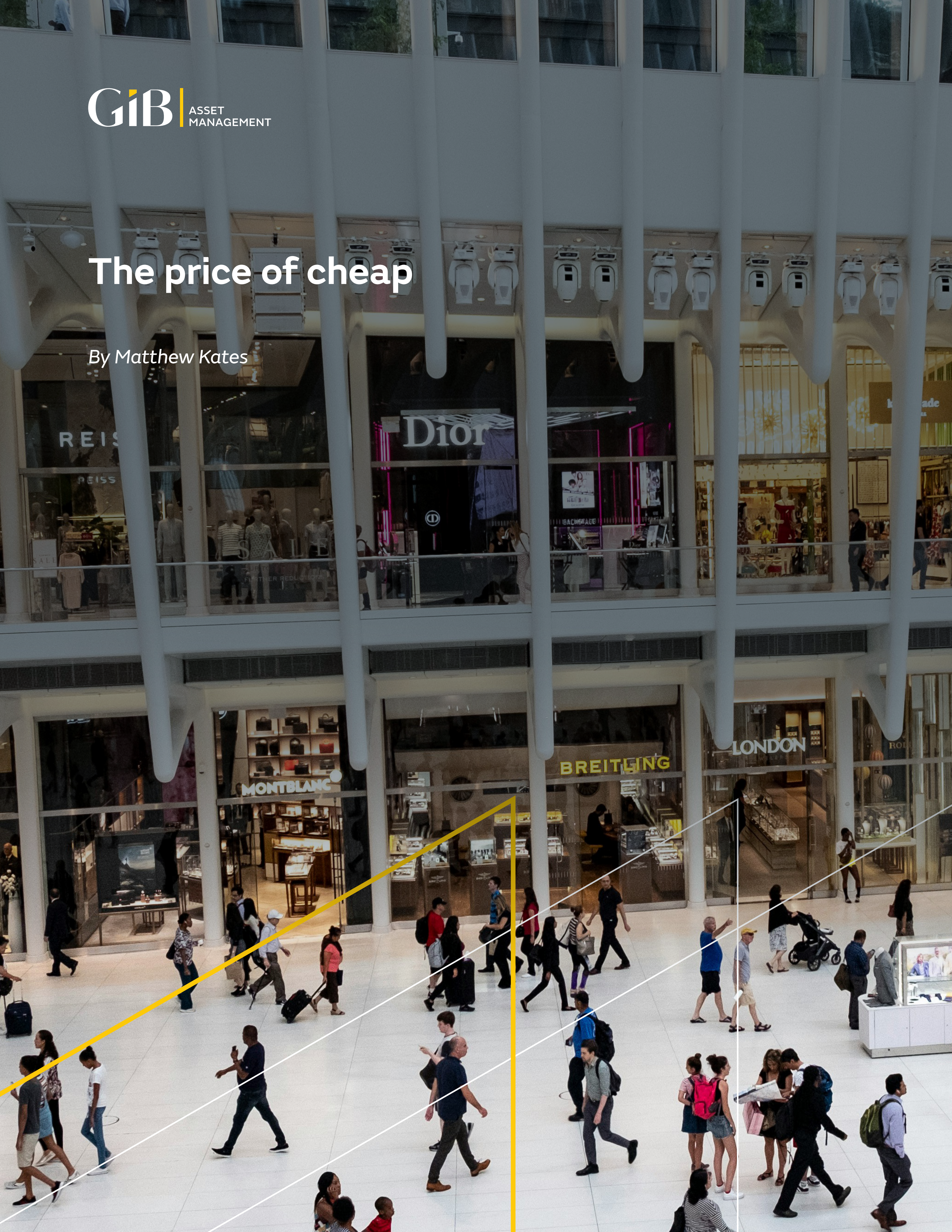
GIB ASSET MANAGEMENT

The price of cheap

By Matthew Kates



Executive Summary

Whilst the consumer is under pressure, not all consumer facing businesses are faring badly. We argue that those with strong customer value propositions, where the price of the product or service is materially outweighed by the benefits provided, should continue to do relatively well. A consistently highly valued product or service acts as a key differentiator for companies and, we believe, derives not only from a strong business model but a strong culture. The European Focus strategy specialises in long-term investment in businesses with both excellent cultures and business models, that result in excellent economics for their owners. The firm belief is that these companies can survive and thrive in all market environments.

