GLOBAL LONG-TERM UNCONSTRAINED

MARTIN CURRIE
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Protecting margins through pricing power

The importance of seeking companies with strong pricing power

With a persistent inflationary backdrop, pricing power is crucial to protect a firm's margins and returns: this underlines the importance of seeking companies with strong pricing power

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Key points

- Higher and longer lasting inflationary pressures globally are putting downward pressure on the margins of companies with weak pricing power
- It is unclear how long this higher and stronger inflationary pressure will last, but there is a risk of generally stickier inflation
- There is a risk that inflation shifts from being frictional to becoming structural, if wage inflation picks up
- Investors need to focus on retaining or gaining exposure to companies with stronger pricing power
- Companies with stronger pricing power will have more potential to protect margins from inflation's downside pressures
- Gross margin trends can be a good indication of a company's pricing power
- Our long-term unconstrained strategies always focus on companies with strong pricing power. They show superior pricing power compared to the broader market, both when assessed through our proprietary analytical framework, and when looking through the gross margins lens

As investors and fundamental analysts, we have always been putting a lot of emphasis on companies that are in a position to have strong pricing power, which for most of the past three decades has been related to an environment of low inflation, or constant deflationary trends in certain industries. Finding companies with pricing power in that context gives investors the potential to find companies that can either grow their margins, or protect them from constant erosion.

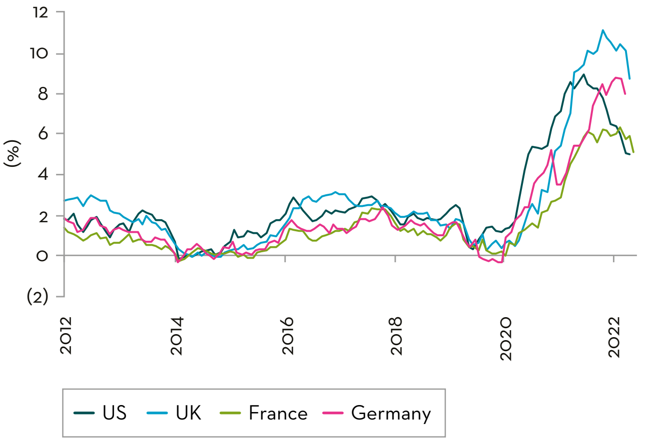
Globalisation, faster speed of innovation, and constant competitive pressures have tended to bring an underlying deflationary trend to many industries over the past two-three decades, which again led to the importance of pricing power for businesses operating on the global scene.

At the same time, pricing power is also important to protect companies from periods of strong inflation, such as the period we have been going through since the global pandemic crisis.

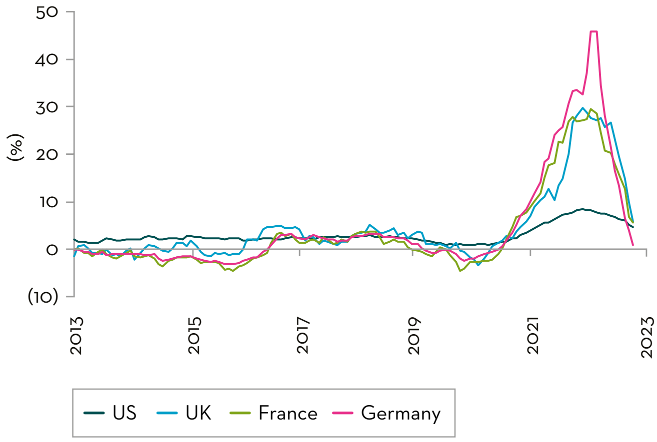
Longer lasting inflation is putting pressure on company margins

Supply shocks from Covid restrictions, geopolitical instability and wage inflation are leading to persistent inflation – emphasising the need for pricing power to protect a company's profit margins. Inflationary pressures have been very rapid, as can be seen in the chart below, and appear to be more prolonged than many market commentators have been predicting. We believe that inflation could prove stickier than expectations, and therefore longer lasting still, as a result of ongoing supply chain bottlenecks, the trend towards onshoring and near-shoring, and the technological fragmentation brought by geopolitical tensions.

