Magellan – In The Know: Episode 51

Exploring the market: Key insights on trends, spending and growth

Announcement (00:00):

The information contained in this podcast is for general information purposes and does not constitute investment advice. You should seek investment advice tailored to your circumstances before making an investment decision.

Host (00:17):

This is In The Know, a monthly investment podcast brought to you by Magellan Asset Management.

Emma Henderson (00:20):

This pressure on the lower income consumer has disproportionately impacted certain parts of the retail sector. So, we've seen that impact the performance of the Dollar store chains and also the fast food industry, where we are seeing brands really need to lean in to value menus and promotions to try and drive traffic.

(00:38):

As we move up the income spectrum, we are still seeing this middle and higher-income US consumer being in a healthier position relative to the low end, but they haven't been immune to the rising cost of living, inflation, higher rates.

Alan Pullen (00:51):

It's a very interesting backdrop we're seeing again from the top-down. We've got the employment strong, but some of those consumers are clearly struggling. And that's impacting certain companies within that sector. So, it's one we really need to be aware of, the opportunities and risks with the consumer at the moment.

Host (01:08):

That's Investment Analyst Emma Henderson and Portfolio Manager Alan Pullen discussing how the rising cost of living is affecting the global consumer and its impact on companies within the sector.

(01:24):

Welcome to Magellan In The Know. The current investment landscape is a turbulent one, but it is possible to survey the situation, find stable ground and map a rewarding future. In this episode, Investment Analysts Emma Henderson, Claire Britton, and Roy Harrison, along with Portfolio Manager Alan Pullen, cover everything from consumer trends, luxury spending, restaurant franchises, and social media, to the anticipated stimulus package in China, and the opportunities to invest in the infrastructure behind the growth of data usage. First, here's a warm welcome from Alan Pullen.

Alan Pullen (02:04):

Hello, and welcome to Magellan In The Know. I'm Alan Pullen, portfolio manager for our Global Equity Strategies. And today, I'm joined by Emma, Claire, and Roy, three of our key analysts. As a PM, we're expected to sit up there in front of clients and have all the answers, but I can tell you these guys are the stars of the show. This is actually where we get all our information from. These are guys who know their sectors backwards and really have such a depth of understanding. So, thanks for taking time out from a busy reporting season to be here today.

(02:34):

Reporting season already kicked off, and we've seen some big wins and some big misses already. So, on the pluses, Netflix and SAP have had some really solid results. On the negatives, ASML and LVMH are a little bit more disappointing. And we'll turn to LVMH soon, Emma, with you. But overall, I think the big moves that we're seeing on these beats and misses, yeah, five, 10% moves in these really large global companies, just goes to show where markets are at at the moment, I think. They've had a 20% return year-to-date on top of a very strong return last year, and that's left valuations relatively full, I would say, in the marketplace.

(03:12):

Now, our base case is, we still get a soft landing in the US. The data's been pretty good that we've seen coming out of there. But just given where valuations are, if we do get a disappointing outcome, and that could be the election, that could be geopolitics, there's definitely some risks there. So, we want to be conscious of the defensive side of the portfolio. Now, the US economy has been fairly strong. Underlying that has been the strength of the US consumer, which has powered the US economy for years, but we've started to see a little bit of mixed data there. So, why don't we turn first to Emma, who is part of our consumer team?

(03:50):

Now, Emma, you were on In The Know back in July, so maybe if you give us a bit of an update of what's happening in the consumer sector since then.

Emma Henderson (03:58):

So, with respect to Western markets and particularly the US, as you mentioned, I would say that a lot of the themes we were speaking about back in July remain broadly consistent. So, we are seeing a slowing, but overall still relatively healthy consumer backdrop and level of retail spending that is really being supported by strong employment. However, within this broader picture, we are still seeing some pretty clear variations in performance by income cohort.

(04:24):

Back in July, we spoke about how we were observing a lower income consumer being under significant pressure. And this is after dealing with the cumulative waves of inflation over the last couple of years that have dramatically increased the cost of everyday essentials, such as your household grocery bill. We are seeing this trend continue, however, more recent commentary from consumer companies and from the banks suggests that we may be starting to see this pressure stabilise at these low levels.

