ROAD TO RECOVERY STILL PAVED WITH A "K"

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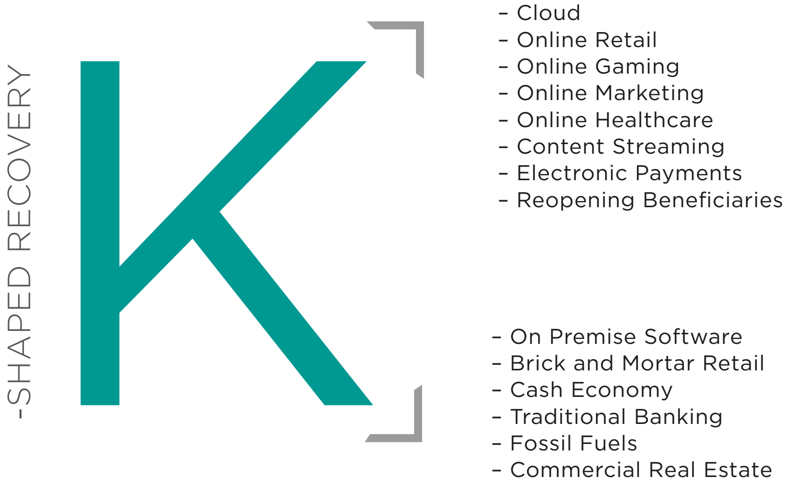
- K-shaped recovery continues into 2022
- Three emerging challenges relating to environmental, supply chain and inflationary pressures
- Companies trending on the upward slope of the "K" riding beneficial tailwinds that boost growth

Last March we wrote about how the post-2020 "K-shaped recovery" was playing out across the globe[1] and stated that despite short-term challenges, our belief was that there would be a longer-term shift in the pattern of economic growth since the Covid pandemic had dramatically accelerated the rise of the digital economy.

This means any broad-based, cyclical recovery that we have witnessed is unlikely to be sustained, with structurally challenged companies falling further behind while those on the upward leg of the "K" continue to pull ahead. The companies that Comgest has identified as trending up include hyperscalers in the cloud, content streamers and electronic payment companies, while fossil fuels, traditional banking and brick-and-mortar retailers are drifting downwards.

Over the past year, however, three challenges have emerged which could change the shape of the "K" at a macro level. First and foremost, there has been a much greater focus on the environmental impact of companies and their carbon footprint, particularly after United Nation's COP26[2] climate change conference. Secondly, in 2021 some sectors witnessed

Comgest's portfolios are positioned for the long-term K-shaped recovery



Source: Comgest

[1] *"Investing in the K-shaped recovery: strong growth or structurally challenged companies?"*, Comgest, 2021. (https://bit.ly/3v8NiFe)
[2] *UN Climate Change Conference* in Glasgow (COP26), 2021. (https://bit.ly/353Z8pw)

huge supply chain issues which have created a number of headwinds for companies. The third is the impact of inflation and what this means for valuations.