Headline CPI inflation on a monthly basis (%)



Headline PPI inflation on a monthly basis (%)



Source: FactSet. For CPI data is shown as at 30 April 2023; for France as at 31 May 2023.

Competitive dynamics, customer power and a firm's innovative strengths all impact a company's pricing power, and in turn its ability to grow and protect margins. A systematic risk assessment of these parameters can help investors understand the risks to a company pricing power.

Investors need to focus on gross margins to avoid companies with weak pricing power

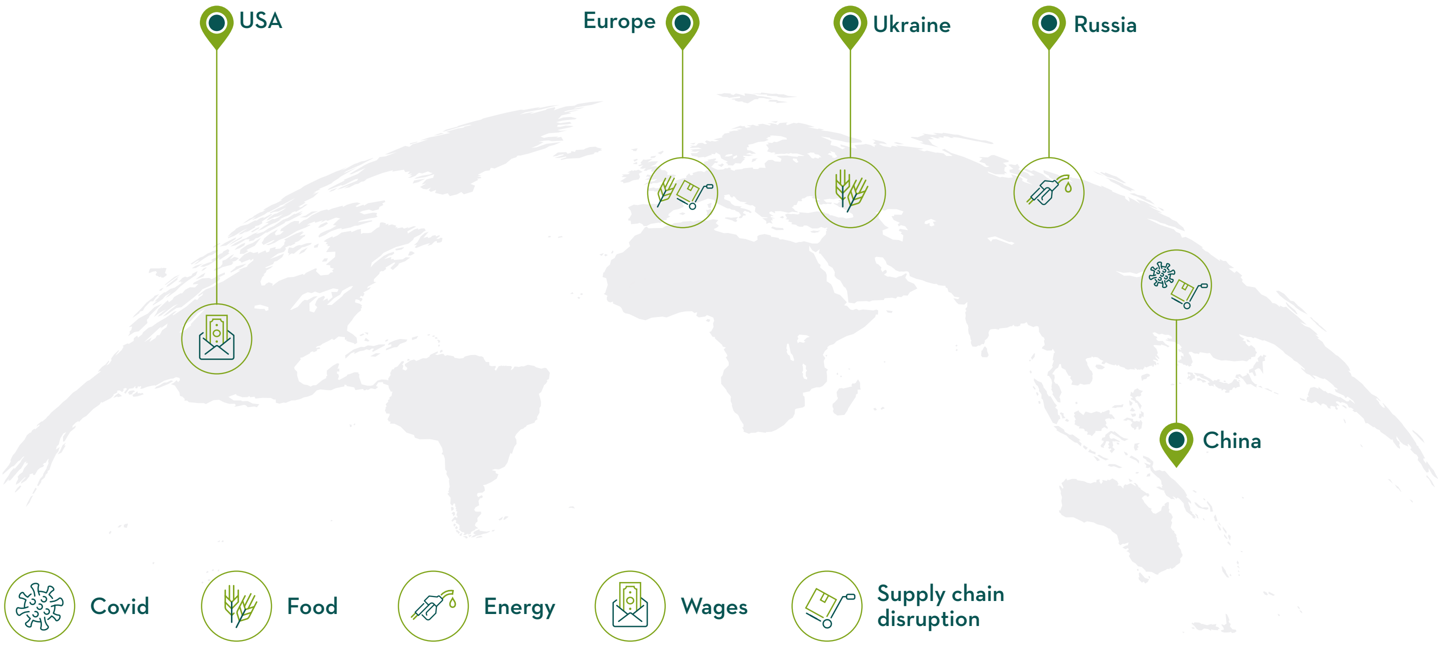
Companies with stable or rising gross margins show stronger pricing power, than companies where gross margins are eroding.

Longer lasting inflation is putting pressure on company margins

Inflationary pressure is proving to be stronger and longer lasting than expected, with the dual supply shock of Covid restrictions impacting supply chains and production lines, and the Russia/Ukraine conflict leading to tighter energy and commodity markets over the past 12 months. Across certain geographies, these also have the potential to turn from frictional to structural – for example in the US, where wage inflation has accelerated during the course of the past 12 months, but we are now seeing some easing of this trend. This environment highlights the need to have a structured and fundamental approach to analysing a company's pricing power and understanding this at an aggregate portfolio level.

