

Tom Russo on Shareholder Value Creation and Global Brands

Tom Russo spoke during a keynote Q&A session at Wide-Moat Investing Summit 2017. He addressed long-term shareholder value creation in global brands, including the shortening of management and investors' time horizons and the potential impact of Third Point's activism at Nestlé.

Tom also shared his thoughts on the threat posed to established global brands by so-called "challenger brands" as well as by "local champion" brands in countries like China and India. Another topic was the evolving power of brands in a world in which voice-based buying (e.g., via Alexa) may gain traction.

The following transcript has been edited for space and clarity.

MOI Global: The timing is prescient for this Q&A session as a lot seems to be going on in the world of leading global consumer brands. I'll just throw out Unilever and Nestlé as keywords and let you set the stage...

Tom Russo: The title of today's discussion, "Wide-Moat Investing", is really the segue into why it has been my preference over the years to invest largely behind international consumer companies. The brands are indeed the wide moats. To the loyal consumer a brand suggests that there is no adequate substitute for the product. "Well-branded" means the consumer will stay with a brand regardless of price to some measure. The products offered by our portfolio companies are largely global branded products, demand is price-inelastic, and that is valuable in business. It means that during periods of rising inflation or increases in commodity or labor costs, you can typically pass through those costs without suffering drop-offs in volume that normally accompany higher pricing.

In the extreme, we own businesses like Cartier, Johnnie Walker, Chivas Regal Whisky, and Martell Cognac. There is even an argument that, at the very high end of businesses, their products ascend to "Giffen good" status, i.e., the more you charge, the more they are in demand, because the brands stand in part for "price paid is value received". That is obviously an unusual status and hard to sustain, but the general notion that a brand allows you to have steadier, loyal demand for a product at prices sufficiently high to generate high returns on capital is profound. I first heard of it through Berkshire Hathaway's Warren Buffett at Stanford Business School in the early 1980s when he described his affairs with See's Candies. Over the years, we have watched See's go from a company for which Berkshire paid \$30 million to providing \$2 billion of investable funds for Berkshire's deployment as well as built to the point where today the business itself is probably worth \$2 billion. They only got there because they adhered to the demands of their consumer, they exceeded the expectation of their consumer, and they stayed true to their calling.

Wide-moat investing internationally is particularly interesting because it gives our portfolio companies, whether it is Unilever or Nestlé, the capacity to reinvest their mature market cash flows into parts of the world that are growing in population and GDP, which leads to

consumer disposable income. Our businesses, if they are managed properly, will extend the reach of their brands into underserved markets — often in advance of demand, which requires on-the-ground managers and people who run the businesses to have the capacity to suffer the earnings burden that comes from early investing to develop first-mover advantage. That ability is rare in public life because of the short tether Wall Street typically places on management to deliver more near-term results than is good for the long-term health of the business franchise. Many managers lament this, but it is something most public companies accept because of the reality that compensation is increasingly through stock options. As managers, they attempt — through smooth and steady earnings — to maximize the near-term share price to make the options quite valuable.

We avoid these motivations by finding businesses that have a reinvestable brand architecture to grow globally and are run and owned by families. If the founding families are still involved, they will stretch the investment horizon to reflect more the investment horizon I share with my taxable investors. The latter would just as soon own businesses that have the power to reinvest and have management able to reinvest without regard for near-term earnings burdens. Families with control can provide such protection, as witnessed by Heineken eighteen months ago when SAB Miller launched a takeover offer for Heineken. The family simply said, “We control 50.1% of the stock and we say no.” That was all it took for the management of Heineken to realize they could continue to invest for the very long term even though it depressed near-term results. The family stood behind them and protected them from the pressures other public companies cannot avoid.

The brand provides the moat. Management has the duty to widen and deepen it. The effort to widen and deepen has become furious because of rapidly changing forces. Think about Amazon. Think about the constant search in which younger consumers are engaged to discover the next brands. Balkanization of demand is ongoing across categories including food, beverage, tobacco, and certain other products, like MasterCard. The bulk of what we do is subject to a massive amount of pressure around the centrifugal force of younger consumers being far less brand-loyal and new routes to market, such as those presented by Amazon, Alibaba, and open markets. The goal is to keep widening and deepening moats, and that challenge has increased due to the rise of digital commerce and the increasingly fickle nature of younger consumers.