(04:51):

This pressure on the lower-income consumer has disproportionately impacted certain parts of the retail sector. So, we've seen that impact the performance of the Dollar store chains and also the fast food industry, where we are seeing brands really need to lean in to value menus and promotions to try and drive traffic.

(05:09):

As we move up the income spectrum, we're still seeing this middle and higher-income US consumer being in a healthier position relative to the low end, but they haven't been immune to the rising cost of living, inflation, higher rates. And we are seeing some caution there, and we're really seeing consumers be choiceful about what they're spending on. Where we're seeing companies outperform in this environment is where they are delivering strong new product innovation, for example, in Colgate's premium oral care business, or where they are offering goods or services that are considered very good value for money, say, a Chipotle burrito or bowl.

(05:46):

Other relative winners we've seen during this period of choicefulness have included travel and expenditures, which we're still seeing win out over goods in this environment. And also, interestingly, the convenience economy, with consumers continuing to prioritise spend on things like expedited shipping on E-commerce orders, Ubers and food delivery platforms, even though we're seeing them pull back in other areas of discretionary spend.

Alan Pullen (06:08):

Thanks, Emma. Yeah, it's a very interesting backdrop we're seeing again from the top down. We got the employment strong, but some of those consumers are clearly struggling. And that's impacting certain companies within that sector. So, it's one we really need to be aware of, the opportunities and risks with the consumer at the moment.

(06:26):

Now, there's been a lot of interest more recently, of course, on China. Now, China's an area we've been fairly wary on for a number of years. We've seen the property market come under a lot of pressure over recent years. We've seen the consumer really pull back. Since COVID really, they've been struggling. But we have heard about this big stimulus check potentially coming down the track. Does that make China more interesting to you?

Emma Henderson (06:50):

Yeah, you're right, Al. So, news flow on Chinese government economic policies has been a big driver of market sentiment over the last month or so for sectors exposed to the Chinese consumer. For example, luxury and beauty. Before I talk about the news headlines, I think stepping back, I want to mention that prior to this recent news flow, we've been cautious on the Chinese consumer for a while. But our level of caution had only been growing as we've progressed throughout this year.

(07:17):

As you mentioned, the property market, we've continued to see ongoing pressure on property prices, which is having a negative wealth effect on the consumer. Business confidence is low. We've been seeing rising unemployment. And more recently, particularly amongst white-collar workers in China, which is an important customer group for many of the Western brands that have businesses there. And then, unsurprisingly, given all this macro news flow, we've seen consumer confidence in China return to the all-time lows that we saw during lockdown. So, pretty bleak environment from a consumer perspective.

(07:48):

It's also been a tricky environment for corporates to do business in China. They're navigating a deflationary environment, they're having to use aggressive promotions to stimulate demand. And taking a price increase in this environment has been almost impossible. So, in summary, feeling still pretty cautious about the consumer. As you mentioned, we've just started 3Q reporting, and what we've seen to date has been a clear confirmation of this deterioration. And we're expecting some pretty ugly numbers to come. But that's backward looking, so let's talk about the recent stimulus news.

(08:20):

Fundamentally, we do think that the news out of China with the government clearly making a statement that they are concerned about the economy, we do think that fundamentally, this will be a positive for the consumer sector. Although, primarily in our view, through reducing further downside risk from here, ensuring that the government can hit their current growth targets and putting a floor under some of those economic indicators we were talking about that's really hurting the consumer. And where we're more cautious is that, is this going to create material upside risk to near-term earnings from here?

(08:53):

It's still pretty early days in what these stimulus measures are going to look like. There's uncertainty around the magnitude of the stimulus, the design, and most relevant to our sector, how these stimulus measures are ultimately going to flow through to consumer confidence and spending. In Western markets, when we hear about a large fiscal stimulus programme, we might think about a large scale cash distribution, like we saw during COVID, here in Australia and in the US, which drove a really sharp and relatively quick uptick in consumer spending.