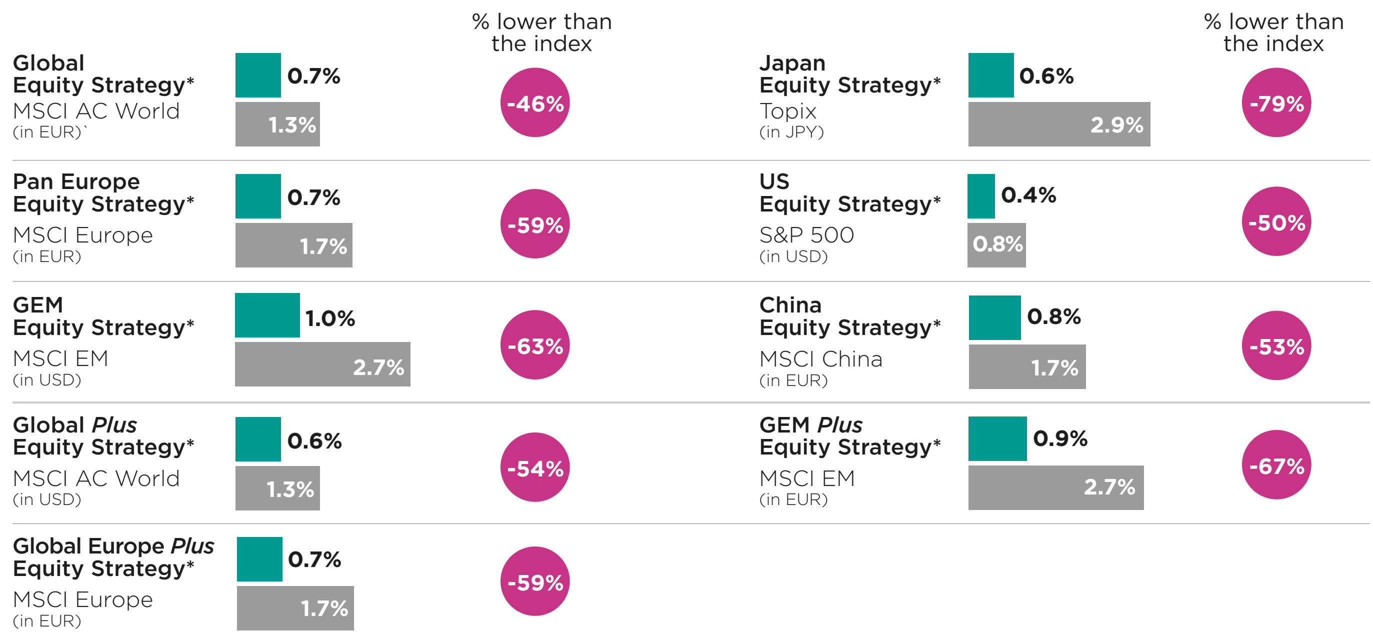
Comgest's Global Equity and regional portfolio management teams explored the types of companies across regions and sectors that are experiencing headwinds or beneficial tailwinds in this shifting environment.

THE ENVIRONMENTAL CHALLENGE

As seen in figure 1, Comgest's portfolios have a favourable environmental footprint versus their comparative indices as measured by Trucost. This is a natural result of our philosophy of investing in long-term, sustainable quality growth, which tends to steer us away from companies with substantial environmental, social and governance (ESG) risks such as fossil fuels, stranded assets, metals, mining, and oil and gas – resulting in low or no exposure to these sectors.

Amazon is one example of a company addressing its environmental footprint. With over 400,000 drivers and shipping more than an estimated 70% of its own goods, the e-commerce behemoth has a large carbon footprint.[3] To address this, the company recently announced an order of over 100,000 electric vans from US automaker Rivian as it attempts to convert its entire delivery fleet to electric vehicles (EVs).[4]