What's driving inflation globally?

Global inflation flashpoints



A company's industry dynamics are crucial to pricing power

Why is pricing power important to companies?

- It can **protect margins** in high inflation environment
- Provides the ability to **grow margins** in low inflation environment
- Can **protect returns** both in long term deflationary underlying trends, and in a stickier inflation environment

We believe the six criteria below are crucial in a company's ability to manage pricing power, and in turn margin pressure. These are criteria that directly or indirectly, feed into a company's ability to have pricing power:

- **Competitive intensity**, i.e. competition risks
- **New entrant risks**, i.e. barriers to entry
- **Customer power**
- **Supplier power**
- **Innovation potential**
- **Disruption risk**.

These are captured primarily through our 'Industry' risk assessments in our proprietary fundamental analysis. We expand on each one in turn.

Competition: The more competitive an industry, the more fragmented a segment of the market is, the less pricing power a company has in that industry and that segment

New entrant risk: This can indirectly determine pricing power - the lower the barriers to entering a market, the easier it for a new entrant to come into a market/segment/industry, and therefore indirectly the more risk there is for pricing power to erode over time in that specific market/segment/industry.

Customer power: The stronger the customer power, the less pricing power a company would typically have. This is dependent of the size/scale of a company, or the ability for customers to switch supplier of the goods or services, in turn impacts the customers bargaining power.

Supplier power: The more suppliers are consolidated, the more they have power over its clients, and therefore corporates facing strong suppliers might not have the same ability to resist price increases, which indirectly can impact their own pricing power negatively.

Innovation potential: A company's ability to constantly innovate, and remain relevant for its customers. By being more innovative, a company's products or services can be seen as superior, and therefore can command a price premium versus competing products or services. The ability to be innovative can depend on many aspects, notably culture, attitude to be daring, and thinking differently from its competition and taking risks, importantly, it is also determined by R&D – being able to channel that R&D rapidly into relevant products/services that reach the market in a timely manner.

Disruption risk: If a company is facing a higher rate of disruption, its pricing power is likely to erode rapidly. Disruption risk can be challenging to assess. It requires a wide assessment of competitive threats, coming both from existing players in a market, but also assessing disruption that could be brought by new entrants, either present in an adjacency, or newly created companies that might be unencumbered by legacy, that can therefore be nimbler and provide better and more radically different products/services to the market in question. Disruption can come from the private equity market, so we systematically assess which companies are backed in size by private equities firms, as an early stage assessment of pricing power threat coming from disruption risk.

Our systematic structured fundamental approach to assessing pricing power for all companies that we research, and that we invest in permits us to assess an aggregate pricing power at the portfolio level.

Industry risks

	1	2	3	4	5
Competition					
New entrant risk					
Customer power					
Supplier power					
Disruption risk					
Pricing power					
Supply chain dependency					

Company risks

	1	2	3	4	5
Financial Leverage					
Regulatory					
Accounting					
Cost Base Inflation					
FX Mismatch					
Political / Country					
Tax Rate					
Acquisitiveness					
Industry Leadership					
Innovation Risk					
Workforce Risk					

Governance and sustainability risks

	1	2	3	4	5
Environmental					
Social					
Governance					
Remuneration					
Ownership					
Customer trust					

Portfolio risks

	1	2	3	4	5
EPS Momentum					
Bid Target					
Cyclicality					
Diversification					
ROIC Quintile					
NOPAT Quintile					
Asset Turn Quintile					
Upside Quintile					
Degree of Consensus					
Dividend Sustainability					
Liquidity Risk					

The range of pricing power for each of the strategies is shown below. Highlighting that even the strategies with the lowest pricing power are still rated at 2.1, which remains strong under our scale of assessment. At the company level, within each of the strategies, the range of pricing power is 1-3, which shows that all companies that we are invested in have reasonably strong pricing power.

