cut costs forever, nor is it viable for companies to raise prices above the rate of inflation indefinitely. Our research has highlighted that the only route to sustainable, real growth for Consumer Staples companies is through growing volume and improving product mix – 'selling more, and better, stuff'.

We know that the attractive margins and ROICs of high-quality Staples businesses are driven by strong pricing power, itself underpinned by brand and franchise values. But the pricing power is 'static': consumers will pay a lot more for a good brand compared to the generic alternative, but they won't pay an ever-increasing premium, and attempting to make them do so incurs the risk of catastrophic market share loss to a competitor. Outside Tobacco, no Staples brand, categories or companies can sustainably price above local inflation for any meaningful period of time.

[3] *Doing What Matters* – Jim Kilts, 2007

Figure 6: Mondelez's LatAm absolute and organic sales

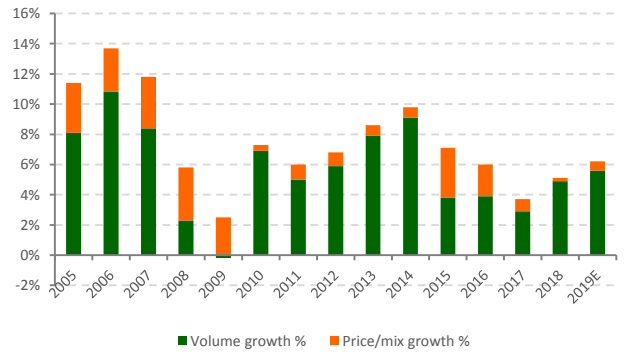


Indexed to 2013
Source: Ash Park, company reports

Any pricing 'growth' from emerging markets will also tend to be offset by the foreign exchange depreciation when translated back into a hard currency. Take Mondelez[4] in Latin America over the last five years: under the standard definition of 'organic growth', sales have risen by over 50%. However, shareholders whose dividends are paid in dollars will be more concerned that absolute USD sales almost halved over the same period. All of the organic growth was driven by 'illusory' pricing – volume/mix declined by almost 25%, a much better guide to the absolute sales performance.

So real, sustainable sales growth has to come from volume (as exemplified by Lindt & Sprüngli, figure 7) and mix. In emerging markets this opportunity is easy to see, because there is significant scope to grow per-capita consumption on both a volume and a value basis. We estimate that, on average, EM consumption in Staples categories is around one-third of the Developed Market level when measured by volume, and only 10% by value.

Figure 7: Lindt & Sprüngli organic sales growth breakdown

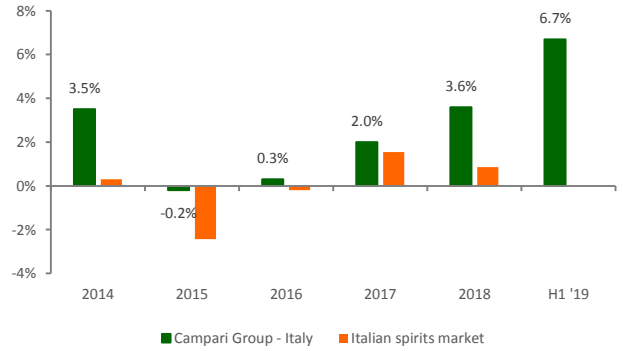


Source: Ash Park, company reports

2. Ability to grow in 'ex-growth' markets

What about markets where the per-capita consumption opportunity is not so obvious? With the right mindset, it is still possible to generate growth, even for brands that have been around for a long time. Figure 8 shows the organic sales growth of Campari in Italy over the past five and a half years. Driven largely by the 100-year old *Aperol* and 150-year old *Campari* brands, Campari has delivered accelerating annual sales growth for over three years, to an impressive 6.7% in the first half of 2019 – not bad given that the Italian spirits market has not really grown over the same period.

Figure 8: Campari group Italian sales growth



Source: Ash Park, company reports

Market share gains are one source of volume growth, but while we always prefer the businesses we own to be holding or gaining market share, there is a natural ceiling to this as a source of long-term sales growth. You can't get over 100% market share, and realistically the limit is likely to be a lot lower than this because consumers – and retailers – like variety and choice.

Sooner or later you need to help grow the categories in which you are operating. In mature markets which are often written-off as 'ex-growth', great companies can differentiate themselves by refusing to accept defeat when it comes to delivering growth.