(09:22):

I think it's important to keep in mind that there isn't precedence for this large consumer-driven type of stimulus in China. And we are not really expecting any massive waves of stimulus, like we saw from China back in the GFC, which underwrote many years of strong growth and consumption. We have seen some announcements to date around supporting the property sector, supporting local governments, and all of these indirectly should help the consumer feel more confident in China. But the benefit that we see may just be more gradual than some are hoping for.

Alan Pullen (09:54):

Thanks for that update, Emma. I think it's fair to say that five or 10 years ago, we were pretty confident on the quality of some of these domestic Chinese companies. They were clearly innovative, they were being run for shareholders. We weren't interested in things like the state-owned banks, which are clearly being run as part of Chinese government policy.

(10:15):

I think we've seen the government take a bigger impact in private markets, which has left us pretty wary from investing in Chinese domestic equities from a governance point of view. And there's a very high bar there that I don't think we're likely to cross, unless we see some pretty significant changes. Is there any domestic companies you're keeping an eye on, or how are you thinking about exposure to that large Chinese market?

Emma Henderson (10:39):

Yeah. So, we're not looking at any domestic Chinese consumer companies. As you mentioned, we do find it quite difficult to get confidence that the government and regulators aren't going to change the goalposts on these companies. And yeah, as you mentioned, that they'll always be putting shareholders first.

(10:54):

The other way that we do get exposure to the Chinese consumer, though, is through multinational companies. Given our cautious outlook on the Chinese consumer more broadly, we've been pretty selective in how we have wanted to take a Chinese consumer exposure through this volatile environment.

(11:11):

In luxury and beauty, we have two small positions in LVMH, as you mentioned earlier, and L'Oréal, which we consider to be two of the highest quality consumer companies in our investable universe. In terms of how they're faring, I think it's fair to say that no business in China that has exposure to the Chinese consumer has been immune from the slowdown. And in recent results from both of these companies, we've seen their growth inflect negative, which is worrying for a lot of people after they've been delivering such high growth in this market for many years.

(11:43):

However, when you dig into how they're performing, relative to peers, both of these companies are still outperforming their broader categories and taking share, which I think is reflective of some of their quality characteristics that we really like about these companies. Really strong brands, loyal customers, and a really disciplined approach to distribution. So, they haven't chased growth in China like we've seen other companies that has really, really come back around to bite some companies that had just had growth for the sake of growth in China up until now.

(12:12):

I mentioned before that there is clearly still a lot of uncertainty around the Chinese economy and Chinese consumer, but both of these companies will be really well-positioned if we do see things start to stabilise and improve from here.

Alan Pullen (12:24):

I want to dive in a little bit more on LVMH because I did promise we'll talk about it. And you're right, it was a pretty disappointing sales result that we saw with Chinese sales down 5%. You say not entirely surprising, but it was definitely a bit weaker than people were expecting.

(12:38):

I guess, conceptually, how do you think about your investment recommendation when you have what is a very, very high-quality company in LVMH, with these kind of shorter-term potential headwinds, but could turn into medium-term headwinds as well? It's a small position at the moment, so how do you think about positioning in that kind of backdrop?

Emma Henderson (12:57):

So, yeah, as you mentioned, China risk was clearly a headwind we were worried about into this reporting season. And part of that risk and range of outcomes has been reflected in our smaller position size. I'd say what we saw was a step-down to a magnitude which was much worse than we'd feared.

(13:13):

When I'm thinking through what does this mean for our investment and our longer-term view, firstly, asking myself, has the quality changed? Has this slowdown in China been because there's an issue with LVMH's core brands, Louis Vuitton and Dior? Has there been something that's structurally changed with the Chinese consumer that they don't want to buy luxury goods going forward, or that LVMH is not their preferred brand?

(13:38):

And I think when we step back, we continue to think LVMH is super high-quality business. It's got some cyclical pressures at the moment, and we saw that this quarter with China. These periods of economic volatility have historically presented really good opportunities to buy quality companies, so we will look closely at companies that sell off on what we believe are short-term headwinds.

(14:00):

But we'll always be asking ourselves, is this truly a short-term issue, or is this something more structural longer term that we need to be worried about?