MOI Global: New brands also seem to be springing up in places like China, or longstanding local brands becoming more sophisticated in how they approach the market. How do you see the cache of Western brands in Eastern markets?

Russo: Competition is both global and local. Businesses need to have a local presence that makes sense for the communities in which they operate. The fight is typically fair, but not always. In India, for instance, Nestlé suffered a [below-the-belt punch](#) with its famous Maggi instant soup business, which has hundreds of millions of servings a day — a veritable staple to the Indian consumers’ lifestyle. It suffered a massive goodwill assault by local forces that alleged the product would kill young children because of ingredients that were toxic. There is absolutely no hard science to support the claim. Yet, it ran across all 250 newspapers in India, and Nestlé’s brand preference score for the Maggi product dropped from 98% to 8%. It was an assault against the brand franchise.

Nestlé has disputed everything, resolved all the fake science, and clawed its way back up to a 90% rating. In the void, there was activity by local competitors who tried to gain share and said that Nestlé was a foreign-owned, not-caring company, and that demand for its product should be replaced by a new “champion” of local products. This was a below-the-belt punch.

Where the playing field is more level, our international companies can offer the best of both worlds. The consumer in those markets often wants the Western trademarks. There is some dilution towards some local trademark appeal at the margin, but in the center, the assurance that comes from global brands is quite high.

In most markets the longstanding international platforms are almost invariably considered local brands. In England, Heinz *Beanz* is considered a British product. Throughout the world, the brands that are in fact multinationals have a perception among consumers as local brands. The ability to capture rising GDP in emerging markets inures in part to the benefit of companies whose brands have been unaffordable historically and, hence, have become aspirational over time.

The battle is well-fought. It's not always fair, it's not always above the belt. Generally, however, the brands that have inhabited markets but were unaffordable remain aspirational as people can spend more money because they are considered to be part of the local fabric.

MOI Global: There's been a lot of talk around Third Point and Nestlé [\[source\]](#)...

Russo: In terms of deepening and widening competitive moats, few companies have benefited my investors more than Nestlé, in which I first invested in 1987. I have had Nestlé as a core holding, just under 10%, for the vast bulk of my time as an investor, and it has delivered. It has gone from being in 125 countries 150 years ago to reaching into ever more countries with ever more products, adapted for local markets. They favor the long term over the short term. When I first met them, somebody asked then-President/CEO what the time horizon was at Nestlé, and he said thirty-five years, but they break it up in five-year increments. To my way of thinking as long-term-minded, taxable family investors, that was a very satisfying answer.

It doesn't satisfy every investor. Many investors find the notion of thinking out thirty-five years to be overly extensive, and they do not engage in such "antics". Nestlé has engaged in such antics for a long time and they have rewarded us. For the longest time, Nestlé was chastised for owning a stake in a company called Alcon, for which they paid \$30 million in 1973. They were never given credit for the holding. They were always asked to sell it, not by activists but generally by American and Western investors, who said, "How can you hold those shares? They are not part of your core business." The holding went from \$30 million to \$42 billion when they finally sold it. It was unorthodox. They did not yield to pressure to sell, and we benefited.

Today's world is different. The ability for managements to ignore shareholders' specific requests has been eroded to some measure by regulatory corporate governance changes. The ability to take for granted the payoff of long-term endeavors has possibly weakened because of the ever-faster transformation the digital world has brought upon us.

Today, if Nestlé considers the suggestions from Third Point, it will do so in a different [context]. There is a realization that the world has a shortened time horizon, and Nestlé accedes to it. The company's investment activity is improving dramatically as a result of the arrival of Mark Schneider, who had a reputation for setting strong KPIs within Fresenius and then letting management have the room to do what's needed in order to deliver. They reward accomplishments and they review failure; it is very much built around local execution.

Nestlé could benefit from the types of skills the new CEO brings to the table. He began the sale of partial divisions even before the Third Point announcement. Just recently, Nestlé

announced a willingness to sell the North American confectionery business. They are taking action. They are also setting up accountability in a way that will not let something like the North American division fester for three or four years. That happened over the past five years. Under Mark, there is heightened urgency, and the company will demand more from the divisions. We are going to see more come out of Nestlé because of the changes that are underway.

