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ADVISERS

Weekend Thoughts 1/7/23

Net: In a light news week, there was no noticeable change in the signs of modest softening and the Federal Reserve slowing rate hikes and holding them near the current elevated level. The market remains data dependent as the interplay between the lagged cumulative effect of policy tightening, investor demand for profits today, and corporate expense reduction calls into question some margin forecasts and potential earning weakness.

- Information Technology
  - Duck Creek Technologies, Inc. (DCT)
    - “Deal activity in the quarter was significantly better than earlier in the fiscal year as we signed a number of exciting wins with carriers of all sizes. Reflecting on our performance this past year, while we experienced some elongated sales cycles earlier in the year, we had a strong fourth quarter performance as we closed in some of the opportunities that we're building up in our sales funnel. As Mike noted, we had some good cloud migration deals in the quarter and still believe we can drive incremental subscription revenue growth within our base as they continue to adopt our SaaS solutions in addition to driving deals for new logos.”
    - “we have seen more conservative behavior from our customers. And I think that the way that, that's manifesting itself in our deal flow is especially in the Tier 1s and 2s, perhaps smaller deal sizes to start out. We're not seeing that deal duration is shrinking on us.”
    - “So we're not seeing, I'm going to say, the length of the term of our contracts be reduced. We are seeing in the larger carriers, our average deal size reduced. But we do think that still represents good buy-up opportunity in the future. So nothing concerning for us. It's just out of the gate, we're going to get less, but I'm not going to say a shrinkage of the deal term or the length.”
  - ON Semiconductor Corporation (ON)
    - “there are trends within each of these markets that are holding up and driving the design win funnel and subsequently, the growth in these markets. In the automotive, you have electrification and ADAS. In industrial, what we call the core industrial, factory automation, energy infrastructure, medical, those are what's driving a lot of that design funnel and also, obviously, subsequently the revenue projections that we've had."
- Consumer Discretionary
  - Helen of Troy Limited (HELE)
    - "During the third quarter, consumers continued to tighten their purchasing patterns in some categories in response to high inflation and higher interest rates. As consumption slowed, some retailers continued their conservative repurchase patterns to further reduce their inventory. Our promotions across online and in-store channels were slightly elevated on certain parts of our business, such as Beauty and Health and Wellness, helping to support the consumer trends we are seeing and helping our retail partners better reach their inventory reduction goals. The holiday season started off slower than expected with discretionary categories generally under pressure from these trends. In some categories, performance

improved in late December, ending largely in line with our expectations."

        - "The consumer continues to feel the impact of inflation, and as we have seen during the holiday period, was seeking to buy discounted or promotional items. We are seeing positive signs that inventory at some key customers is beginning to rebalance, and we will continue to monitor closely as retailers finish their holiday season."
        - "Looking ahead to fiscal '24, there remains considerable uncertainty in the near-term macroeconomic and consumer outlook. We expect that many of the same macroeconomic factors that made calendar '22 so challenging may persist into calendar '23 as well as the compounding effect of the uncertainty of a potential recession and whether or not the Fed can execute a soft landing. These factors continue to make the ability to forecast consumer behavior patterns difficult."
        - "We believe that fiscal '24 sales growth will be challenged and highly dependent on the health of the consumer and that the variability of these factors could drive a wide range of potential outcomes which would be impacted by the depth and length of any potential recession."
- Consumer Staples
    - Conagra Brands (CAG)
        - “Despite our most recent wave of inflation-justified pricing, consumer demand for our products in the second quarter was strong as elasticities remained muted and well below historical norms. The ongoing durability of demand is a testament to the strength of our portfolio and demonstrates how the Conagra Way playbook has positioned our brands to continue to resonate with consumers even in an inflationary environment.”
        - “as we continue to play catch-up by increasing price incrementally to account for the extraordinary extended rise in inflation. At the end of the first quarter, we reached a significant inflection point in the relationship between net sales and COGS, marking the end of the temporary margin compression phase in the beginning of the margin recovery phase.”
        - “We expect gross inflation to continue, but moderate through the remainder of the fiscal year, resulting in an inflation rate of approximately 10% for fiscal '23. Additional inflation-justified pricing actions that have previously been communicated and accepted, will go into market in Q3. However, the magnitude of these pricing actions will be smaller and more targeted than previous pricing actions.”
        - “What's been unusual in this cycle is the sheer magnitude of the inflation super cycle and the number of waves. So the reason -- the shape of that curve on that slide, you see it is, because it reflects multiple waves of COGS inflation and the follow-on pricing effects. The sheer number of those waves is now slowing down. And that is why you're seeing the sharp recovery and sometimes it slows down faster than you might expect, which is why the recovery might come in faster.”
        - “The first big trade down is the trade down from away from home to at home. If you're looking at consumers over $100,000 a year income, you're still seeing they're going out to eat. But below that threshold, it's not where it was pre-pandemic. So one of the reasons -- a big one of the reasons why you see muted elasticities across the sector on average is because there has been -- there was a trade down into at-home meeting during COVID. And that has not fully reverted to away from home because the prices away from home have gone up so high that it's a better value to

