M1 CAPITAL
INVESTMENT MANAGEMENT

Some Expensive Biscuits – Market Commentary

South African ("SA") equities returned +4.6% in USD terms in March, outperforming Emerging Markets ("EM"s) but still trail by almost 8% for the year-to-date after a poor start to the year.

EMs themselves underperformed the MSCI World which includes Developed Markets ("DM"s) only. For the year-to-date EMs have returned +2.1% vs the MSCI World (DMs) at +8.8%.

The MSCI World returned +3.2% in March. DMs are led by the US with a year-to-date return of +10.4% for the S&P 500.

In respect of styles the month was very definitely a Value month with the MSCI Large Cap Value Index returning +4.6% vs the corresponding Growth Index's +1.8%.

The stronger Value return was also evident in the US market where the S&P 500 returned +3.2% while the Tech-heavy Nasdaq managed only +1.2%.

The various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for March 2024*

	Mar-24	YTD 2024
FTSE/JSE ALSI (ZAR)	3.2%	-2.2%
FTSE/JSE ALSI (USD)	4.6%	-5.6%
MSCI World	3.2%	8.8%
MSCI EM	2.2%	2.1%
MSCI Value	4.6%	7.4%
MSCI Growth	1.8%	10.2%
S&P 500	3.2%	10.4%
Nasdaq 100	1.2%	8.7%

*Total return indices, Source: Factset

At the time of writing in April, US Q1 GDP growth has just printed at a relatively weak, and below expectations, +1.6% annualised rate. The Personal Consumption Expenditure ("PCE") price index, excluding Food and Energy, another inflation measure, increased at an annual rate of +3.7%. The US market is falling in response.

Re the former we wonder if it might not be the start of a more pronounced downturn. The latter means markets will be worried about (a lack of) rate cuts. Both are negative for stocks. Treasury yields have increased in response, suggesting an inflation (and rate cut) concern vs a growth concern (for now).

We note that equity markets originally got into trouble in 2022 when bond yields started to rise. Despite commentary to the contrary (often by Value managers) we remain to be convinced of the sustainability of higher bond yields. Other than the currently falling inflation a recession would certainly also lead to lower yields.

We also note some exceptional stocks however which through this period of inflation, higher interest rates and a falling (in 2022) market barely registered declines and have since soared to valuations usually associated with Tech stocks. This commentary more specifically covers a Belgian biscuit-maker called Lotus Bakeries.

Lotus’s signature product is Biscoff Cookies, 5th biscuit brand in the world (not a leader), with ambition to be 3rd – Oreo is #1 - and which, incidentally, can be found at your local Checkers store. Biscoff-branded products which include biscuit spreads and ice cream account for 54% of company revenue. The remainder is differentiated into Natural Foods and “Local Heroes” i.e. local market biscuits, waffles, cakes and gingerbread brands.

The company sells primarily into Europe with the biggest market, the UK, accounting for 24% of revenue while the US accounts for 17%.

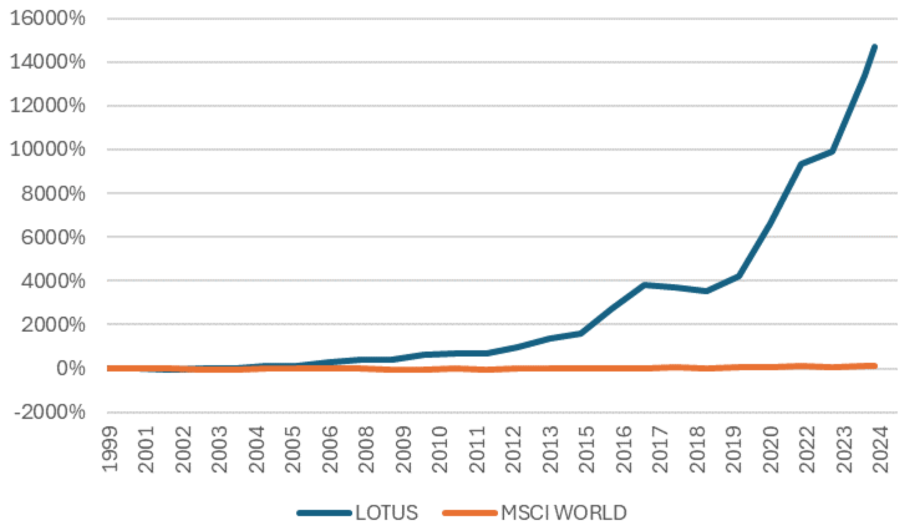
The company is 50% family-owned, and managed by Jan Boone, grandson of the founder.

