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EP41 | Playing the plan: Mawer's international equity portfolio

Cam Webster: 00:40

With me today is David Ragan. He's the lead portfolio manager on international equity at Mawer and we have him in to speak to playing the plan. Let's start with the big picture—lots going on out there. You guys are on the road talking to management teams…is there anything that's connecting what the management teams are saying to the big picture? One big concern is Brexit, and the largest currency exposure is British pounds. So, start there!

David Ragan: 01:11

Brexit's been in the news for a very long time and Brexit just got extended. The UK wasn't ready for it. There still seems to be some almost impossible decisions to make. Like, for example, how do you have a border in Ireland and not a border in Ireland? Because Northern Ireland is part of the UK and would separate, and the Republic of Ireland has to be connected to [it] because of [a] very troubled past. They can't reintroduce the border there. And that's just one of the many, many issues. So, this is a problem and a topic that's been talked about for a long time and will probably continue to be talked about. There hasn't been a lot of change with what we're looking for. Core to our philosophy is looking for those high quality companies that have pricing power and smart management teams, and those two competitive advantages really help you weather storms that, as an investor, I may not ever foresee or I wouldn't know what to do for a specific company.

02:07

These managers in these businesses—if they run into problems, they can raise prices if new barriers pop up. The management team is intelligent by having production capacity nearby their customers. And this is really how we focused on this issue ever since David Cameron announced that there would be a referendum; if they want to exit the EU. And that's the way it continues to be. We still think we have some pretty high quality companies that can weather this. The number of companies that we have in the UK that are head officed there is high. Currently, about 26% of the portfolio is there. But in reality, these are incredibly international companies where they have little or nothing to do with the country. One of our top holdings, Intertek Testing Company, their core business is actually being in the manufacturing basins—that's where their operations are, though their head office is in the UK. So their exposure to the pound is very, very low and I still think that the portfolio is well-positioned for Brexit, even though I do personally hope it doesn't happen.

Cam Webster:	03:03	Maybe the next big picture window to open would be U.S.-China relations. I'm thinking you're going to give me the same response, but is there anything particular about that situation that you're doing something about in the portfolio?
David Ragan:	03:17	Trade wars reduce the productivity of the world. The reason that we have certain things produced in certain areas of the world is that area has a competitive advantage for that product. And Canada having a massive amount of land—Brazil is another example, lots of land, even better weather—we have a competitive advantage to grow crops. China has a lot of labour force, so anything more manual labour—that can help to be produced there. The U.S. labour is much more expensive, so it has to be a lot more productive. And sometimes it can work, but when you force these changes to where things are produced and how the economy chooses to allocate capital and factories…that makes it less productive.
	03:56	In this case right now…yeah, it's a war going on. There are tariffs going back and forth. We've seen steel prices [impacted]—one of the bigger impacts, [as] one of the earliest tariffs was on steel, so heavy users of steels have had issues. There's been some decisions on moving factories, or allocating a new factory to a different region in the world because of this. But I mean the overall impact is not going to be massive. The thing that we keep talking about, or the biggest thing I'm watching for, still remains central banks keeping interest rates low, massive amounts of liquidity in the system. And that's why we're still in very much a bull market mode.
	04:35	We saw earlier in the year when there was the threat that the central bank in the U.S. would start raising rates, take away more capital, and the market went straight down. It dropped just over 10%, I believe. And the second the central bank said, "no, I think we're going to keep rates lower for longer," it's back [to] full on bull market. And that's been the messaging even more from the U.S. and around the world.
	04:59	So, if I was going to focus on one thing, that's the number you're looking at. The liquidity. All these other trade wars, Brexit, I mean they're big, but they're insignificant relative to that.
Cam Webster:	05:10	One of the messages I've been delivering to clients is just complacency over expecting a central bank to step in and basically have your back. If you compare [the] fourth quarter to first quarter, that basically materialized. Is that a good characterization of that risk?