		Global	European	International	US
Industry risks	Competition	1.9	1.8	1.9	1.9
	New entrant risk	1.9	1.9	2.0	1.8
	Customer power	1.6	1.8	1.8	1.5
	Supplier power	1.7	1.8	1.8	1.7
	Disruption risk	1.9	1.7	1.9	2.1
	Pricing power	1.9	2.1	2.2	1.9
	Supply chain dependency	1.9	1.8	2.0	2.0
Company risks	Innovation Risk	1.6	1.7	1.8	2.0

Readers should note that all of our strategies also have on aggregate a low competition risk (ranging from 1.8-1.9), a low new entrant risk (ranging from 1.8-2.0), a low customer power risk (ranging from 1.5-1.8), and a low disruption risk (ranging from 1.9-2.1). In aggregate, the strategies also have a low innovation risk (ranging from 1.6-2.0), which illustrates that companies held within the strategies we manage tend to have a good degree of innovation, that would typically enable them to remain at the forefront of their industries in terms of competitive advantages.

Source: Martin Currie as at 13 June 2023. Representative Global, International, European, US Long-Term Unconstrained accounts shown.

Investors need to focus on gross margins to avoid weak pricing power

Key points

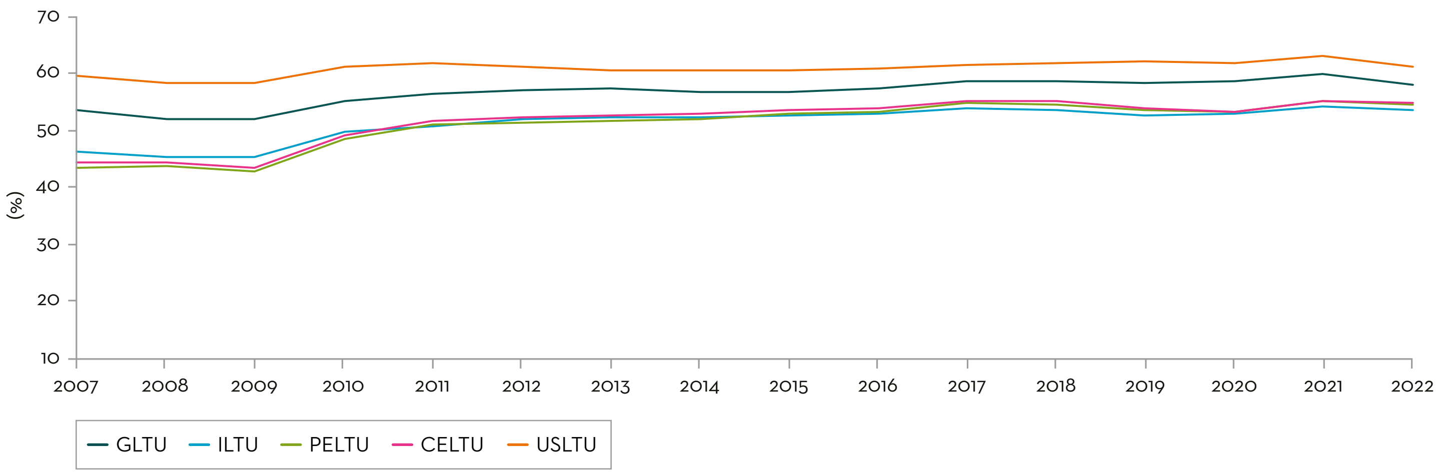
- Gross margins movement and stability over time can be an indication of pricing power for corporates
- Assessing the variation and trends historically at the portfolio level highlight stability in gross margins for companies within our strategies, therefore showing stronger pricing power
- In contrast, aggregate gross margin trends of the various geographic markets we assess show a lot more volatility over time, and hence significantly less pricing power than the companies in our strategies
- Gross margin pressure at the market level is particularly acute in the past 24 months, as inflation trends have been accelerating sharply

We believe the movement and stability of a company's gross margins over time can be a good reflection of its pricing power. Companies with stable gross margins, or rising gross margins, could be taken as having stronger pricing power typically. Stable gross margins can indicate that a company is able to maintain margins no matter the inflationary backdrop. We have assessed the current holdings we have over the long term, to assess gross margin stability. The details over the last 15 years are found below at the aggregate level.