Figure 1. Environmental footprint of Comgest equity strategies

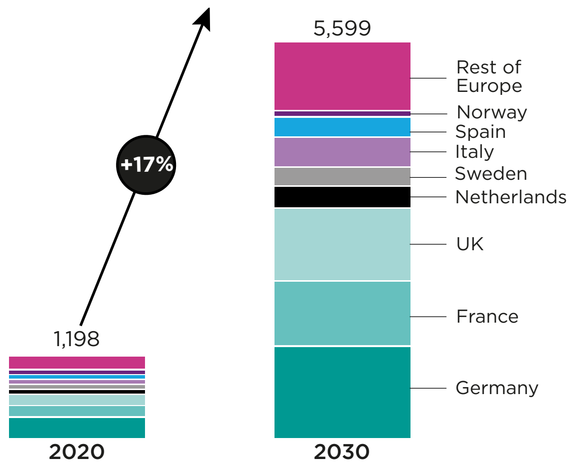


*Source: Comgest, MSCI as of 31-Dec-2021. The footprint estimates the ratio of annual costs annual costs linked to greenhouse gases, water abstraction, waste generation, air, land & water pollutants, and natural resource use associated with the portfolio holdings per EUR/USD/JPY million for the aforementioned year. The calculation date or currency used by MSCI for each index/portfolio can lead to differences in the results of comparable indices/portfolios. *Data for the representative account of the corresponding Composite, managed in accordance with the Composite since the Composite's inception (corresponding Composites: Global All Cap Equities, Global Emerging Markets Large Cap Equities, Pan-Europe Large Cap Equities, Japan Equities, US Equities, China Equities, Global Sustainable All Cap Equities Plus, Global Emerging Markets Sustainable Large Cap Equities Plus, Pan-Europe Sustainable Large Cap Equities Plus). Please refer to the important information section for more details on the representative accounts, their selection methodology and where to receive the GIPS compliant presentation of the Composites.*

[3] Schoolov, Katie. "Amazon is now shipping cargo for outside customers in its latest move to compete with FedEx and UPS," *CNBC*, 4-Sep-2021. (https://cnb.cx/3v7oail)
[4] Amazon, 3-Feb-2021. (https://bit.ly/34WJ8pB).

Governments and companies are well aware that to transition to a lower carbon world that EVs require accessible and reliable charging networks, which are also needed to overcome 'range anxiety'. **Alfen**, based in the Netherlands, is a company with a long track record in the smart grid and is seeking to benefit from supplying and operating charging stations. As figure 2 illustrates, the EV charging stations market in Europe is expected to grow at 17% per year for the next decade. This is supported not just by customer demand, but also by regulatory measures and programmes such as the EU's 'Fit For 55'.[5] Similarly, the European Commission is trying to set minimum standards in terms of public charging infrastructure with their 'Mobility Strategy and Action Plan',[6] which has mandated one public charging station per 10 EVs.

Figure 2. European outlook for annual installed EV charging stations (in 1,000 charge points)



Source: Alfen 2021 HY Presentation based on Guidehouse June 2021

Another area of increasing demand over the past couple of years is e-bikes. If you own a bicycle currently there is a high chance that your bike is equipped with **Shimano** components.[7] Given the company's huge presence in the traditional bike market, they were rather slow and cautious to enter the e-bike sector. However, after putting a lot of effort into developing new products, their e-bike business – based on our estimation from speaking with Shimano's management,[8] has grown around +85% year-on-year in the financial year ending December 2021. Many Western countries are investing greater amounts into public infrastructure, such as dedicated bicycle lanes, particularly as a way to reduce carbon emissions. We believe Shimano has positioned themselves well to take advantage of these expanding opportunities over the long term.

Photo by Kuchihige Saboten@mustachescactus/unsplash.com

Of course, powering these e-bikes and EVs requires batteries. Our analysis shows the battery market could grow by double-digit percentages per annum over the next decade. **LG Chem**, the second largest EV battery manufacturer via its consolidated subsidiary LG Energy Solution,[9] started their research and development in EV batteries back in 1995 – an early advantage that enabled them to gain expertise and numerous patents. That edge has translated into LG Chem being capable of producing batteries for most automakers around the world – which makes this business appear competitively positioned for growth over the next five years and potentially into the next decade.

[5] Council of the EU, "Fit for 55". (https://bit.ly/3pbDnuT)
[6] European Commission, "A fundamental transport transformation: Commission presents its plan for green, smart and affordable mobility". (https://bit.ly/3LMlIDI).
[7] Shibata, Nana. "Shimano pedals faster as COVID pandemic propels cycling boom", *NikkeiAsia*, 21-Jul-2021. (https://s.nikkei.com/3sYUiBV).
[8] Engagement call with Shimano management on 10-Feb-2022.
[9] Vaswani, Simran. "EV Battery Giant LG Energy Solution Soars On Debut After Completing Korea's Largest Ever IPO," *Forbes*, 27-Jan-2022 (https://bit.ly/3KIdScW).