Third Point brings to the table an argument for greater urgency and capital markets sensitivity. Ten days ago, prior to the Third Point announcement, Nestlé had already filed for the ability to execute the \$20 billion share buyback. It had been approved by the board quite some time ago. They applied to the stock exchange, which is required in Switzerland. They sought approval and received it ten days later, and that is why they announced the buyback yesterday. They did not announce it because of the Third Point news. They already had placed the wheels in motion to authorize a buyback.

I spoke with the management recently. Some of the excitement about the buyback [relates to] the debt they will need to fund it. Longer-duration debt still comes in at such a compellingly low interest rate that the company will effectively substitute equity with low-interest, long-dated bonds. This is going to be a strong move for Nestlé. Whether that is induced by Third Point or not, whether Nestlé had started ten days earlier because they had an inkling that Third Point would file, I don't know. The fact is, it is good for the company to have this program announced and available.

Management remains set on building deeper and wider moats. They will still invest billions in primary food and beverage research for health and wellness. It is my hope that we do not diminish the source of that spending. Does Nestlé need to spend all of those funds internally? Absolutely not. Do they understand the value of outsourcing R&D and taking the best discoveries from wherever they occur in the world? Absolutely yes. Under Mark [Schneider], they are going to run the company with a greater eye for outside solutions, and [internal] investment will remain considerable.

Ultimately, it is a question of timing. I would be pleased if I could hold the shares and see the same kind of returns over the next thirty years as they have delivered over the past thirty years. How we handle long-term investments with near-term cost will determine the long-term return. If we cut too dramatically, our moat will fill and narrow. I would rather not see that happen at Nestlé.

They are in a position where they can take advice from Third Point and other investors. I don't think they are particularly proprietary about the source of a good idea. The \$20 billion buyback shows they are not entrenched or inflexible. [The activist news is] a remarkable development considering how unassailable Nestlé would have been from a corporate governance standpoint thirty years ago when I first invested as an American investor in non-voting shares, the only shares allowed to us. The company has come an enormous way and still has a great future ahead.

MOI Global: How do you deconstruct Walmart recently acquiring Bonobos in terms of “challenger brands”?

Russo: I just visited Bonobos. For Walmart, it is another step in their efforts to cover the omnichannel world. They have arrangements where you can have e-commerce orders picked up at the store or sent to your home. There are many different ways to approach their product line. With this business, they do two things. They get private label expertise, which

Amazon picked up through Whole Foods. It is important because they want to have a competitive product with solid margins and no price competition. [\[related article\]](#)

Inside the Bonobos portfolio are products they could make with a fashion approach, an element no one else can offer. That is something valuable for Walmart to develop. Otherwise, they continue to do a good job delivering value through their stores and village formats. In the case of the Bonobos, they also have this interesting developing skill set — local storefronts where you see, feel, and touch the product, even try it on, but then it's digitally ordered and home-delivered. It is a benefit for Walmart to extend into premium private label and learn more deeply the nature of e-commerce as they deepen their omnichannel skills. They have to stay competitive.

MOI Global: Looking at the bigger picture, it has never been cheaper, better, and faster to build a challenger brand. You have Warby Parker, Away, Harry's, Dollar Shave Club, Casper. How do you think about threats or opportunities posed by challenger brands?

Russo: It's exactly as you say. The tendency for moats to fill and narrow is accelerated because of the ease at which challenger brands come about.

For the past thirty years, people have tried to dislodge Gillette from its 85+% adult shaving market share, which is built over decades of sports-related marketing and father/son transfers of preferred technology. Unilever tried to compete directly with Gillette many years ago with a partner brand under the trademark Axe via Target. They got completely "axed" by Gillette, which dominates traditional routes to market. Schick Wilkinson tried to go straight at Gillette. They were rebuffed because they tried to go through traditional store channel distribution. That was clearly a channel that was unavailable to them despite their best efforts.