David Ragan:	**05:29**	Everyone is expecting that the Fed will keep this party going. I think that's black and white looking at the valuations. You have a U.S. president that's very clear that that's what he wants as well—he seems to almost measure himself based upon the stock market. So, there [are] a lot of reasons why everyone wants this to continue. The trade war is an excuse to keep interest rates lower as well. So is Brexit. This is what everybody wants, this is what everybody's expecting. And if that expectation ever doesn't get met, it's going to be...I would say more of a painful realization, painful correction, in the valuations of stocks.
Cam Webster:	**06:04**	Let's talk a little bit about, in this environment, what are you seeing as opportunities? We talked about Brexit, we've talked about labour in China being a competitive advantage. I know on a few of my trips to China, [I] see a lot of luxury goods, so that's the lead in to the opportunity that we've seen.
David Ragan:	**06:22**	The opportunities to us, going back to "playing the plan," is always finding some company that, for some reason, the market is underappreciating. And one of the recent additions to the portfolio was the luxury goods company LVMH. And LV stands for Louis Vuitton, and MH stands for Moët Hennessy. So you have primarily the luxury goods of Louis Vuitton and a lot of other luxury brands in this house making most of the money for the entity. I mean, obviously the champagne business is quite fantastic as well, but these luxury goods, the actual cost to produce them...I think, deep down, we all know (and looking at the financials, I do know) it costs a lot less to make [them]. But the whole product is not just the bag that you buy with the little LVs on it. It's the image that that portrays. It's what people take from it. And this image is created through a lot of advertising, a lot of brand building; who they choose to associate with, and I would say more importantly, what they choose not to do.
	07:20	LVMH is the best luxury house in the world in my opinion, and that's because I think the management team is the best. They understand how you manage a luxury brand: let it thrive and prosper over the long-term, or you can easily kill it. And they have brands that have been around for...I think there's been some over a hundred years. They had that heritage which helps create that cachet with it, but they also nurture it by never discounting. Nothing would bug you more than buying a purse for $10,000 and the next week seeing it for $6,000. They won't do that.
Cam Webster:	**07:55**	It's not the Gap model.

David Ragan:	07:56	No, that's core to how you keep it luxury. There [are] other brands—I think Coach is one of the biggest that has really killed their brands. They make it too accessible. You have very expensive products and you have much more cheaper products with the same brand on it. You do see discounting. LVMH…they don't really have cheap handbags. They've even moved away from canvas, which was one of the more accessible entries into the LV family. But they're moving away from that. It's more leather, very much high-end. That's all they're going to do. … Mr. Arnault is the CEO and he's, I think, core to why this house worked. He really built this house. He's collected numerous brands, he will buy some (and these aren't assets that you can buy cheaply), so they are never cheap[ly] priced, but he gets a lot out of them. He can take that a more regional brand and make it global.
Cam Webster:	08:49	Has he taken a brand and moved it from a discounting model to a non-discounting model? Is that part of the way?
David Ragan:	08:55	Not that I know of. I don't think he would do that, because you taint the brand, and I would say taint it for the long-term. He has taken…Christian Dior was one of his first brands that he purchased among some other assets for very little, and turned it from a struggling, almost nonexistent house a few decades ago, to a very powerful brand. And that was actually part of the core vehicle that he grew one of his empires with. And one of the reasons why he's a billionaire today.
Cam Webster:	09:22	Any succession worries for you? If you're highlighting the CEO that has built this house, then what's the succession plan there? How did you go about evaluating that?
David Ragan:	09:33	Yeah, at this point we don't have a lot of details on the depth. I mean, there [are] a lot of different houses, so there [are] lots of different places for internal candidates to get a lot of this experience. And then…most likely…I mean, the LV brand is the biggest, the most powerful—it is the likely place to select your successor for. I know he's still a massive owner of the company. He's older, but very active. So I think he'll do well. And that's something that the company has done very well in—the head designers for the houses. Every once in a while they have to switch out the designer for a house. They may get tired of doing that, they may get poached to go somewhere else.
	10:11	That's one of the key decisions that you have to make as an owner of a luxury brand: who is the guiding source of the brand over the next five, ten years? And they've done a fantastic job while other houses, other companies have struggled. They seem to do succession quite well, which leads us to believe that probably they'll do it well in the future.