THE SUPPLY CHAIN CHALLENGE

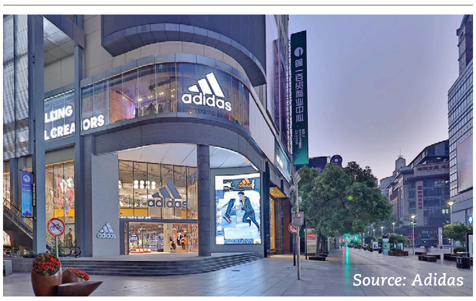
As we noted in our previous K-shaped investment letter, the rise in online sales is reshaping supply chains. In the last 12 months, supply chains have seen a number of significant difficulties. Within Comgest's portfolios, however, we've seen that not many of our holdings have been impacted since they tend to have better established supply chains.[10] Any short-term implications should therefore not result in long-term changes with respect to their market share.

One company which has benefitted from these supply chain challenges is the freight-forwarder **DSV**. The current market conditions are very favourable for this sector because freight forwarding businesses add the most value to their customers by finding alternative routes and combining various methods of transportation – via air, sea, road and rail – to find the right solution and secure capacity. This flexibility is reflected in DSV's expected operating profit growth for 2021 which is robust.[11] Considering that supply chain complexity seems set to last for some time, we do not think freight yields will reverse immediately, which could be advantageous for such businesses in this environment.

Source: DSV

Another beneficiary of the broad range of supply chain problems – triggering significant labour demand from sectors such as logistics, retail and healthcare – is the Japanese human resource company **Recruit**. Perhaps best known for their American acquisitions of Indeed.com and glassdoor.com, Recruit now covers over 80% of US job seekers[12] and offers the best cost per hire[12] ranging from traditional small businesses to, more recently, larger enterprises. As a high-quality HR, tech-driven business, our view is that Recruit could continue to lead the digitalisation trend in hiring, which is still in the early stages globally.

Despite potential short-term headwinds, another business that we believe still has the potential for strong long-term growth is **Midea** – China's largest home appliance manufacturer which conducts one-third of its domestic sales online. After a very strong 2020 in terms of overseas business expansion,[14] the company's CEO described last year as "being the worst of his 20 years at the company" given the huge headwinds caused by freight-forwarding prices.[15] Despite this, Midea still has strong capabilities in e-commerce in China and have been replicating in the US and Europe, with continued strong growth to date.



Source: Adidas

On the other side of the coin are companies like **Adidas** in the consumer sports industry, which have been directly impacted by supply chain issues. A look at the German sportswear giant's 2021 financial results, however, reveals the potential for only one particular headwind: low single-digit, organic growth that is purely linked to supply chain issues. While these could persist for the next quarter or two, we do not believe there will be a structural impact on the company's positioning or their ability to drive growth in the medium term.

[10] As of the date of publication. This may be subject to change without notice.
[11] DSV Annual Report 2021, 9-Feb-2022. (https://bit.ly/3suNUmR)
[12] Glassdoor, 16-Dec-2021. (https://bit.ly/3ItEptL)
[13] Waugh, Bob. 'The pandemic triggered the next big disruption in hiring,' *The Telegraph*, 1-Feb-2022. (https://bit.ly/3vuls6C)
[14] The 2020 Annual Report of Midea, Apr. 2021. (https://bit.ly/3pqs3uU)
[15] CEO remarks during interim earnings call for 1H2021, 6-Sep-2021.

THE INFLATION CHALLENGE

Is inflation transitory or temporary? This is still the question asked by most investors. There is no denying that pressures on both the demand- (as the world opens up post-Covid) and supply-side (notably, freight and energy/oil) have driven inflation higher. The Russian invasion of Ukraine in late February has triggered a global sell-off in equities. Oil and other commodity prices are rising, further fueling fears of a stagflation shock to the global economy.

Our view, as always, is that we invest for the long term, in strong franchises that are able to navigate any increase, not just on the inflationary side, but also should interest rates rise. Some companies could well be facing tough times. However, in our view, inflation matters significantly less for quality growth companies than it does for others. Furthermore, our portfolios are typically in a net cash position, while more importantly – they are self-financing, with strong free cash flow generation to help reinvest for innovative growth in the long term.