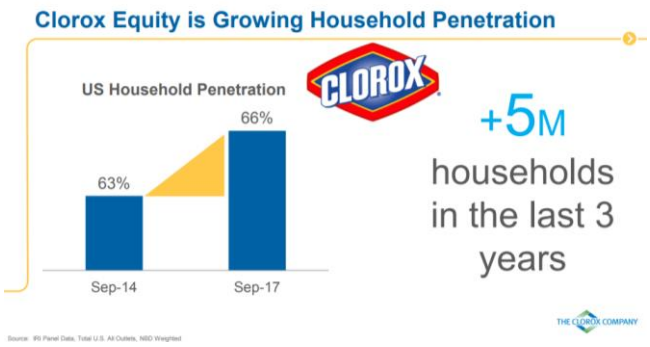
A key Ash Park mantra[5] is that there is no such thing as a good or bad Staples category, just good or bad category leaders. We sometimes joke that the Clorox company is proof: who would think that a collection of bleach, trash bags, charcoal, salad dressing and cat litter could deliver 3-4% annual organic, hard-currency sales growth?

Clorox's eponymous bleach brand is a great example of the refusal to accept that there is no growth available. Between 2014 and 2017, the *Clorox* brand increased its household penetration from 63% to 66%, which equates to 1.5% pa volume growth (which is already impressive for a mature category). Add in the fact that the number of US households increased by 0.8% pa over the same period, and that the company probably took a modest amount of pricing (sub-inflation), and you end up with a very respectable 3% annual sales growth in dollars.

[4] Perhaps quite an extreme example, but Mondelez is by no means unique in this regard.

[5] Maybe verging on dogma.

Figure 9: Clorox focuses on household penetration

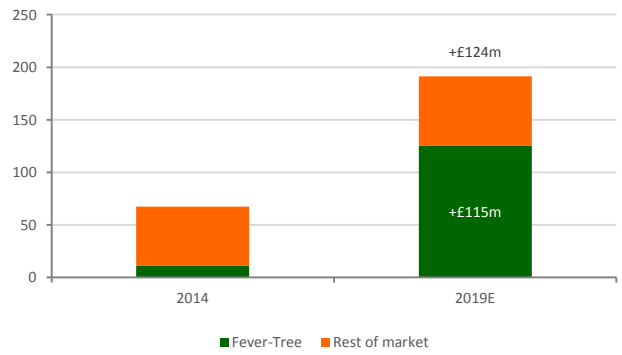


Source: Company reports

There isn't anything magic about these situations – just a strong focus on innovation and marketing by companies who refuse to accept the status quo. At a category level, veggie ('plant-based') burgers, tonic water and even 'milk' (particularly the non-dairy variety) are great current examples of 'ex-growth' categories that are currently being transformed by such investment.

One of these – tonic water – is where a recent portfolio addition has been operating with great success. Fever-Tree's total UK off-trade sales have grown from £11m to almost £150m in the last 5 years, helping to drive the value of the category from less than £70m to almost £200m. As well as encouraging existing consumers to trade up to a better product, it has also increased household penetration by half, from 25% to 37%.

Figure 10: UK off-trade tonic water: the Fever-Tree impact



Source: Ash Park estimates

A common attribute of many of the faster-growing Staples categories is competition. We prefer to turn Peter Lynch's line *"competition is never as healthy as total domination"*[6] on its head: that might be true in 'lousy industries', but we generally regard competition as healthy in Staples. The investment in marketing and innovation that other companies bring can help stimulate consumer interest in a category and accelerates growth; monopolies in this industry are vulnerable to taking their consumers for granted and, at some point, a major competitive incursion when the conditions that support the monopoly break down.

We typically dislike the idea of companies selling 'ex-growth' businesses ('a bad workman blames his tools'); usually an admittance of defeat, the prices received tend to be low due to the low-growth nature of the asset being sold, and as such tend to be dilutive to the selling company (and can be highly value-creative for the acquirer).