In the case of Harry's, three college roommates decided when they graduated, "We're not going to go to work for XYZ Company." They might just take a shot at taking over Gillette's market share. On what basis could they possibly have thought that made any sense whatsoever given the experience of the major competitors who got rebuffed? It's because, at some level, the message *is* the product. The medium through which it's sold is the product as much as anything else. The blades are not superior in any way whatsoever. It's about the experience of being different. Allowing for digital [buying] and home delivery opened the door. Now they have 4% of the market.

Dollar Shave Club did a similar job and sold to Unilever for a billion dollars. Now Unilever has that business. "[Dollar Shave Club has] the technology and know-how for going to market digitally, so we'd better add it." Unilever has e-commerce plans as well as products that will become more omnichannel. They will become more Internet-savvy with their product offerings.

It may have been easy for Dollar Shave Club and Harry's to do what they have done, but Gillette has responded. There is Gillette.com. They have cut prices at retail and are slowly doing what they probably should have done quickly earlier. They face the same lessons that Chobani delivered to Yoplait about disruption capturing new needs. The world is full of examples of companies hurt by fast startups. The major companies have to recognize they have a duty to respond or even lead from the start.

Philip Morris has done that aggressively with a non-ignited replacement product for cigarettes that is rolling out around the world with great adoption. Their view is that over the

decades they will become a 100% non-combustible products company. They have first-mover advantage even though theirs was the market share most directly impacted by the growing new business. They felt they had to destroy themselves to survive. That is probably a good mindset for most of the consumer products companies we hold. You see a tremendous amount of exploration around the edges. Whether it succeeds or not is going to determine the course of our investment returns.

MOI Global: How do you see voice-based buying — Alexa/Echo and so on — impacting the moat of brands?

Russo: *[Content restricted to members of MOI Global]*

About Thomas A. Russo:

Tom Russo joined Gardner Russo & Gardner LLC as a partner in 1989. In 2014 he became the Managing Member of the firm. Tom and Eugene Gardner, Jr. each manage individual separate accounts and share investment approaches and strategies. In addition, Tom serves as the Managing Member of the General Partner to Semper Vic partnerships. Tom oversees more than \$10 billion through separately managed accounts and Semper Vic partnerships. Gardner Russo & Gardner LLC is a registered investment adviser under the Investment Advisers Act of 1940, and is not associated with any bank, security dealer or other third party.

Tom's investment philosophy emphasizes return on invested capital, principally through equity investments. His approach to stock selection stresses two main points: value and price. While these would seem to be obvious key considerations in any manager's approach, it is equally obvious that all too often they are either misjudged or, perhaps more frequently, simply not viewed together. Tom looks for companies with strong cash-flow characteristics, where large amounts of "free" cash flow are generated. Portfolio companies tend to have strong balance sheets and a history of producing high rates of return on their assets. The challenge comes in finding these obviously desirable situations at reasonable or bargain prices.

Tom's investment approach is focused on a small number of industries in which companies have historically proven to be able to generate sustainable amounts of net free cash flow. (These industries typically have included food, beverage, tobacco, and advertising-supported media.) This fairly narrow approach reflects his training and discipline at the Sequoia Fund in New York, where he worked from 1984 to 1988. Tom tries to limit risk by not paying too large a multiple of a company's net free cash flow in light of prevailing interest rates. He attempts to broaden this otherwise narrow universe by including companies with smaller market capitalizations and companies in similar industries based abroad. Tom's goal is one of an absolute return rather than a relative return, and he continues his long-term investment objective of compounding assets between 10 and 20 percent per year without great turnover, thereby realizing a minimum amount of realized gains and net investment income.

Tom is the Managing Member of the General Partner of Semper Vic Partners, L.P., and Semper Vic Partners (Q.P.), L.P., limited partnerships whose combined investments are roughly \$3 billion, along with overseeing substantially more funds through separate accounts for individuals, trusts, and endowments. He is a graduate of Dartmouth College (B.A., 1977), and Stanford Business and Law Schools (JD/MBA, 1984). Memberships include Dean's Advisory Council for Stanford Law School, Dartmouth College's President's Leadership Council, and California Bar Association. Tom is a charter member of the Advisory Board for the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School. He serves



on the boards of the Winston Churchill Foundation of the U.S., Facing History and Ourselves, and Storm King Art Center.