Factors driving weak consumption

It has been a sobering first 9 months of 2024 for investors in consumer companies globally: notwithstanding the recent bounce, from America's Nike and Estee Lauder to the UK's Burberry, Kering of France, Amorepacific of South Korea and Japan's Shiseido, share prices have been hit hard. Even traditionally defensive companies like Nestlé have not been spared, disappointing with their half-year results in July.

Whilst it is obvious that the consumer is feeling the pinch, it is perhaps the depth and breadth of the recent deterioration that is surprising. Chinese consumers, for a long time the global sector's backbone, are retrenching due to mixture of economic and political pressures. In the U.S., sharp cost-of-living increases and slowing jobs growth are taking their toll. Similarly, European consumers are evidently trading down to more affordable brands, including private label. Bringing it all together, we can identify a confluence of quite specific factors including:

- **Post Covid impact:** A prolonged hangover from the pandemic spending binge, when money was quite literally handed out in order to maintain solvency and liquidity.
- **Rising cost of living:** The price of everyday items such as food, rent and healthcare remaining elevated even as broader inflation cools.
- **Higher interest rates:** Squeezing disposable incomes despite net real wage growth.
- **Geo-political uncertainty:** Denting confidence and by extension investment and hiring intentions.
- **The wealth effect:** Weak property prices (most pronounced in China) causing a reallocation of spending priorities.
- **Excessive price increases:** Companies pushing prices too far in the wake of the pandemic, causing something of a consumer revolt.
- Potential changes in consumer preferences and tastes.

Despite these headwinds, it is not all bad news. Some companies, and pockets of the retail industry, are still faring well, for now at least. One common theme is that the pain is most acute amongst the low-income, or 'aspirational' consumer, as the luxury houses describe them. Hence the pain should be most pronounced in 'big ticket' discretionary spend items: products ranging from jewellery to cars, TV's to cosmetic procedures and so forth.

Quality determines price

However, we see the situation as more nuanced than simply a 'two-speed' consumer economy. Consider the contrast between Dollar General and Walmart: while the latter thrives, the former is struggling despite the two companies having a reasonable overlap in customer demographics. As a discount store, shouldn't Dollar General be benefitting from selling low-priced merchandise, not only to its regular clientele, but also to a slew of customers trading down?

The consumer typically comes across as a somewhat unsophisticated creature, responsive to almost any stimuli, so long as it is catchy and appealing. Why else would so many competing shampoos, clothes, washing machine brands etc exist? However, experience has taught us that our species has an intuitive understanding the price/value relationship. It is here that humans possess a sixth sense for what constitutes quality, value, and an appropriate price, in most rational situations at least.

And herein lies the point – that quality is the ultimate arbiter of the price/value relationship. In non-commoditised products, it is quality that determines the price. Charge a high price for low quality and we all know how the story ends. Set a low price for high quality and watch the throngs descend. And whilst low quality, low price might appeal in the short-term we would argue it is entirely unsustainable, ever more so in today's drive to preserve resources.

Customer value proposition

Warren Buffett's maxim (or Ben Graham's to be precise) 'price is what you pay, value is what you get' rings true here. The message is that, most of the time, we get what we pay for. Provide a consistently high-quality product or service, where the value derived far outweighs the purchase price, and you have a strong customer value proposition. Further, not only do you build a loyal base of customers who buy your products repeatedly, but those same people become your greatest ambassadors. You don't have to pay to acquire and keep customers. In other words, the customer value proposition is critical to the ultimate success of a business, and quality is integral. Low quality does not work in the long run:

Buffett's early success was built on the philosophy of buying 'cigar butts'. This involved purchasing the shares of a business so cheaply that even the last 'puff' (or liquidation value) was worth more than it was being priced at in the stock market. However, when Charlie Munger promoted a shift in his philosophy towards buying high quality businesses at a fair price, the Berkshire machine really started to motor. In Buffett's own words, the ideal business is one that provides exceptional value to the customer, resulting in exceptional economics for the owner. Estee Lauder summed it up as targeting customer loyalty over everything else.