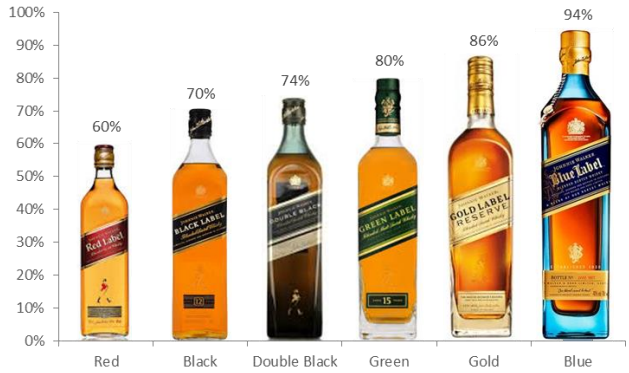
3. Gross margin focus

If the volume part of sustainable sales growth is easy to understand, 'mix' is perhaps a less-appreciated element of the virtuous circle of growth, tieing-in directly to gross margin progression. In the absence of unusually large (and probably unsustainable) rates of top-line growth, a rising gross margin is vital to sustain attractive levels of profit growth, as well as generate funds to spend on marketing and innovation to drive future sales progress.

Good businesses are always looking for ways to reduce packaging costs or supply chain complexity, but the best way to create long-term gross margin improvement is through mix, or what is known in the industry as 'premiumisation' – persuading consumers to pay a little more for a product as a result of some new benefit.

Premiumisation can come in many forms, including things like packaging mix (glass bottles of *Coca-Cola* are more expensive than PET or aluminium cans) or channel mix (hair colourants are more expensive in salons than in supermarkets), but if you can trade consumers up to a product that is a higher price per unit, the extra price more than makes up for any increase in cost of goods sold.

Figure 11: Gross margins in the Johnnie Walker price ladder



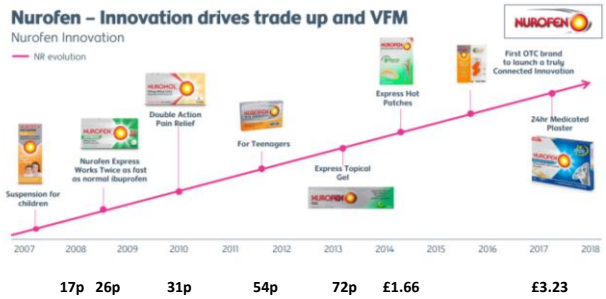
Source: Ash Park estimates

Good examples of this include *Johnnie Walker* whisky, whose price ladder stretches from *Red Label* (c.$25/bottle), though *Black* ($43), *Double Black* ($50), *Green* ($60), *Gold* ($70) and *Blue* ($230)[7]. Great marketing persuades consumers to pay more for the real and perceived benefits of the higher-priced products.

[6] From *Beating the Street* – Peter Lynch, 1994

[7] Prices taken from North Carolina state control price list, August 2019

Figure 12: *Nurofen* innovation drives gross margin expansion



Price per dose shown along x-axis
Source: RB

RB's basic *Nurofen* ibuprofen painkiller cost 17p per dose in the UK 10 years ago, but consumers now have the choice of all kinds of other variants: *Nurofen Express* (works twice as fast) at 26p per dose; a 54p-per-dose version for children/teenagers which is self-dissolving (no need for water); and, at the top end, the recently-launched 24-hour medicated plasters, which work out at £3.23 per dose for (Figure 12). As the company said at its 2018 full year results, "*this is how RB has been growing its categories for years, and we've honed and sharpened it and built these drivers of gross margin into our DNA . . . higher gross margins lead us to the ability to invest higher amounts into capabilities and brands*".[8]

4. Capacity to suffer

A lot of investment dialogue focuses on 'efficiency', 'cost obsession' and an 'ownership culture' as desirable attributes for portfolio companies. We like efficiency too, and an obsession with keeping costs down is probably vital in lots of inherently low-return industries – otherwise the business sinks. But in high-return Consumer Staples companies, which are already generating attractive margins and returns on capital, there is a balance to be struck between profit and the future health of the business.

We would rather invest in companies where margins are not as high as they might otherwise be because of investments expected to produce returns that might not pay off for some years. We would like our portfolio companies to generate superior long-term earnings growth, and we are less concerned with that growth progress being 'smooth'.