The company’s second-largest production facility, after the largest one in Belgium, is located in Wolseley in the Western Cape.

Why are we discussing Lotus Bakeries?

As with all investment commentary the underlying driver is investment performance. Chart 1 below sets out Lotus’s stock price since 1999.

Chart 1. Lotus Bakeries’ price performance vs the MSCI World since 31 Dec 1999



Source: Factset

Per Chart 1 above, Lotus has returned 146.7x money since 1999 vs the MSCI World’s 1.4x. On an annualised percentage return basis this converts to +21.8% p.a. in USD terms for Lotus vs +3.4% p.a. for the MSCI World. Not bad for Lotus Cookies.

Several further comments are in order before we proceed

1. Note there was no decline in 2022 (the stock price did in fact decrease up to May 2022 but then more than recovered)
2. There were two consecutive years of negative returns in 2017 and 2018, during which an investor would have realised a cumulative price return of -6.8% vs the MSCI World Index of +5.7%
3. Lotus is a good example of the benefits of long term investing
4. Lotus is also a good example of why, assuming one is able to identify it, and/or assets similar to it, ahead of time, indexing can be wildly sub-optimal

Why has the stock price performed so well?

The company has had consistent but perhaps somewhat volatile revenue growth. In recent years this has been helped by inflation. It achieved an average of 17% p.a. sales growth in the 3 years from 2021-2023, but only 7% p.a. in the 4 years prior. Margins have been consistent at just over 15%, and return on capital also averaging close to 15% - satisfactory but also not necessarily the best available.

In 2023 the company reported a 25% increase in earnings per share and raised its dividend 29%. This was, however, an exception rather than the rule, with previous increases being more muted.

While Lotus has been a clear beneficiary of the inflationary environment in the last few years, the long term operating and financial performance could probably be characterised as being steady and consistent rather than necessarily outstanding. This is no Tech stock but the company exhibits many of the traits we tend to look for.

So what is the problem?

Lotus is a member of the select group of global stocks distinguished not only by its superior stock price performance, especially in 2022 (though, as noted, with some volatility) but with what happens to be an eye-watering valuation in recent years. Chart 2 below illustrates the historical PE of the stock.

Chart 2. Lotus Bakeries' PE multiple

Source: Factset

Examination of the history in Chart 2 is also instructive. The time to buy was clearly, as so often is, in the midst of financial crisis i.e. the 2008/9 period. The valuation then steadily increased until it reached a peak in 2016 before settling around 30x for the next few years leading into the Covid period.

With the advent of Covid, the stock experienced the exact same uplift as so many Tech stocks in the US and elsewhere. Inflation was yet to arrive then so perhaps the company's products were perceived as comfort food at home.

Since then the PE has only increased further, reaching a high of 60x earnings recently and currently trading at 58x.

What does it mean?

Multiples of 60x are not unusual in the US and some other DMs, but some context is required. US Treasury yields are closer to 5%, implying a PE of 20. Alternatively Lotus's 58x PE could be seen as offering a yield of 1.7%. This against a short term USD rate of 5% (a bit less on Euro), admittedly with steady growth attached.

It is probably also fair to expect however that the high nominal sales and profit growth rates will not persist as inflation comes down, even though management action, certainly on past record, is very likely to still see growth.

On the other hand, by the end of 2020, the US 10-year Treasury yield was at 1%, or a multiple of 100. Again for context, Belgian government bonds at the time were yielding 0%.

The current valuation appears more appropriate to the pre-Covid period, as opposed to the current one. One could still argue the market might be anticipating rates to decrease but in the context of the rest of the market we would consider this far-fetched.

As a result, and as a share we do not own, we prefer to wait and see.

What about those inflation risks and the interest rate outlook?

As a final comment we note that current pre-occupation is when and by how much the Fed might cut rates. We point out that breakeven inflation i.e. the difference between the Treasury yield and the real yield on inflation-linked bonds remains at 2.3%. Treasuries incorporate an inflation risk premium therefore it is safe to say the bond market continues to expect inflation at 2% p.a.