One such business example of strong pricing power is **Louis Vuitton Moet Hennessy (LVMH)**. From a fundamental perspective, LVMH is normally a reliable inflation hedge, given its pricing power across most of the group's luxury brands. Despite being in the midst of the Covid-19 pandemic in 2020, LVMH increased prices on its Louis Vuitton brand by roughly 5%.[16] An initial hypothesis might have projected a sales decline, but volume growth continued unabated.

Chow Tai Fook, a well-known jeweller with an 80-year operating history in China, is another example of a brand with strong pricing power. Amid an environment of rising gold prices, their domestic business not only grew 39% in 3Q2021, but they also opened close to 10% more stores than initially expected at the start of this year due to the continued demand for jewellery and market share gain.[17] As a domestic brand that creatively incorporates traditional Chinese elements in their gold designs, their recent sales have been helped by a trend that we have observed whereby younger Chinese consumers are preferring local brands and designs.

Daikin illustrates an additional perspective on being able to raise prices without curtailing demand. The company is a global leader in air conditioning (a/c) units that use an innovative, environmentally friendly refrigerant. At the same time, it faces tough cost pressures from rising raw material costs. When Comgest's Japan investment team met the CEO last year we were assured of the company's ability to cope with inflation, a competitive position that it has backed up by raising prices in many markets. We believe Daikin can continue to leverage, and even strengthen, its global presence in the a/c market, while also aiming to mitigate global warming through the development and supply of energy efficient units.

STILL K-SHAPED?

We still believe that the upward curve of the K is strong, and that Comgest's portfolios[18] are well positioned to benefit from these sector and structural growth drivers over the long term through our exposure to innovative companies with durable competitive advantages.[17] We remain wary of those industries on the slippery downward slope that were already structurally or secularly deficient pre-Covid and continue to be lacking even now as we emerge from the pandemic.

Source: Getty

[16] LVMH, Q1 2021 Sales and Revenue Call, 13-Apr.2021.
[17] Chow Tai Fook, 3Q21 earnings results.
[18] In this document, "Comgest portfolios" refers to the representative accounts managed in accordance with the corresponding Composites (i.e. American Equities, Global All Cap Equities, Global Emerging Markets Large Cap Equities, Japan Equities, and Pan Europe Large Cap Equities) since the Composites' respective inception. Please refer to the Important Information section for more details on the representative accounts, selection methodology and where to receive the GIPS compliant presentation of the corresponding Composites.

Given this unequal recovery, one thing we can be sure of is that Comgest will continue to invest following our philosophy – which is unwavering and unchanged – to seek sustainable quality growth for the long term. We believe that the expansion of the digital economy is self-reinforcing, meaning that companies on the upward leg of the K have the potential to generate strong and sustainable earnings growth over many years, while companies on the descending leg risk falling ever further behind.

The challenges identified in this paper relating to environmental, supply chain and inflation pressures may present themselves more acutely in the short term. However, given our quality growth investment approach,we believe that these headwinds could be well managed over the long term by our investee companies as they tend to be buffered by durable competitive advantages. Our experience has shown that during inflationary periods quality growth stocks typically have defensive qualities such as strong balance sheets, free cashflow to fund innovation and strong franchises that allow the pass through of pricing. While external forces and sentiment may impact valuations, some companies can catch a tailwind to benefit from these challenges. For quality growth investors such as Comgest, these market challenges have not changed our long-term point of view.

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Zak Smerczak joined Comgest in 2016 and is an Analyst and Portfolio Manager specialising in Global equities. He is also a member of the Comgest Group's Investment Committee. Zak started his career in 2006 at Deloitte in London, initially in Assurance & Advisory Services before moving to Transaction Services where he was responsible for operational and financial due diligence. In 2011, Zak joined Mirabaud Asset Management where he worked as an Analyst covering global equities. In 2015, he moved to Polar Capital Holdings where he held the position of Analyst / Portfolio Manager for the firm’s global multi-asset income strategy. Zak holds a Bachelor of Business Science Degree with Honours in Finance from the University of Cape Town. He is a CFA charterholder and has been a member of the Institute of Chartered Accountants of Scotland since 2009.

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