Distiller Brown-Forman has regularly demonstrated this 'capacity to suffer'. Here's former CEO Paul Varga explaining the company's approach in a 2016 conference call:

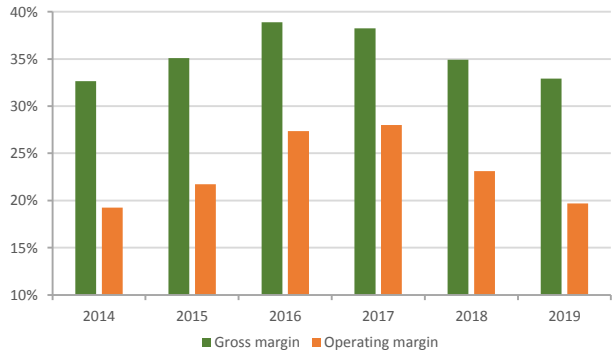
"*Looking back over the last 20 years, we have periodically taken actions or made investments that tempered near-term earnings in favor of sustaining or accelerating the Company's growth over the long term . . . two good examples of this would be our strong globalization push in the early 1990s, and the launch of the* Woodford Reserve *brand and distillery a couple of years later. In the mid-2000s, further examples were the sale of our consumer durables business, followed by the acquisitions of* Chambord *and* Casa Herradura."[9]

More recently the company has invested in further capacity increases, placed substantial investment behind single malt Scotch whisky brands and, most visibly, mitigated the consumer impact of tariffs:

"*. . . we decided to invest behind the continued momentum of our brands, absorbing much of the short-term tariff costs through delayed price increases. This helps our consumers maintain the affordability of our products against a competitive set that is not subject to these tariffs* [note: Scotch]. *While this creates some short-term pressure on gross margins, we believe it's the right strategic move to make during a period of uncertainty.*"[10]

We have written before about the shortcomings of the 3G approach to branded consumer goods, and the recent troubles at Kraft Heinz show what can happen to under-invested businesses which have pushed margins too hard. Operating margins rose by almost 900bps post the merger, but will now have fallen by the same amount over the last two years. Despite that, sales are still falling and operating profit will be lower this year than it was five years ago (on a pro-forma basis). Net debt is also higher, despite the recent dividend cut.

Figure 13: Kraft Heinz margin progression



Source: Ash Park, company data

5. Long-term thinking

Another Brown-Forman line which sticks in our minds is: "*We continue to have regular strategy conversations. One of the more recent ones I had probably three or four weeks ago, we were heavily focused on 2035*" [our emphasis].[11]

One of the most important ideas underpinning our strategy is that of longevity: if properly handled, consumer brands should be able to last for generations – and thus sustain their competitive advantage and the superior returns that brings. In our view, the market often underestimates the durability of supernormal returns, thus structurally undervaluing these companies.

[8] RB Full Year 2018 Results Presentation, 18th February 2019
[9] Brown-Forman Q2 2017 earning call, 7th December 2016
[10] Former Chairman & CEO Paul Varga, speaking on the company's Q1 earnings call, 12th September 2018
[11] Paul Varga, Q3 earnings call, 5th March 2014

That's one of the reasons why we prefer the notion of stewardship rather than ownership when it comes to management's role. If you are the team responsible for brands that have been around for a very long time, your job ought to be that of a custodian seeking to protect them so that they survive the next 50 or 100 years.

That's a little bit different to the popular concept of creating an ownership culture, which we have seen mis-applied. Offering employees large financial incentives for success can create perverse incentives and lead to a vicious cycle in difficult times, as disillusioned employees leave. Former Unilever CEO Paul Polman summed up the issues nicely in an interview with Forbes in July 2015:

"A lot of companies are driven by the short-termism of the markets. [They] make short-term decisions that often go against the long-term viability of the company. Before I came, we were making a lot of short-term decisions to make the quarterly numbers, [and these decisions were] actually driving the company, over time, downwards.

It's very easy to show more profits, if that's what you want, by cutting investments in training and development of your people or your IT systems. And you can do that for a few years but in the long term, you erode your company. So what I said when I came here is I need to create this environment for the company to make the right longer-term decisions. So we stopped giving guidance. We stopped doing quarterly reporting. We changed the compensation for the long term." [12]

It's not that we pay no attention to nearer-term issues; rather, that if a company doesn't look to the long term it is unlikely to be a reliable compounder of the type we want to own. We have found that some form of controlling or dominant shareholder (often a family) is frequently conducive to companies striking an appropriate balance between short-term performance and long-term investment: 10 of the 20 stocks in the current Ash Park portfolio (and 10 of the 16 non-Tobacco investments) have some form of dominant shareholder.

6. Integrated approach to ESG factors

Inextricably linked to long-termism is the need for companies to incorporate into their businesses environmental and social responsibility, as well as good governance. These should be an integral part of business planning, not an exercise in virtue-signalling or appeasing wider stakeholders.