At the aggregate portfolio level, gross margins have been trending up over the c.15 years period that we have been assessing (from 2007 onwards), from c.54% to almost 58% for the Global strategies, c.46% to c.53% for the International strategies, c.44% to c.53% for the European strategies and, 60% to c.62% for the US strategies.

Source: Martin Currie as at 31 May 2023. Representative Global, International, European, US Long-Term Unconstrained accounts shown.

Historic Gross Margins (%) – LTU Porfolios

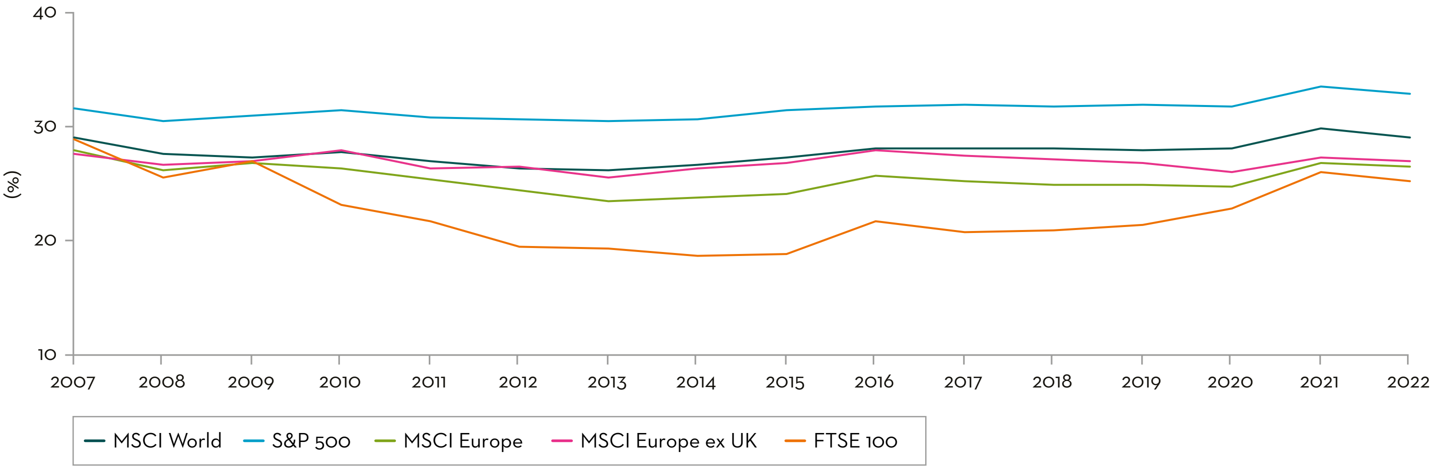


Source: Martin Currie and Factset as at 28 June 2023. Representative Global, International, European, US Long-Term Unconstrained accounts shown.

Over various recessionary years during the period, gross margins have remained fairly stable at the aggregate strategies level. They only dipped slightly if at all in 2020 compared to 2019 for the European and US strategies, and being marginally higher for the Global and International strategies. Similarly, for the GFC crisis in 2008/09, all of the strategies showed a small dip in gross margins, in the range of 110-150bps depending on the strategy, before a very sharp recovery in 2010, to levels significantly higher than when compared to 2007, as can be seen on the chart. This highlights the strength of the strategies we manage, and indeed of the collection of companies within our strategies, in terms of pricing power, gross margins have remained fairly stable at the aggregate strategies level, only dipping slightly if at all in 2020 compared to2019 for the European and US strategies, and being marginally higher for the Global and International strategies.

For comparison, at the various market levels, there has not been the same consistency in improvement in gross margins over the long term, as can be seen in the chart below, capturing the major US, European, Global and Asian equities indices.