Alan Pullen (14:07):

And that's a really good point. We are medium to long-term investors, so we were happy to look through short-term cyclical issues, where we're confident on the structural strength of the company and its long-term outlook. But we're always looking for anything that could be impacting that structural strength that those companies have. All right. Why don't we turn to the tech sector where we have Claire? And in particular today, we're going to dive into Meta.

(14:34):

So, Meta went into the portfolio earlier this year, following some concerns last year, I guess, where TikTok was on the rise. And there were questions whether TikTok might've potentially had an impact on user time spent on Meta. And also, there was a lot of spending on the Metaverse, which you don't hear much about anymore, do you, Claire? But they were spending a lot of money on that over a couple of years, and there were some concerns about how that would impact margins.

(14:59):

So, I guess, it's gone back in. It's performed very, very strongly this year. Can you remind us why we like Meta and how we got over those concerns?

Claire Britton (15:08):

Yeah. Thanks, Al. If we look at Meta today and its portfolio of products, it is best known for its social media platforms, Facebook and Instagram, which are the most popular social media platforms globally. But Meta is also the owner of WhatsApp, which is the most popular messaging platform worldwide. And one of the reasons why we like Meta, and why we got back into that position, was for the breadth of that user base.

(15:33):

Across Facebook, Instagram, and WhatsApp, Meta has four billion monthly active users. And that figure is still growing, which is remarkable. And with that user base and that valuable social graph and that social networking dataset that they've developed, alongside some significant investment in their technology and their algorithms, Meta has built one of the largest advertising platforms globally, with incredibly efficient targeting capabilities.

(16:00):

Their expertise in the digital advertising market has advanced to a point where they actually have a better understanding of how to maximise a brand's return on ad spend better than the brand itself. So, it's no longer the case that advertisers come to Meta with a specific audience that they want to reach, with a certain age group, with certain interest or geography. Instead, Meta can better predict who is likely to buy their product. And that is hugely valuable to advertisers to generate a return on their spend, and particularly for small businesses who don't have the luxury of a large sales and marketing team.

(16:37):

And it's a large market opportunity. The global advertising market is almost a trillion dollars in size, with digital advertising making up the majority of that. And we think there are opportunities for the digital ad market to continue taking share from traditional offline advertising formats and support that long-term growth that we think Meta will be able to really capture.

Alan Pullen (17:00):

You talked about the amazing engagement Meta has, and I've actually been pretty shocked. You're even seeing the Facebook Blue, the classic Facebook growing engagement in developed markets like North America. I'm like, "Who is not already on that thing? Where are these people coming from?"

Claire Britton ([17:15]()):

Yeah.

Alan Pullen ([17:16]()):

So, that's been remarkable. But there was a lot of concern that TikTok, particularly the younger generation, was going to take share. What's happened there?

Claire Britton ([17:25]()):

Yeah, you're right. So, TikTok, which is, for those who are unfamiliar, it's owned by the Chinese firm ByteDance, it really started gaining momentum around five years ago. It was a big pandemic winner between 2018 and 2021. They very quickly grew their users to about a billion globally with a skew, as you say, to those young users. And the risk for us and for Meta was the potential loss of user engagement and user time, and the loss of advertising dollars.

([17:52]()):

But something that Meta is very good at is adapting to change, and really innovating when it sees new trends or recognises a disruptive threat. For example, when Snapchat was founded and started gaining momentum in the 2010s, Meta launched Instagram Stories, which very quickly surpassed Snapchat in terms of usage. And I think if we look at those two companies side by side today, Meta's annual revenue is 30 times the size of Snapchat's.

([18:22]()):

Similarly, as Meta observed TikTok growing in popularity, it introduced Instagram Reels, which is Meta's short video format built with young adults in mind. And it's competing really well against TikTok. That threat that we saw, they have been able to rise to the occasion and compete against them really well. Just last quarter, Meta commented that it is seeing really healthy growth in young adults, that really important 18 to 29-year-old cohort, across its social media apps.