As Clorox likes to say, *"diversity is good, although inclusivity is better"*, recognising that *"if we look after our people, our people will look after our brands"*. In a similar vein, and one of many examples in the portfolio, Estée Lauder employees in the US from May last year who have, foster, or adopt a child now get twenty weeks of paid leave — regardless of sex, gender, and sexual orientation[13].

When Paul Polman became CEO of Unilever over 10 year ago, he announced a Sustainable Living Plan that was to be at the heart of everything the company does. As well as helping to tackle real environmental concerns, one of the hidden benefits of this plan was its attraction to graduates – Unilever became a company where the best people wanted to work because they could see they could 'make a difference' in many areas, notably emerging markets. Unilever is now the 'graduate employer of choice' amongst FMCG companies in 42 of its top 50 markets, up from less than 10 a decade ago.

New CEO Unilever Alan Jope has continued Mr Polman's work, saying at the recent Cannes Lions festival that *"Purpose is one of the most exciting opportunities I've seen for this industry in my 35 years of marketing . . . brands without a purpose will have no long-term future within Unilever."*[14] Unilever has said that sustainable living brands generally perform better than those without a purpose – 28 of its sustainable brands, including *Dove*, *Knorr*, *Persil/OMO* and *Rexona* – grew 69% faster than the rest of the business in 2018, compared to 47% in 2017. *"Done properly, done responsibly, it will help us restore trust in our industry, unlock greater creativity in our work, and grow the brands we love,"* he argued.

Responsible environmental and social behaviour makes business sense when it's integrated into the essence of a company's brands. Equally importantly, doing the right thing in these areas helps to protect the business' 'license to operate' – and a failure to deal with future challenges could present an existential threat. Examples of this might include alcoholic beverage companies helping to tackle the social problems of underage use or drink-driving, tobacco businesses shifting their consumer base towards lower-risk products, food companies improving the nutritional profile of their products, or the whole Staples industry tackling single-use plastic use.

We intend to return to the ESG topic in a future letter.

7. Agility and entrepreneurship

As we mentioned earlier, we are fishing in a high-quality pond and we expect the businesses we own to be less vulnerable to having their attractive ROICs competed away by new market entrants or 'disruption'. But a static look at a business will never tell you how it might deal with as-yet unthought-of challenges or opportunities coming some years down the line.

That comes down to culture, and how responsive organisations can be to change. Smaller companies should have a natural advantage here[15], but that doesn't mean large companies can't adapt. Here is RB's former EVP of Developing Markets, Frederic Larmuseau, on how the company encouraged entrepreneurial behaviour:

"The Benckiser guys were great entrepreneurs; they came from the chemical industry and they launched brands like Calgon *and* Calgonit *with which they created new markets. After the merger with Reckitt & Colman, they injected that entrepreneurship into the*

[12] Unilever's Paul Polman: CEOs Can't Be 'Slaves' To Shareholders – *Forbes*, 20th July 2015

[13] This compares to The Family Medical Leave Act which currently gives women 12 weeks of job-protected unpaid leave

[14] Unilever CEO Alan Jope laments the 'woke-washing' ads 'polluting' brand purpose – The Drum, 19th June 2019

[15] Campari's mission statement includes the line: *"Campari Group aims to be the Smallest Big Company in the spirits industry."* – Campari Group Sustainability Report, 2018

merged organisation. For example, I had worked at Procter & Gamble before, where I had five projects to do at any point of time and I had to make sure that four out of these five projects were well done – because if not, I was going to get in trouble – whereas at RB, I had 25 things to do but it was up to me to decide which of these I was going to focus on and I would probably end up doing six or seven projects. It is up to you to smartly figure out which projects to pick, which ones have the most impact on business performance. That was extremely liberating because you act as an entrepreneur, you learn by doing. At P&G you learn to swim with inflatables around your arms. In RB, they throw you into the deep end without inflatables, which means that initially you struggle a bit – but you learn to swim much faster that way [our emphasis]."[16]

Investing in new systems and competences is critical. In our Q1 *Disruption* piece we mentioned Unilever's *'Connected4Growth'*, organisational change programme, which amongst other things is seeking to increase decision-making speed, ramp-up digital marketing capabilities, and build a massive cloud-based data management programme. Heineken is investing heavily in its own business transformation programme this year, including further building its e-commerce and ERP capabilities.[17] BAT recently announced a 2,300 global headcount reduction, aimed at removing and simplifying management layers in order to increase decision-making speed and free resource to invest behind its next-generation tobacco and nicotine products.[18]