Historic Gross Margins (%) – Indices

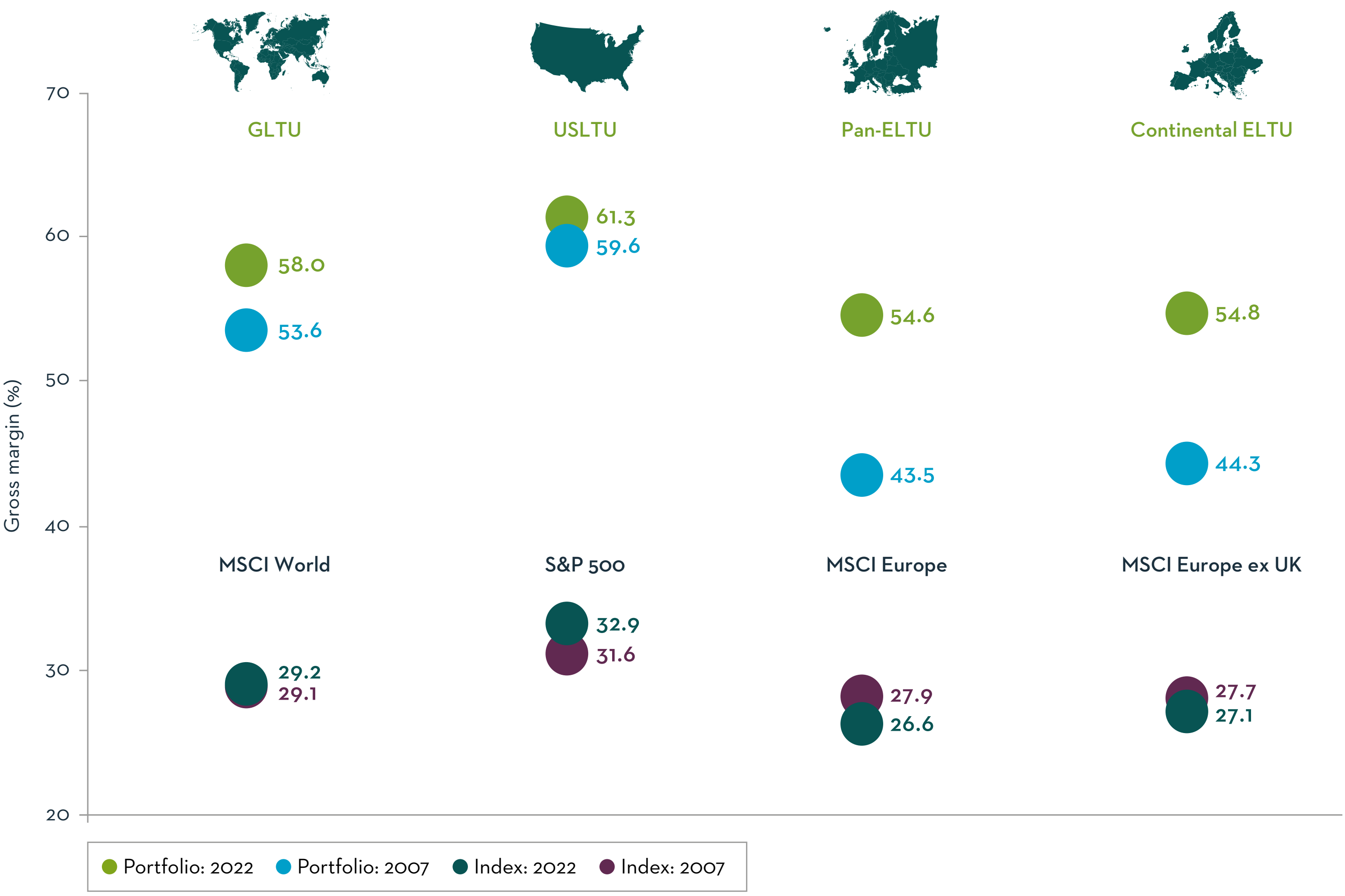


Source: Martin Currie and Factset as at 28 June 2023.

Gross margins trends for the broader market have been much more volatile over the period shown, and significantly lower to the gross margins achieved by our strategies, highlighting in general a lack of pricing power at the aggregate market level for the various geographies we show.