([18:54]()):

The other really strong driver for Meta for engagement with these young adults has actually been Facebook Marketplace, that old Facebook Blue app, which really goes to the value of that social graph and that social networking dataset that I mentioned earlier. So, TikTok absolutely still remains a competitive threat and it's something that we will continue to monitor closely. We think Meta is adapting very well. And we think that that ability to adapt is a really important quality, particularly for companies in my sector in the tech industry, where the pace of change can be very fast.

Alan Pullen ([19:28]()):

Yeah. Well, they attempted to adapt to the Metaverse. Of course, they were spending a lot of money there and it was impacting, potentially impacting margins going forward. Whatever happened to that? You just don't hear about it much anymore.

Claire Britton ([19:38]()):

Yeah, you're right. So, they had a really, I would say, a really tough year during 2022 when they had a number of headwinds. There was the TikTok risk, as we've noted. There was Apple brought out changes to how users interact across apps. We saw Meta invest heavily in their Metaverse, their Reality Labs strategy. And subsequently, we saw margins reduced from 40% to about 25% between 2021 and 2022.

([20:09]()):

And since then, Meta has really reset. We saw them really adapt to change and innovate and manage to compete with TikTok, but we also saw what they've called the Year of Efficiency. And we've seen Meta really tighten costs where they needed to, really focus on their margins and their margin growth. Really take out overlapping costs, or take out costs where the return on that investment was not as clear for investors, and subsequently really pulled back some of that Metaverse Reality Labs spending.

Alan Pullen (20:45):

Yeah. As shareholders, that's been great to see. Obviously, that means more money flowing into shareholders' pockets. Now, you spoke about their adaptability, and we've got so far an investing podcast, and I don't think we've mentioned AI yet, which is remarkable.

Claire Britton (20:59):

We haven't. We should have.

Alan Pullen (21:00):

So, well done, everyone. But of course, with Meta, are they able to adapt to AI? What's happening with them?

Claire Britton (21:07):

I'm glad you mentioned AI, Alan. I was desperate for the opportunity to talk about it. You're right, AI is infusing its way into nearly every company that we look at today. Certainly in our technology sector, but well beyond just our sector as well. But I would say, there's a large variance between the companies who really have an opportunity to utilise AI, to monetize it and to drive future growth, and those that are using it on the edge cases. And I would say, Meta firmly sits in the former category, and really has opportunities across its ad systems and its suite of products to capitalise on AI. So, let me elaborate on a couple.

(21:46):

Firstly, I spoke of Meta's strength in messaging, particularly through its WhatsApp channel. But it also operates the Facebook Messenger and Instagram Direct Messaging platforms. Meta has introduced its AI assistant to these channels, and is on track to becoming the most used AI assistant by the end of the year. Now, granted, perhaps some of that is by accident from people accidentally interacting with Meta AI unintentionally, but it shows the power that they have with that huge installed user base. And what we think Meta will be able to do is unlock opportunities in business messaging in the future. And not only help businesses use automation to help scale these consumer interactions, but also facilitate the full cycle of customer engagement. We're already seeing really strong traction here and think there's a considerable untapped monetization opportunity there.

(22:38):

Secondly, Meta is building AI tools to help sellers create content. So, I mentioned that Meta can very effectively push your content to the right audiences to maximise your return on ad spend. But as the advertiser, you are still responsible for creating that content. And where Meta wants to get to is a point where advertisers can approach them, simply with an objective and a budget, and Meta will do the rest for you, including creating that content with the use of AI. And again, these tools are particularly valuable for small businesses who lack the time and the resources for content creation.

(23:14):

Thirdly, Meta is building its own large language models, which have been trained on its unique first-party dataset, which we believe will be a competitive differentiator for them. Meta has chosen to open-source its large language models, which means anyone can access them and develop tools and capabilities on top of them. And we believe in by doing so, Meta will be a really important player in this market.

Alan Pullen (23:37):

Thanks, Claire. Yeah, it's interesting. AI affects so many different companies in so many different ways, but for Meta, it's a really clear opportunity to actually implement it. Well, they've been doing machine learning for years, but to really take it to the next level and drive revenue today in the near term. So, now let's turn to infrastructure.