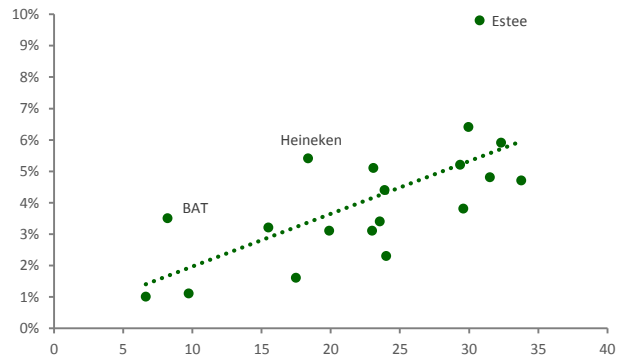
Trying to judge the adaptability and degree of entrepreneurship within organisations cannot be an exact science. We watch for clues from financial reports, investor days and our conversations with industry contacts, and hope that our long experience of following the companies in our universe will help us spot who's best positioned to cope with the challenges ahead.

8. Diversity of country and category exposure

We are sometimes told that the way we go about portfolio construction – from a risk, rather than a returns, perspective – is unusual. Our biggest positions are the ones where we see least chance of a major hit to earnings, rather than the ones with the greatest potential upside. This stems from our work over the years showing that the Consumer Staples industry is packed full of potentially high-quality compounders; the key is to avoid the ones that don't ultimately deliver that promise.

The market tends to value companies according to recent growth rates (figure 14), and not on the source of that growth – and thus its risk. For two identical companies growing sales at 5% and earnings at 10%, we would always prefer the more diverse business because if something were to go wrong with a brand, category or country it would be less severely impacted than a narrower business.

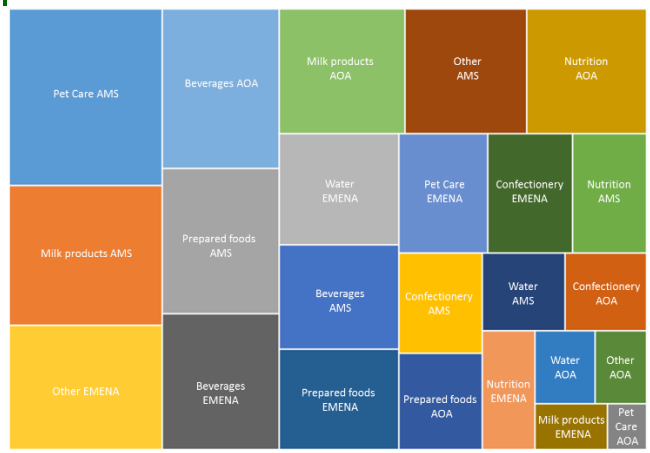
Figure 14: Fwd P/E vs average organic sales growth of past 3yrs



For Ash Park portfolio and watch list
Source: Ash Park

A good example of this came shortly after our launch when Nestlé suffered an unfortunate episode; its Indian *Maggi* noodles were (wrongly) accused of containing dangerous levels of lead.[19] Before the damage could be undone, Nestlé had lost a large chunk of its sales in India and also incurred considerable cost destroying old stock; the share price of Nestlé India fell 30% between May 2015 and February 2016 as the scale of the harm to the business became clear. Meanwhile Nestlé the parent company, for which India generated around 2% of sales, was virtually unscathed.

Figure 15: Nestlé sales split by reportable segment 2018



AMS = Americas; EMENA = Europe, Middle East and North Africa; AOA = Asia, Oceania, Africa
Source: Nestlé, Ash Park.

Figure 15 sets out Nestlé's sales by reportable segment (division and region). Its single biggest business is Purina USA, which we believe accounts for less than 8% of group sales and, even then, is broadly spread across more than half a dozen brands (eg *Friskies*, *Fancy Feast*, *Dog Chow* and *Felix*). In the event of even a large *Maggi*-esque issue, Nestlé is well insulated from any exogenous effects.