continue to eat in home as people are trying to stretch their household balance sheet. And we are the beneficiary of that. And it shows up in muted elasticity. When you double-click down from there, within grocery, what you see is there is trade down taking effect. And if you look at private label by category, you can see that in certain categories, they are making progress. Those categories almost, always tend to be categories that are more highly commoditized. So things like in food, like cooking oil. And outside of food, things like ibuprofen. When a consumer knows it's a single ingredient product and one is a lot cheaper than the other, the switching costs are lower. It's easier to make the trade down."

    - "with respect to inflation from here, it's still with us, right? So we're calling 10% on the year. It's not deflation. It's sustained inflation. And that's just an important reminder that we're not looking at a deflationary period. So that's got to factor into the retailer conversations as well. . . We're not experiencing deflation on average by -- across the board"

- Constellation Brands (STZ)
    - "given continued inflationary pressures and the potential impact of recessionary environment, we remain mindful of balancing the momentum of our brands against near-term cost challenges. To that end, based on our current expectations of the pressures that the consumer will continue to face in the near term, we are giving even more careful consideration to our pricing actions for fiscal '24. In particular, we currently expect pricing actions for our beer business to be more muted in fiscal '24 as our pricing actions in the current fiscal year were ultimately above our medium-term algorithm. While input costs remain at historically elevated prices we strongly believe that additional consideration in our approach to pricing in fiscal '24 is warranted to sustain healthy growth for our brands. In addition, while some input costs are below the peaks from earlier this fiscal year, we now anticipate inflation to remain above historical trends in the high-end single-digit range for fiscal '24. As always, we will continue with our disciplined approach to manage these evolving conditions through cost-saving initiatives. But these persistent inflationary headwinds will be compounding on the double-digit cost uplift we have faced in fiscal '23. As such, we now expect operating margins for our beer business in fiscal '24 to be more in line with our anticipated margin structure for this fiscal year, and therefore, below our stated 39% to 40% medium-term range."
    - "operating income and operating margins were negatively affected by ongoing inflationary pressures across raw materials and packaging, particularly as more favorable hedges rolled off. Increased logistics expenses related to higher fuel and freight costs, incremental operating costs and increased depreciation as a result of our brewery capacity expansions, and increased marketing spend"
    - "Beyond our hedging program, most of our beer business input costs have a greater exposure to inflationary pressures, including raw materials, such as wood pallets, steel crowns and cartons. The majority of these input costs are subject to contractual agreements that tend to reflect negotiated prices that are based on existing inflationary conditions. So as we move forward with our annual planning and supplier cost determination process, we will develop a clearer view of these contractual prices and on the resulting margin expectations. Against that backdrop, with these processes now underway, we have greater visibility into the high single-digit cost segments that will continue to build off the double digit unfavorable cost outlook that our beer business faced in fiscal '23."