(23:55):

There's been a lot of talk. We could talk about AI and data centres again, but I feel like that's been talked about a lot. There are other structural growth drivers, and I think we touched on some with Meta and the growth in video usage that infrastructure is also essential for. The growth of communications infrastructure is also becoming crucial for our online society. What trends are driving this asset class growth and keeping it relevant?

Roy Harrison (24:17):

Yeah. Thanks, Al. I think talking about trends like cyber security and demand for data centres has been done to death. And I think one trend in this communications infrastructure space that, I think, is a bit underappreciated at the moment is the growth in mobile data traffic.

(24:34):

So, just to give you a sense of what that's done recently, and to echo some of Claire's points on how much video content we consume through Meta, globally, since 2017, mobile data traffic has grown by about almost 50% per year. To give you a sense of what that looks like in a developed market, in the US, for example, where the majority of people already own a smartphone, that growth figure is around 33% per year. And over the recent period, that's been driven predominantly by the amount of video content that we consume.

(25:07):

Video content is around 150 times more data-intensive than browsing the web, for example. So, whilst you might think there is a limit to how much doomscrolling we can do on Instagram, the latest forecast according to Ericsson, they expect in the North American market for mobile data traffic to grow by around 20% through to the end of the decade. So, that's pretty staggering. And beyond the usual suspects driving that growth, such as social media usage, mobile phone sales, more video content, there are a few more developments that I'd like to call out.

(25:40):

So, the first one would be 5G conversions. People with 5G-enabled devices consume around twice as much data as those without them. So, simply because of the improved user experience you get on a 5G-enabled device. And it might surprise you, but only 60% of people in North America have a 5G-enabled device. So, we're only just past the halfway point in the rollout of this technology.

(26:04):

The second one would be fixed wireless access, which is essentially a technology that delivers highs-peed broadband directly to your home via a wireless telecommunications tower, and removes the need to connect that fibre directly to your home.

(26:18):

Thirdly, there's a technology called the Internet of Things, which is essentially a network of millions of connected objects that communicate with each other and are integrated into other systems. So, think of wearables that monitor vital signs, or sensors that provide predictive maintenance on large-scale infrastructure, and that's the technology that will enable driverless cars one day.

(26:42):

And then, finally, I'd just like to add one more technology that doesn't really exist yet, or not on a mass scale. So, generally, in the data transport industry, there tends to be use cases or applications that pop up unexpectedly that turbocharge the demand for data. So, in this category, it'd include augmented reality or virtual reality, new apps that haven't been developed yet, or some kind of AI-directed device use case.

(27:09):

So, mobile data traffic continues to grow not just because of our phones, but also because of the consistent development of new technologies that utilise the wireless network.

Alan Pullen (27:20):

I hope the video doesn't grow too much. If my kids spend any more time watching video on their phones, there'll be no time for sleep. Those other use cases certainly project pretty healthy growth. How do investors get exposure to this?

Roy Harrison (27:34):

Yeah. So, you've probably heard a lot about data centres recently, which is one way you can play it. For our Global Infrastructure Strategy, we really prefer to invest in this structural growth story through the telecommunication towers. These are defensive local monopolies with highly predictable income streams.

(27:53):

So, to provide you a bit of context, companies like Telstra in Australia, or Verizon in the US, need to provide the capacity in their mobile networks to support this level of mobile data consumption. So, they can increase capacity in three ways. The first is through new spectrum. The second is through technology enhancements, so think 4G or 5G. And the third is through more towers, or more equipment on existing towers.

(28:20):

So, if we think about addressing that problem, spectrum is a finite resource. Those technology generations have 20-year life cycles. So, to immediately address the problem of mobile data growth, which is growing rapidly, you need more equipment on more towers. So, that's the structural tailwind behind those businesses, but we also really like the business model. And personally, I think the towers sector has one of the best business models ever.