Cam Webster:	**10:29**	Good perspective. Last question on Louis Vuitton: where did the idea come from, and how did you make the decision to add it to the portfolio?
David Ragan:	**10:38**	We've actually held this previously in the portfolio. We know it quite well. It's really a factor of relative opportunities. Previously we sold it with some concerns and demand in China, which I think is absolutely core to this investment thesis. China's a huge source of demand, and we sold it with some concerns there. Things have been going well, so we've initiated a position—it's not a large position, I'd say slightly smaller than neutral—because I think it's a good opportunity. But our investment philosophy has three tenets: wealth-creating company, smart management team, reasonable price. The price is reasonable for a very high-quality asset. But in all honesty, this is an expensive market. So, personally I'd love to buy it cheaper among everything else, but I think this is one that potentially we could have that opportunity.
Cam Webster:	**11:24**	Thanks for walking us through that. One of the other, I guess, structural things that could happen for holdings in the portfolio is, because it's an all cap mandate, so, all capitalizations (you can own small cap, medium cap, large cap, doesn't matter) is some of those companies get added to an index. In the latest quarter, we had a couple of holdings—Spirax-Sarco, and Halma—added to the FTSE 100. Quite a visible index. How do you view that—when companies get upgraded? I'd characterize it as upgraded, [getting] into an index.
David Ragan:	**11:58**	When they get introduced into the index, it's fantastic for the people who already own it because then there's all this passive money that immediately has to buy them. And that's why these shares have done incredibly well. I mean, they're fantastic businesses, which is why they've grown to the point where they can get into the FTSE 100 which is…it is the S&P 500 of the UK, so it drives a lot of money and it's driven these shares…I would say a lot. We're not really playing the game of: is this going to go on the index or not? And there [are] investors out there who do that. We're just looking for great companies. And when we find these great companies, we can often ride that ride with them—where we owned them before they go into the index or they go into a lesser index and they go to a bigger index and bigger index. And it's very valuable for shareholders.
	12:43	And this is one of the reasons why passive investing versus active investing—we have a structural advantage over the longer term. [If] everybody else on the planet was passive and I was the last active investor, I choose what goes in and out of the index.

So once I sell something, it gets kicked out, and whatever I bought gets put in. And then you get this huge tailwind behind you. So this has been a big benefit. And as this has happened, we have actually trimmed a little bit from both the stocks. Just as valuations [are] a little bit more stretched, people have had to buy this, and we've given them some stock, I think, at a very attractive price and kept our position a little bit more neutral at this point.

Cam Webster:	13:20	Have you ever had an experience with the holding going the opposite way?
David Ragan:	13:23	Yes, those are less pleasant.
Cam Webster:	13:27	[Laughs] we're going to round out the conversation with some discussion of a not-so-good performer and a good performer. So, in the mix on the downside, is a company called Bunzl. Why don't you walk us through the investment thesis there, and maybe what's impacting the share price right now. I think we're down about 17% year-to-date on that one.
David Ragan:	13:48	Bunzl—it's actually a very good company. They source all the products in a store that doesn't get sold. So, in a coffee shop: cups, cutlery, clean supplies; hospitals, gloves, more cleaning supplies; grocery stores, the little trays you put the meat in…all this stuff that doesn't actually get sold, but you need to run the store. Obviously a very critical product to have there. If you're buying a Louis Vuitton bag, or actually—I think they do supply Sephora, one of Louis Vuitton's holdings (Sephora the makeup company). If you don't have bags at Sephora, that's rather disruptive to people trying to buy a bunch of cosmetics, which are much higher margin. So you're happy to stick with a supplier that works.
	14:31	Sorry, like a bag to carry out your purchases? I just want to clarify that you're not buying a Louis Vuitton bag at Sephora.
David Ragan:	14:38	You are not buying a Louis Vuitton bag at Sephora. You're buying a bunch of makeup that is very high margin and you get a little plastic or paper bag with logos on it. This is their business model: they source all this stuff, they break it down to warehouse. And as you know, malls—I mean there's not a lot of storage space. They can't store a week's worth of all these consumables at a mall or at a strip mall. With a coffee shop, they have deliveries, sometimes multiple times a day, often a few times a week.