[16] Harvard Business School, October 2017

[17] Heineken NV reports 2019 half year results – 29th July 2019

[18] Simplifying BAT to drive New Category growth – BAT press release, 12th September 2019

[19] Nestlé's Half-Billion-Dollar Noodle Debacle in India – *Fortune*, 26th April 2016

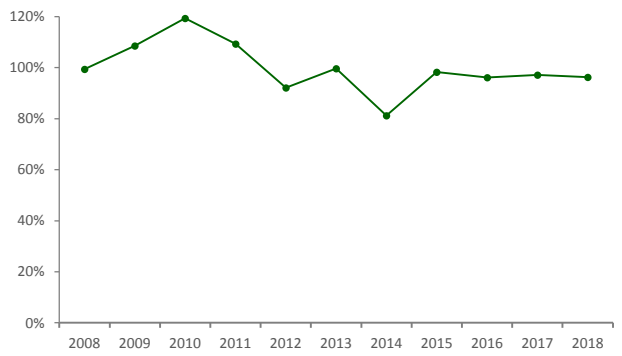
We regard Nestlé as a 'sleep soundly at night' stock; and we aim to manage a strategy with the same attributes. In a portfolio we don't need every stock to be as diversified as Nestlé: there is room for companies focused more narrowly on a particular category or region, which might also be faster-growing, but they are unlikely to be our largest positions.

9. Effective capital allocation

All the businesses we follow are significantly more cash generative than the average listed company, with free cash flow generally averaging around 90% of net income (in the case of Tobacco, often even higher – eg PMI, Figure 16). The difference between good and great compounders in Consumer Staples is frequently how companies choose to use that cash.

Dividends represent 50-65% of free cash flow for most of the major staples companies (the AP portfolio average is around 60%), which still leaves 100% of net income to be re-invested every 2-3 years.

Figure 16: PMI free cash flow conversion (as a % of net income)



Source: Company reports

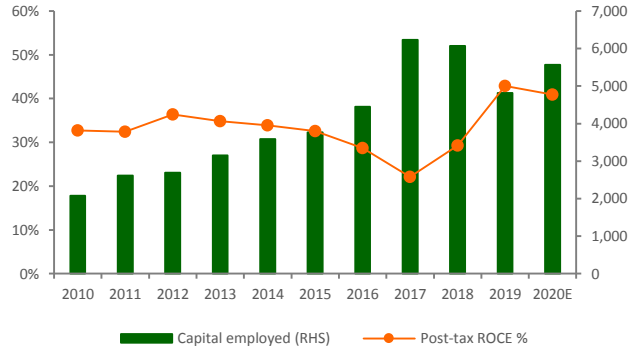
The highest returns are often available from internal, organic capital investment. Heineken has found very attractive markets in some of its developing regions in which it can organically invest 8-10% of sales. That's a level which scares many investors but delights us – after all, if that capital is likely to earn a 30-40% return, we would like the company to find as many of those opportunities as possible.

However, for most Consumer Staples companies the opportunities for internal capital investment are usually modest relative to the size of the overall business[20]. External investment, in the form of M&A activity, has plenty of detractors, and the financial press often repeats the well-trodden line that 'most large deals destroy shareholder value'. Investors generally look for hurdle rates to be beaten quickly, which makes sense to us in industries such as technology or manufacturing – where the state of the art, or consumer demand, can change rapidly and potentially render large businesses obsolete quite quickly.

But consumer brands, if looked after properly, can survive for decades or even centuries, and are not subject to the kind of cash flow fade you might expect in other industries – they can continue to grow for many years. Sensibly done, M&A for consumer companies can help to diversify geographic exposure or add new products which can be sold through the acquirer's existing distribution system.

Estée Lauder (Figure 17) is a good example of a business using M&A to complement its own internal investment initiatives: over the last decade it has managed to maintain 30%+ returns on capital (including goodwill) whilst doubling the amount of capital deployed into the business, much of it through bolt-on acquisitions.

Figure 17: Estée Lauder capital employed and post-tax ROCE



Capital employed includes goodwill and brand intangibles
Source: Ash Park and company reports

We are generally supportive of moves like these but keep an eye out for miscreants. Acquisitions in areas which fall outside a company's core competence raise red flags for us: amongst the worst deals we can remember in recent history was Campbell Soup's 2012 purchase of Bolthouse Farms, in order to create a fresh foods division. Campbell paid $1.55bn for a business with over half of its sales in carrots; it was sold in June this year for just $510m.

We are also extremely wary of business models which rely on M&A for growth in the absence of an ability to grow the company organically – witness the cautionary tale of Kraft Heinz.