(28:47):

If you think about what they do, they provide the passive infrastructure to the wireless network. So, that's the steel in the air and the land under the towers. And those businesses like Telstra and Verizon rent space on your tower to hold their antenna equipment. So, if you think about the revenue line for those tower companies, that rental income grows at a fixed escalator of around 3% in the US. Plus, you get any ancillary revenues from those carriers doing any works on their equipment.

(29:14):

And then, the contracts with those customers are long-term in nature. So, generally, 10-plus years, plus the option to renew. And the operating and maintenance expenses for these companies, generally very low. We're dealing with fairly basic steel structures in most cases. So, your operating cash flow is fairly predictable. And the kicker is, if you add another tenant onto your tower, your rental income almost doubles, but it requires very limited incremental operating expenses to accommodate that new tenant. So, the majority of that revenue goes straight to your bottom line.

(29:48):

So, what you get as an investor in these tower assets is very defensive, predictable income stream that grows as the telcos invest in their mobile networks to support that level of mobile data growth that we spoke about.

Alan Pullen (30:02):

Yeah. I've heard these companies, these tower companies, being described as some of the best business models in the world, which is amazing when you consider some of the quality businesses out there. But that combination of long-term structural growth, very defensive, it is really attractive when you're looking to protect against the downside. Of course, which the infrastructure fund always has that in place. And we've funded these kind of companies in global portfolios as well. Very, very high quality. But all investments have risk, so what are the potential risks with these companies?

Roy Harrison (30:34):

If we're talking about what's going to move share prices for these companies in the short-to-medium term, I think the greatest risk has to be interest rates. So, if you look across our infrastructure coverage, I'd say, the towers sector is probably the most interest-rate-sensitive. And that's comparing to a group of companies that are fairly long duration and interest-rate-sensitive in themselves. And that's for a few reasons.

(30:56):

So, the first reason is that, as I mentioned before, the pricing index is at a fixed rate for the towers. So, those tower companies cannot pass on abnormally high levels of inflation onto their customers. The second reason is that because these assets are so defensive in nature, they can be quite highly levered. So, if you're refinancing debt, which is mostly fixed rate debt on the balance sheets of these businesses, what originally costs you, say, 3%, can now cost you 5%. So, that's a headwind to the equity investor.

(31:27):

And then finally, rightly or wrongly, some investors view these companies as having bond-like qualities plus growth. So, what I mean by that, historically, over the last 10 years, let's say, these stocks have offered you around 5% cash flow yield. Those cash flows have been very predictable, and they've grown at mid to high single digits. If you go through a period of rising interest rates, that can impact the demand from those investors who view these stocks as bond proxies plus growth. Because the yield is very important to them.

(31:59):

So, yes, over the last three years, these tower companies have underperformed due to rising interest rates. But I think it's fair to say, and you jump in if you disagree with me, that the interest rate outlook today is a lot more stable than it has been in the past. Therefore, these businesses are better positioned today to deliver stable and reliable returns for investors going forward, which is what we like to see in infrastructure.

Alan Pullen (32:24):

Yeah, I'd agree with that, Roy. Obviously, we saw a bit of a structural increase in interest rates post 2022. And when we saw rates come from zero up to current levels effectively over a year or so, that was a real structural move in rates. Since then, I think we've seen more cyclical moves around that four to four-and-a-half percent range. And we're talking about the 10-year yield here, which is the long-term rate that's going to impact the valuations of these companies.

(32:53):

That structural increase in rates was actually a headwind to a lot of our low-risk companies, like the tower companies. But where we are now, we figure that four, four-and-a-half percent is a fair medium-term outlook for the 10-year bond yield. Might move a little bit above, might move a little bit below, but it's not going to be a structural headwinds-to-returns going forward. So, the quality of those companies should show through over time.

(33:16):

Well, thanks, everyone. We've covered a lot of territory there. Thank you so much for taking time out from a busy reporting season. It's been a great discussion. Thank you.

Host (33:25):

That was Magellan Portfolio Manager Alan Pullen in discussion with Investment Analysts Emma Henderson, Claire Britton, and Roy Harrison. We trust you've enjoyed this episode. For more information on previous episodes, visit magellangroup.com.au/podcast, where you can also sign up to receive our regular investment insights programme. Thanks for listening.