		But it's always the same time, very consistent. You know what's coming, and they're going to have all the products you need. So it's a great business. And we were recently talking to...I believe it was the CEO that said this. If you had to guess how many products we supply to a coffee chain in the UK, so the equivalent of like a Second Cup or a Starbucks, how many products do you think we supply over a year? Different, specific, we call them SKUs. A specific cup.
Cam Webster:	**15:32**	So a cup, a cup lid, stir sticks...
David Ragan:	**15:34**	Small cup. Large Cup. Yeah. Most people guess 50 because you don't ask that question unless it's a high number. It's actually over 300. There [are] a lot of different products they have.
Cam Webster:	**15:45**	In a single shop?
David Ragan:	**15:46**	This is a coffee shop. Yeah. So if you're trying to displace them, that is incredibly hard, because you have to source these 300+ items, and you have to prove to this company that you're going to do it better. And margins are incredibly tight because they are very basic products—it's a distribution company. So the business is good. The problems recently have been labour costs, [which] are obviously very important to these guys. You have a lot of deliverers, you have a lot of people picking [up items]. Labour costs have been going up, especially in the States, which is a big market for them.
	16:16	One of the very big grocery retailers in the States is one of their big clients there. They got a huge contract from them. Bunzl's performance had been so good that this unnamed entity allocated hundreds of millions of dollars in new business for them over a few years. So this has been big growing pains for Bunzl—where you have to hire new staff and new staff is never as efficient as old staff. They've had to use temp workers. So all this added up to some margin pressure. We actually bought it while this was starting because the market really didn't understand why this was going on. It saw good growth, but poorer margins. We're still seeing some of that, but the other issue has been the tax rates in the U.S., the trade war. This has all caused a very, very tight labour market in the U.S. which has made labour costs go up and constant pressure on Bunzl.

	17:05	I don't think this is a very long-term problem. They're very good at eventually getting the efficiencies running, at getting the people they need, passing on the price increases. Obviously this very large customer is a bit harder to pass through prices than a random coffee shop, but they still should be able to do it. That's why we're happy to hold the position. We are somewhat cautious and curious on when this ends, so this is one where...you almost wait for the evidence, you actually can see things have started to improve. And then maybe we increase the position.
Cam Webster:	17:36	Thanks for that walk-through Bunzl—it's pretty clear why it's come down and where you're positioning. Let's talk about a winner. There's a company called IWG plc.
David Ragan:	17:47	So, International Working Group—that would be the acronym. And "plc" is just like "incorporated" for the UK. But you might know them more so as Regus, the short-term or flexible office space company based in the UK but [that] operate[s] around the world.
Cam Webster:	18:00	What's the overriding investment thesis here?
David Ragan:	18:03	I think you have a good business. It's not an amazing business. The management team is solid, they're decent-sized owners. And when we bought into this, they were doing well; the value of flexible office spaces...it's there for companies. Especially, say, you're a multinational corporate. You have a sales force that needs to be able to travel all around Nebraska, but you want them to be able to work while they're doing that. So if you have an entity like IWG, they would have office space all over the world. Pretty much every major city, every major country in the world—they can help you. And at Mawer Investment Management, we actually use them. Definitely in Toronto, we might've used them in Singapore as well. So it's a good business.
	18:43	People have probably heard about WeWork. That's more the internet start-up—they're bleeding money. They don't seem to understand exactly how this business runs, and it's more of a club there. But Regus is very much the professional management where, you, as a legitimate office person or worker, can rent a space and have an office wherever you need it.
Cam Webster:	19:03	Does it leg into [a] higher proportion entrepreneurial type business model? So, self-employed and things like that? Is that a growth dynamic for them?