        - “we continue to see ongoing macroeconomic pressures on the consumer, which are leading us to plan to take more subdued pricing actions across our beer portfolio in fiscal '24.”
        - “time is we've seen variable trade down at our price points. It doesn't mean -- you're correct, there has been trade down, but it has tended to be from price points below us going even lower rather than trade down from our brands”
        - “more -- we took more price now in October which will inherently have some rollover benefit within the P&L. But relative to new pricing taken in next fiscal year, we expect them to be back in that 1% to 2% range that we have consistently delivered. We think that's important, especially in an environment where the consumer is overly sensitive to pricing actions. We're in an inflationary environment across all areas in the consumer space. And our view is we need to be careful in balancing our growth profile with our pricing profile.”
        - “Certainly, inflation continues to be enduring, and it's lasted longer than anyone had expected. And as we noted, many of our costs are contractual in nature, and those contracts when they get renegotiated, they get renegotiated at sort of the then inflation rate, not necessarily what the outlook for the year is. And we're going through that process again right now. So we'll have more clarity around where we land on those as we go through the next several weeks and months. We've talked about hedges in commodities, and commodities coming off their highs, but certainly, they certainly haven't reverted yet to where they were pre-pandemic, so they will continue to be a bit of a headwind for us next year”
    - Lamb Weston Holdings, Inc. (LW)
        - "With respect to pricing, we continue to drive pricing actions across our portfolio to counter input cost inflation. The environment remains generally favorable as a result of the solid category demand that I just described, coupled with constrained industry supply. Our Global segment led the way in the quarter with strong pricing through a combination of inflation-driven price escalators, new pricing structures for customer contract renewals, working with certain customers to accelerate pricing actions for contracts up for renewal in the coming years and improvements in customer mix."
        - "With respect to next year's potato crop, we've agreed to nearly a 20% increase in contract prices for potatoes grown in the Columbia Basin
        - "Input cost inflation, however, continues to be challenging. Once again, it was the primary driver of a double-digit increase in our manufacturing and distribution cost per pound in the quarter, largely due to higher prices for edible oils, ingredients for batter coatings, labor and transportation. Potato costs were also up as a consequence of the historically poor crop that was harvested last fall."
- Industrials
    - MasTec (MTZ)
        - “we're one of the largest renewable contractors, if not the largest renewable contractor in the United States. And what we're seeing is an immense demand for anything that's renewables related from all of our customers, be it developers, be it our oil and gas customers to our utility customers. And it's predominantly wind and solar."
        - “The realities are that with what happened with IRA with what's coming down the pipe in terms of the tax credit extensions and the availability of federal funds, the demand is unlimited. So today, really, the risk for 2023 for us is really identifying

what projects we think are solid. The biggest issue with the business today on the solar side is panel availability and your access to panels. If double the panels were available, we'd have double the work. It's -- because the demand is that great. So I think for '23, a lot of the projects that we'll be working on were projects that were planned in '22, I don't think they're necessarily IRA driven. I think the IRA-driven projects will come later because it's being driven by panel availability. The tax credits will be there. So it's really the preparation of the future of what will come. Our business this year from a growth perspective, the growth will predominantly be driven by solar. So our renewables business should be up about 35% in '23 versus where we were in '22 with the majority of that growth coming from solar. We think wind is going to be a huge beneficiary of the IRA especially in outer years. There's a number of transmission lines that are currently being built that are going to open up a significant number of wind corridors. So we expect a really hefty increase in wind business in '24. And the reality is if we had the product and the supply chain to be able to double our solar resources this year, that's the level of activity that could exist. So we're going to be up nicely, but the reality is that over the course of the next few years, the growth potential in this industry is pretty immense."

  - "I feel like we're blessed to say it was kind of written for MasTec, right? It has a huge impact to our renewable business, both on the wind and solar side. We have a huge pipeline business. Traditionally, it's been oil and Gas. But the reality is that there's a significant number of sequestration projects that are going to happen on the carbon capture side. You can have these giant pipelines built across the country that are picking up, potentially ethanol from ethanol farms and the CO2 emissions, taking them on the pipelines and bearing in the deep wells. And that's -- those are new found industries for us that have significant financial federal support now that's going to change our business. So we look at -- we are the largest pipeline contractor in the United States. We're going to see a significant portion of our asset base convert to projects like carbon capture, convert to projects that include hydrogen. So we're impacted by -- this bill actually touches all pieces of our businesses. It touches our Power Delivery business because of the transmission language and the transmission axis that it creates, it impacts our renewable business, obviously. It impacts our pipeline business and it even impacts our telecom business because there was a significant amount of broadband spend in there, along with additional monies that were in the infrastructure bill. So at. The reality is that in a rising interest rate environment, there are other companies out there that are struggling. We had a lot of competitors that 2, 3 years ago, might have sold out, private equity, might have bought. Companies got levered up. Maybe they had some performance issue, and all of a sudden leverage that was 4 or 5x has turned into 9 and 10x. Those are companies that are in a rising rate interest environment are going to really struggle because they're going to have a hard time paying off their debt. At some point, that's going to create a lot of opportunities in our industry, either to re-purpose those assets or potentially see some of those businesses fail or close that creates further opportunities for the more stable contractors. And I think in those kind of opportunities, we would still be aggressive around M&A."
- MSC Industrial Direct Co (MSM)
  - "In addition to our focus on market share capture and productivity, we are pivoting our emphasis within category management. Since COVID began, our priorities were securing product availability for our customers and staying ahead of the rapid cost