There is lack of pricing power at the market level

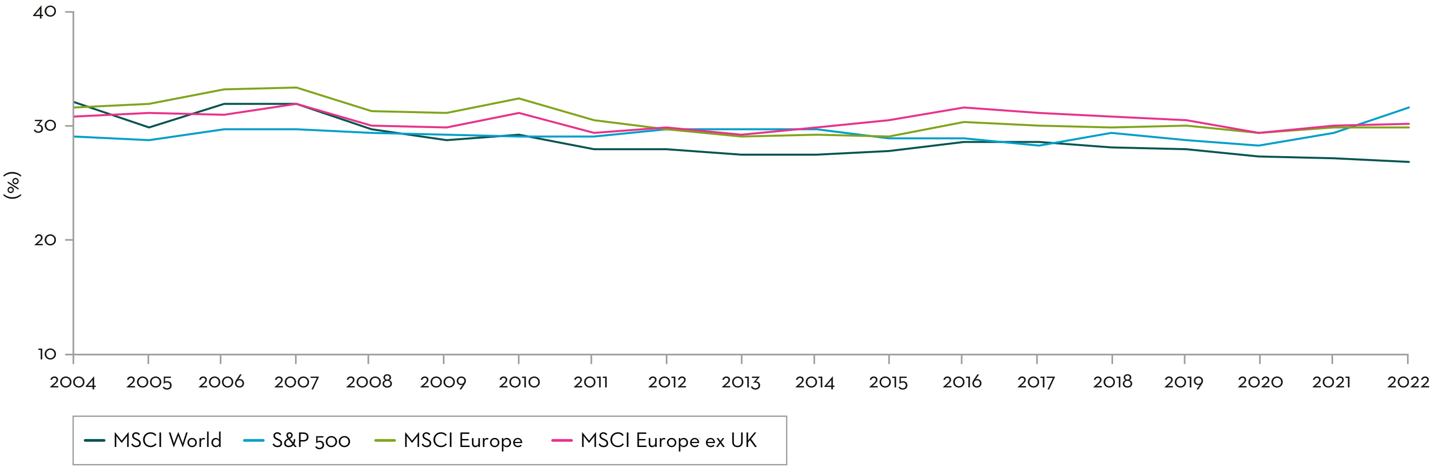
Gross margin growth across markets versus selected LTU portfolios (%) 2007-2022



Source: Martin Currie as at 28 June 2023.

The pedestrian trend in gross margins over the past 15 years in Pan-Europe, Continental Europe and the UK indices is an interesting observation, when compared to the improving trend seen at the MSCI World and S&P 500 levels. As shown in the chart below stripping out the Technology, Telecoms and Energy sectors from the MSCI World and the S&P 500 however does give a similar pedestrian trend in gross margins, when compared to the European indices, when also stripping out Technology, Telecoms and Energy sectors. The European indices does not have the same outsized weighting for European Indices as it does for the US and World indices.

Historic Gross Margins (%) – Indices ex Technology, Telecoms and Energy



Source: Martin Currie and Factset as at 28 June 2023.

More recent trends in gross margins capture some of the early impact of the higher inflationary environment that we are going through at the moment. This is particularly acute when stripping out the Energy sector, as well as Tech & Telecoms.

At the MSCI World Index level, gross margins have eroded by 110bps between 2019 and 2022, as inflation has picked up post the global pandemic, and as companies have struggled to pass through the higher costs. For the S&P 500, the gross margin over the same period has been flat. The gross margin erosion in Europe over the same period has been 210bps both at the MSCI Europe, and 250 bps at the MSCI Europe ex-UK levels.

Overall, what these charts highlight is that gross margin pressures have been much less acute for the holdings in our strategies than for the broader market over the period of elevated inflation since the global pandemic crisis. At the same time, these charts also highlight the lower volatility in gross margins that the holdings in our strategies are emanating, compared to the broader market, over the long term. Both of these aspects highlight that, looking through the gross margin lens as a way of assessing pricing power, the holdings in our strategies appear to have relatively stronger pricing power than the broader market.

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- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.
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