David Ragan:	**19:11**	That's definitely a big positive, yeah. A company that's growing and doesn't know exactly how much space they need or where they need it. They don't want to tie up a bunch of capital or be in a long contract. You'll pay a little bit more using this flexible space, but that's exactly why you want it—it's flexible. And you'll pay a little bit higher prices and maybe share some of the services—where you can have reception, you can have a kitchen. Where, as an individual, you might just have a tiny little depressing office, otherwise.
Cam Webster:	**19:37**	Okay, and is there anything in that business right now that served as a catalyst near term? The shares are up over 30% in the near-term here. What's explaining that?
David Ragan:	**19:46**	The original business model has been primarily…IWG will lease a floor or some office space, then they'll make these short-term leases to their clients. So, they build up the office space to be flexible, to sell well and fit a lot of different people, and then they'll lease it to individuals. The move that they're making now…and I think why the share prices have done so well, is they're moving more towards a franchise model. And they've been doing this somewhat for a while. Where, originally, it was they would partner with landowners, and the landowner could put up some of the money and they created a joint venture vehicle: this entity is [then] owned by the two of them and, say, in an office, [on] a floor that they can't rent, [but] can do this.
	20:29	Now they're moving to the full franchise model where—and it could be real estate owners as well, I think that's a great match. Or it could be [an] individual who just wants to lease a space themselves, run the business—but IWG will run all of the…basically they're the franchise owners. They will do the systems, the IT, they will do the advertising, they'll help get you clients. They have the branding, the advertising. They have the expertise on how to design a floor because designing an office floor is not easy to begin with, but then you add the challenge of it's got to be flexible and work for various groups. They have all of that. And this way, IWG has no capital tied up in this. It's purely: they provide how to run the business. And I think the market is very excited about this, and they've done a successful deal in Japan at very attractive terms.
	21:20	So, I think it's very appropriate what the stock has done and that's why we continue to hold it and see how this turns out, because it is just one deal so far. Hopefully they find a lot more and of similar quality.

Cam Webster:	21:30	Right. So, if this is a new way they're running the business, as a long-term investor, are you inclined to add to it? You're waiting for evidence to see if this transpires, but if they convert say, half their business to this model, what does that mean?
David Ragan:	21:45	This is turning into basically the hotel business model, where you see all these hotels—the Intercontinental, Hyatt, whatever—the actual corporations don't own that hotel, typically. They just manage it, they run it, they have that brand, and they provide the loyalty program that drives customers there. We like that business model, it's a great business model: very capital light, very high return. So that's why we like IWG and why we think it can work. Where does it go from here? What does this mean for the company? We haven't added to it because it is one example. You don't have to have everybody wanting to buy a franchise, you just need one or two or a few in each market. However, IWG decides they want to break it up…so you see that more deals come out, there's a demand for that, that the franchisees are excited about this…and then how much of the company gets hived off like this?
	22:37	The Japanese deal took existing IWG assets and then put them into this, sold them to the franchisee. You could see that the whole company eventually transitioned to this, and there's not much physically left of the company at that point, except the cash that they would generate and pay out would be astronomical and quite exciting. So we're watching this with great interest I would say at this point.
Cam Webster:	22:58	Okay, that's an interesting holding! That, I think, rounds out our conversation. I want to thank you for spending time with us and giving us an image of, if you're the last active investor in the world—that was a good one. And [the] walk-through Bunzl was great. And a little luxury goods in there. So, thank you, David. We'll have you on again soon.
David Ragan:	23:17	All right, you're welcome. Thank you.