Figure 18: *Bolthouse Farms* carrots

Source: Bolthouse Farms

When companies have exhausted opportunities to reinvest organically in their own business, and in the absence of value-creating M&A opportunities, we would expect them to return any

[20] A feature, not a bug, and the flip-side of operating in a high-margin, high-return industry.

excess cash to us as shareholders via either special dividends or buy-backs. We have a modest preference for buy-backs: we recycle dividends into the existing portfolio anyway, and our portfolio companies repurchasing their own shares effectively accomplishes the same thing. An implicit assumption is that if we own the shares then we believe the company is trading at a price below the intrinsic value of the business, in which case those shareholders who sell are giving away value to the benefit of the long-term investors that hold on to their stock.

10. Valuation

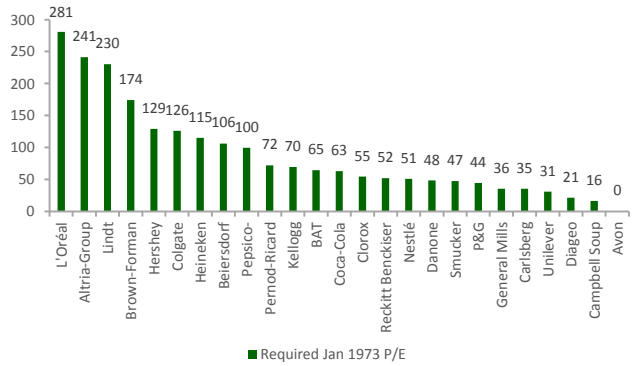
Our conviction that the shares we own are trading substantially below intrinsic value is backed up by our work on long-term returns. Figure 19 shows the P/E you could have paid for an array of listed Consumer Staples companies in January 1973 (when our data starts) and enjoyed 7% annual USD price appreciation up to the end of Q3 2019[21] – equating to total returns of over 10% pa, adding in the average dividend yield of a little over 3%.

For virtually all of the stocks featured, you could have paid a 1973 multiple way in excess of where the stocks are trading today; the market is generally very poor at recognising the longevity of cash flows from successful Consumer Staples companies.

With this as our starting point, we look at valuation as a risk factor rather than an opportunity: we are not looking to buy temporarily 'cheap' stocks or take advantage of short-term valuation anomalies; instead we focus on whether there is a risk that a reduction in valuation multiples will seriously impair investment returns over the mid to long term.

Relative valuations are an important part of our stock selection and review process: if we think two companies have similar quality and growth characteristics we will select for our portfolios the stock with the better free cash flow yield.

Figure 19: P/E you could have paid in Jan 1973 for 7% a CAGR



Based on 12-month trailing P/Es, calculated from 1st January 1973 to 30th September 2019. The price return of MSCI World over the same period was 6.2%.
Source: Ash Park and Refinitiv Datastream, excludes dividends

[21] That is essentially in line with the S&P 500; MSCI World produced 6.2% over the same period.

Conclusion

The late-2014 launch of Ash Park was the culmination of decades of collective research, learning and isolation of what makes Consumer Staples a great industry in which to invest, as well as what dictates the successful companies within the industry. Our process continues to evolve in terms of the drivers of those successful investments, and in particular the importance of company culture in that success.

When it comes to building the portfolio, we continue to look for the perfect investment in the knowledge that it probably doesn't exist. If it did, it might have the long-term thinking of Lindt & Sprüngli, the ROIC profile of Estée Lauder, the growth mindset of Clorox, the gross margin focus of RB, the capacity to suffer of Brown-Forman, the capital allocation of Heineken, the ESG thought process of Unilever, the diversity of Nestlé and the agility of Campari . . . with the valuation of BAT.

Q3 commentary

Amid heightened volatility, the fund returned 3.5% in Euros in the third quarter, bringing year-to-date returns to 16.9%. In an unusually active quarter for trading activity, we disposed of our stake in Japan Tobacco having decided that the short to medium term opportunities elsewhere in the Tobacco sector look more compelling at present. We also made our second new investment of the year – a small position in Fever-Tree Drinks, where we took advantage of weather-related slowdown fears that have seen the shares de-rate significantly.

Thank you for your interest and support.

The Ash Park team
16th October 2019

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All data sourced from Ash Park unless otherwise stated.

Performance for other share classes of the Fund may differ. Please refer to your individual statements or contact Ash Park for further information.

Note: Throughout this newsletter 'Consumer Staples' or 'Staples', where the term is capitalised, refers to the Ash Park definition or proprietary indices of the consumer staples sector, which include Food, Beverage, Tobacco and Household & Personal Care companies; the S&P Global Consumer Staples index also includes the Food Retail sector.