Bringing it back to the present, the point is perhaps best exemplified by consumer industry giants, and portfolio companies, L'Oreal and Unilever. They emphasised the importance of innovation in today's market at their respective first-half results conference calls: L'Oréal stated that whilst 'the Chinese consumer is price conscious… they still pay for innovation'. The CEO went on to say: 'what this tells us is that we need to come into the Chinese market with ever more innovative products. That is what will stimulate consumption'. Similarly, Unilever noted the heightened promotional activity in Europe and a rise in demand for private label brands, yet also commented that European consumers remain receptive to significant innovation. Both companies address consumers across the income spectrum, as do the likes of Next, Inditex (Zara), Games Workshop (Warhammer) and all have continued to do well year to date. Why? Because they focus on quality and innovation. Both are integral to the customer value proposition.

As we know, at the high-end consumption remains in reasonable shape with Hermes handbags, Ferrari's and iPhones are still selling well, albeit aided by the presence of waiting lists in certain cases. This is not to suggest that the affluent consumer is insensitive to economic conditions. They too feel the pain and adjust spending accordingly (2008/09 for reference). However, we do think it further evidences that consumers are willing to spend on brands that offer high quality and genuinely differentiated value: that solve problems, sate desires and make lives simpler and more productive. Portfolio companies Hermes and Ferrari may not immediately strike you as offering great value for money but looking at the second-hand market for their products offers an interesting insight. A used Birkin bag, for instance, sells for a multiple of its original price. More recent second-hand Ferrari models trade at minimal discounts to their new price, with rarer models trading as substantial premia.

"If you walk around Shanghai today, it's interesting to note that the traffic in malls has fallen considerably…but the attachment to quality of Chinese customers remains and this will be an advantage for Hermès,".
Axel Dumas - CEO Hermes

Conclusion

The consumer is weak, the economy unsupportive and the recovery uncertain, but it is precisely at this point that companies can truly differentiate themselves through their culture: a purpose-driven understanding of the customer together with a focus on simplicity, building trust, obsessing over quality, improving constantly, and remaining vigilant, agile and responsive to change. These are the companies that win in both good and bad economic environments. These are the companies with outstanding cultures. Quality in products and services, people, processes, systems, and thinking. Cheap, in any shape or form, becomes expensive in the long run.

This document is not for distribution to retail clients and is directed exclusively at GIB Asset Management's professional clients, institutional clients and/or Qualified Persons. This document has been prepared by Gulf International Bank (UK) Limited ("GIB (UK)"), trading as GIB Asset Management for discussion purposes only with the intended recipient. GIB UK is authorised by the Prudential Regulation Authority ("PRA") and regulated by the Financial Conduct Authority and PRA. GIB UK is registered as an Investment Adviser with the Securities and Exchange Commission in the United States. The document shows market commentary and does not constitute investment research. This document is provided for information purposes and is intended for your use only and does not constitute an invitation or offer to subscribe for or purchase any of the products or services mentioned. The information provided is not intended to provide a sufficient basis on which to make an investment decision and is not a personal recommendation.

The portfolio will exclude stocks with revenue derived from prohibited activities, e.g. alcohol production or controversial weapons. It will also exclude based on international standards, such as UN Global Compact or any environmental, social, and governance controversies, e.g. an oil spill or data privacy scandal of a company. Exclusions can be tailored to meet the needs of our clients.

Observations and views of GIB UK may change at any time without notice. Information and opinions presented in this document have been obtained or derived from sources believed by GIB UK to be reliable, but GIB UK makes no representation as to their accuracy or completeness. GIB UK accepts no liability for loss arising from the use of this document. Moreover, any investment or service to which this document may relate will not be made available by GIB UK to retail customers.

The price and value of investments mentioned and any income that might accrue could fall or rise or fluctuate. Past performance is not a guide to future performance. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income. Nothing in any document constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to individual circumstances, or otherwise constitutes a personal recommendation to any specific investor unless clearly stated. The registered address of GIB UK is First Floor, One Curzon Street, W1J 5HD.

Contact

info@gibam.com

T: +44 (0) 20 7259 3456

Follow us: