"Before anything else, preparation is the key to success" – Alexander Graham Bell.

The expected recovery from China, post their reopening earlier this year, has not been forthcoming, and despite various promises of support from the centre, investors and consumers are showing restraint in their spending patterns.

Investment in Chinese real estate development is still missing.

Source: TIM/National Bureau of Statistics of China

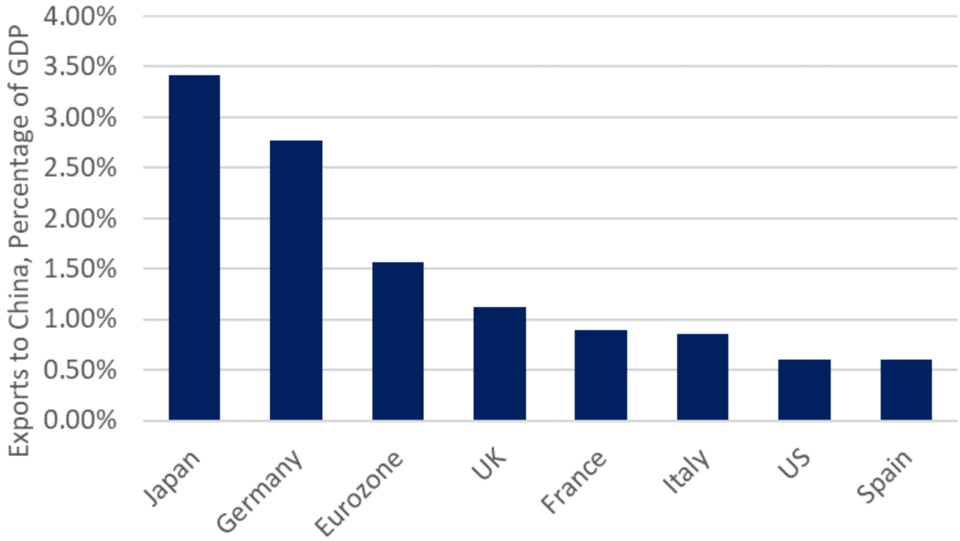
The recent GDP number coming from the region also disappointed those hoping from better news from the region, coming in at 6.3% when expectations were above 7%, and on a quarterly basis came in at only 0.8%. Commentary from the companies with exposure to the region, that have reported thus far, has varied wildly, with many commenting on tight market conditions, while others have seen consumption pick up and are expecting that trend to continue.

We reported on the travails of Estée Lauder in China last month, however, the recent comments from Moncler are similar to those from the other luxury goods companies, suggesting that Estée's problems are company specific. On their conference call, post their earnings, Moncler commented that *"we are going to see, on China itself, a normalisation in Q3….a strong rebound in tourism in the initial result of July….I would say a kind of normalisation in the growth internally and a strong growth that we see in the tourism outside region….our growth was slightly above 50% during Q2 compared to 2021."* LVMH saw sales in Asia ex Japan rise by 23% and Hermès grew at 28% over the same period commenting that *"after a successful Chinese New Year, momentum remained strong in Greater China and throughout the region."*

Confidence in China in the international community remains at multi-year lows, so if these positve outlook statements percolate through to other sectors and the economy, or as recently indicated, the government implements a further stimulus program, there is scope for a large re-rating in those companies exposed to the region.

The lockdowns on last year in China, had a large impact on companies worldwide, and disrupted the just-in-time delivery chains, which has resulted in many companies deciding to diversify their suppliers and instigate programmes of onshoring or nearshoring to bring manufacturing closer to their end markets. Nonetheless, China remains a highly important market, and any recovery or large government stimulus package is likely to be well received overseas as the state of its economy has vastly differing effects on their trading partners as shown by the chart below.

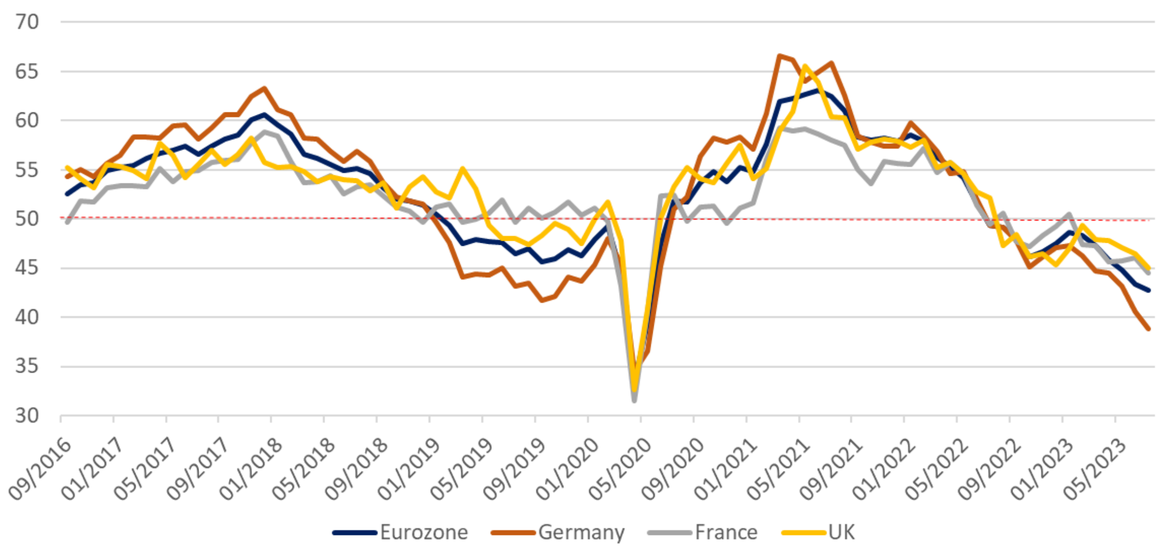
Exports to China matter to Global GDP



Source: TIM/IMF/World Bank

It is not just China that is finding it tough going at the moment, despite inflation stating to normalise, and supply constraints easing. The latest round of Purchasing Managers' surveys surprised to the downside, with German manufacturing, in particular, sliding to the lowest levels since the pandemic. This negative picture of Germany is backed up by the ZEW surveys for expectations of economic growth and assessment of the current condition which continued to slip further into negative territory.

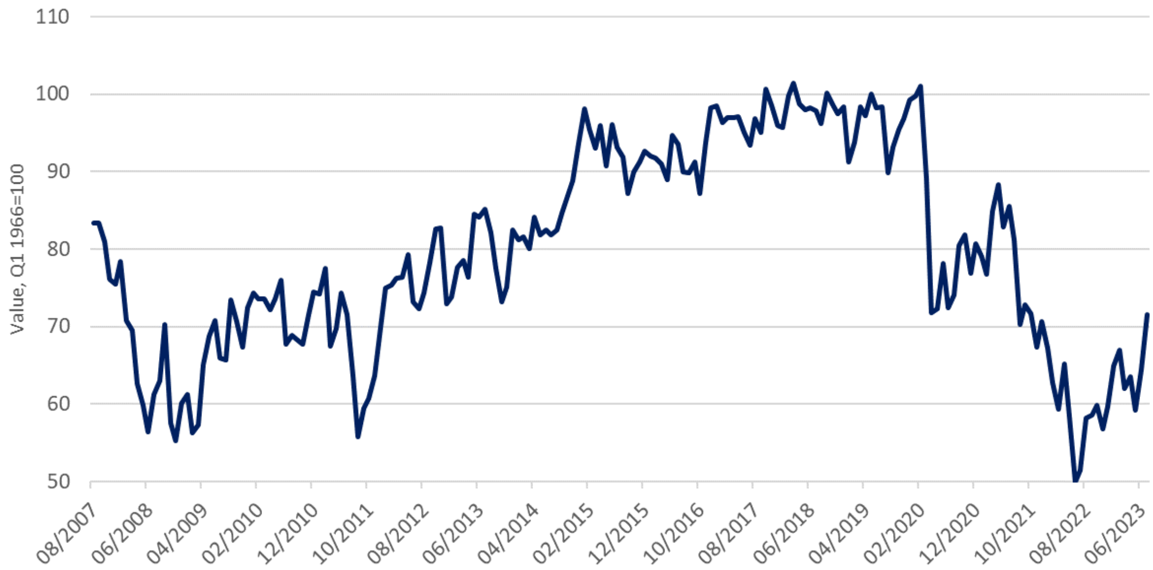
PMI



Source: Bloomberg

The anomaly here is that the macro-economic data does not tally with what most companies are reporting, which may well be due to the backward-looking nature of the reports. In the US, the latest ISM manufacturing number, whilst still below 50, the level above which denotes growth, rose from the level seen in June, suggesting that we may have seen the low, which has been historically a good time to invest as the rate of change turns positive. Consumer confidence in the US also improved significantly in July with the University of Michigan sentiment index rising to a two-year high.

<u>Consumer Sentiment is more inline with companies' outlook statements than the macro data.</u>



Source: TIM/University of Michigan

We are now over half-way through the first half reporting season, and for the most part companies are reporting growth and earnings ahead of consensus estimates. The chart below shows the balance of positive sales and earnings surprises thus far for the S&P 500 Index constituents.

S&P 500 INDEX

Surprise | Growth

Sector (BICS)	Reported	Sales Surprise	Earnings Surprise
11) All Securities	291 / 498	1.80%	6.42%
12) > Materials	14 / 29	-1.96%	6.62%
13) > Industrials	49 / 69	2.27%	8.04%
14) > Consumer Staples	20 / 36	1.41%	5.96%
15) > Energy	13 / 26	1.34%	3.35%
16) > Technology	42 / 80	1.54%	7.29%
17) > Consumer Discretionary	30 / 52	5.12%	12.21%
18) > Communications	12 / 22	0.82%	7.56%
19) > Financials	49 / 59	2.26%	4.71%
20) > Health Care	32 / 65	1.62%	4.81%
21) > Utilities	12 / 30	-4.51%	4.33%
22) > Real Estate	18 / 30	3.18%	4.79%

Source: Bloomberg

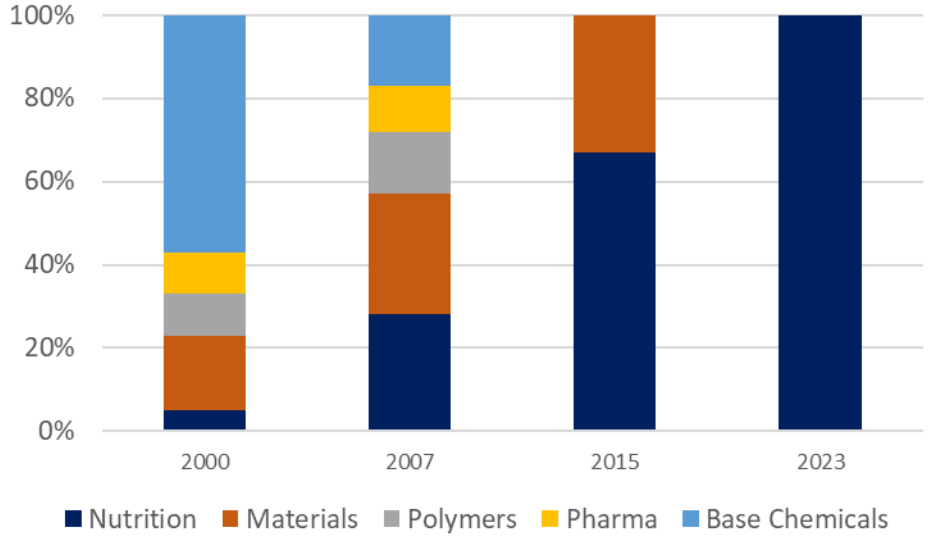
The VT Tyndall Global Select Fund B Acc (GBP) rose by 1.94% boosted by the continued strong returns in a variety of holdings such as Zoetis, Booking Holdings, Nvidia and Intuit. Performance was held back by our holdings in Estée Lauder, DSV and Heineken Holdings. The Fund has risen by 7.20% in the year-to-date.

<u>Fund Activity and News</u>

During the month we sold our small position in DSM-Firmenich, which is the new name of the merger between the Dutch ingredients & nutrition company. Koninklijke DSM, and the private Swiss flavour and fragrance company, Firmenich.

The original DSM business has transformed itself by divesting and spinning off various segments over the past twenty years, most recently the materials business to leave it as a pure play nutrition business prior to the merger.

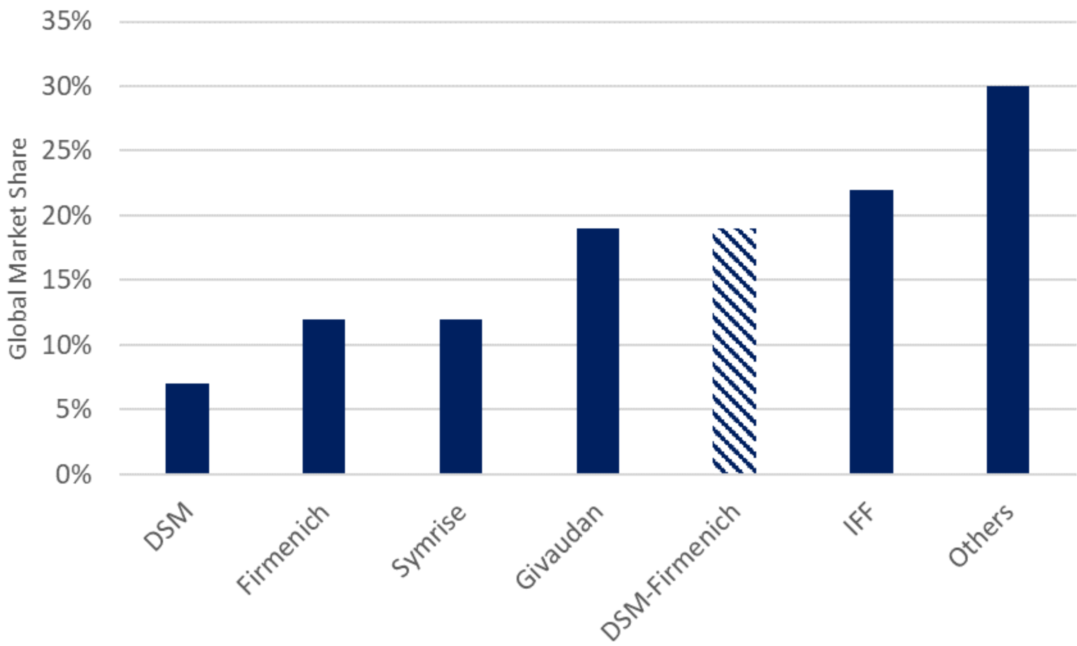
The DSM Chameleon.



Source: TIM/ Company Reports

The merger with Firmenich appeared as an opportunity to DSM as there was little overlap between the two companies and Firmenich, like Givaudan, IFF and Symrise, is a global tier 1 company, meaning that it is on the core recognised supplier list for all the major Fast Moving Consumer Goods (FMCG) companies, which DSM hitherto was not. The benefit of being on the core list is that they are pre-selected by the FMCG companies to compete for any new product briefs, giving them a higher likelihood of capturing growth in the sector. The merger of the two companies would not only give DSM access to this opportunity but also result in the second largest F&F (tied with Givaudan) in the world, theoretically giving it more bargaining power and global distribution.

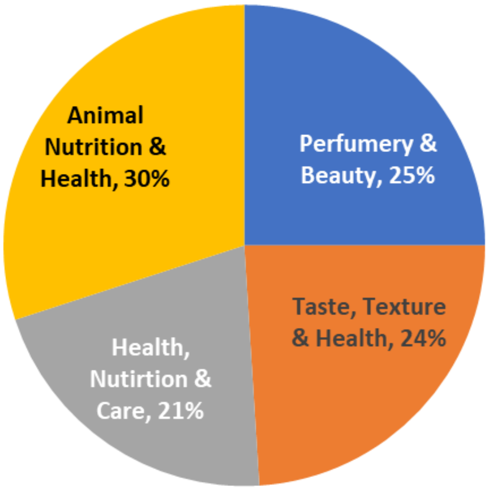
Flavour and Fragrance Companies Global Market Share 2022



Source: TIM/ Company Reports

On paper the combination looks very favourable with only overlap between DSM's Food and Beverage business and Firmenich's Taste and Beyond division as Firmenich's other offering is a Perfumery & Ingredients division, to which DSM hitherto had little exposure.

A new balanced company structure



Source: TIM/ Company

Unfortunately, as the merger formed red flag started to appear. We had questioned why the faster growing, higher margin Firmenich had opted on a merger of equals with DSM, however, saw the argument that the combined company would have the largest R&D budget in the sector and be able to derive significant cost synergies (€350m) as possible reasons. The departure of the key Firmenich management post the merger was a concern for us, nut this was compounded when Geraldine Matchett, the co-CEO of DSM announced that she was leaving in September.

Ms Matchett is well regarded in the industry and had served as CFO for DSM for six years before assuming the co-CEO role with Dimitri de Vreeze. She was the driving force behind the reorganisation of DSMs portfolio and although we are not proponents of co-CEO structures, the departure raises questions.

We also were surprised that the Perfumery & Business division was not to be led by Ilaria Resta from Firmenich, but instead Emmanuel Butstraem of DSM who also has the role of Chief Integration officer and a background in Food & Beverage. All the key C-Suite and divisional head roles are now to be filled with people from DSM and we question whether the roles are being occupied by the most suitable for the relevant jobs, as it seems surprising that no one within the Firmenich ranks have prominent roles.

The impromptu update from the merged company further led us to question whether the merged company was about to go through the problems that have held back IFFs performance over the past five years rather than create value like Givaudan and Symrise.

Source: Bloomberg

The call highlighted the ongoing issues relating to their vitamin exposure, which is much more cyclical than the core F&F business. The company intends to reduce exposure to Animal, Nutrition & Health vitamins to reduce thus volatility, however in the near term will face deteriorating volumes and pricing. While the company had previously guided to improving conditions, the call admitted that this was not the case and and that May, which is normally the peak month of the year, saw further deterioration. Furthermore, they do not expect any recovery during the rest of the year as destocking of inventory continues.

Our final concern is one facing all the F&F companies, that of power over customers and suppliers. Traditionally, given the importance of their products to their clients, and the relative low percentage of the total cost of production of the whole product, the F&F companies have been able to pass through most of the raw material inflation. This cycle this has not proved to the case as the FMCG customers, while passing through price increases to the end customers have been ruthless towards their suppliers too, protecting their own margins.

This reduction in strength of one of the key tenets of Porter's five forces is a major concern for profitability going forward, and with so many moving parts going on within the company, we felt that our capital could be better deployed elsewhere.

Richard Scrope, Fund Manager, VT Global Select Fund, 31st July 2023
Data source (unless otherwise stated): Bloomberg.

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