inflation that we all experienced”

- “As the world now returns to a more normalized state of moderating inflation and stabilizing supply chains, we are initiating a fresh look at our supplier and assortment strategy. Our priorities will migrate towards reducing purchase costs, streamlining operational efficiencies, improving the customer shopping experience and channeling more market share to those suppliers who partner with us.”
- “Turning to the external environment. The picture remained similar to last quarter, with sentiment readings declining and IP readings moderating. The majority of our customers are seeing stable order levels, demand and general activity. We are hearing, though, continued talk of softening among a portion of our customers.”
- “the need for our customers to find productivity to offset their cost headwinds is as strong as it's ever been. And this plays nicely into our value proposition. So we remain focused on delivering that productivity for our customers.”
- “Looking forward, we continue to see new cost increases from our suppliers, although not at the fast and furious pace of last year. As a result, we anticipate taking a small pricing adjustment within the next month.”
- “Warehouse automation remains an area of focus as evidenced by our recent capital investment. We're extending new automation technology throughout our fulfillment centers to strengthen our operations and mitigate the effects of labor inflation.”
- “When we introduced guidance last quarter, forecast indicated a softening economic environment, and we factored that into our annual guidance range. As of now, we would characterize the environment and our growth trajectory as tempering a bit, but still solid.”
- “First, the realization of product cost increases in our P&L is expected to peak over the next quarter. Second, freight costs should subside beginning in Q3. Third, we have several gross margin initiatives in play whose contribution builds in the back half of the year.”
- “I think the headline in terms of the macro is pretty much more of the same. On the last quarter, we talked about some pockets of softening in line with some of the readings coming down. And I think that's what we're still experiencing. So we would characterize the environment as very solid. Look, I mean, we're still talking about nice growth levels. Most of our customers are still talking about solid demand and solid order patterns. There are pockets though. And it tends to be the closer you get to consumer-facing industries, the more extensive you're going to hear the pockets of softening.”
- “from what we could tell, the back half of December is an isolated phenomenon, and we saw a really strong start. So to put some context on that, the first couple of weeks, the growth rates would have been better than Q1. The back half definitely slowed. And we did hear from our sales team that customer -- holiday-related shutdowns were more widespread than the last couple of years and then throw in weather that disrupted things that week before Christmas. So it appears to be what we saw back half of December isolated and nothing systemic”
- “So in terms of the environment, it's an interesting time because on the one hand, like the whole world is suffering from inflation fatigue. And our customers, our suppliers were all not immune from that. At the same time, the reality of the situation is that there's still inflation. And while it is definitely moderating, there's still inflation and there's still cost increases as evidenced by the fact that, yes, we're

still seeing suppliers coming to us with increases. And so that is what drove what I described is going to be a pricing adjustment coming up in the next month. So it's a reality that we all have to deal with, even though there's a bit of fatigue. And I think the message for us is we're really focused for our customers on making sure we're generating productivity for them."

        - "So we're not so much yet seeing it (reshoring demand) in our revenue -- you're not seeing it in our revenues. What we are starting to see from our sales team is lists of new construction and projects that are going up, buildings being put up. And so as you can imagine, our business development team, we're all over that. It's fairly widespread in terms of geography and in terms of industry type. I would say heavy emphasis on manufacturing, obviously. But the tangible evidence now is it's going from talk into new construction. So it's a bit early to see it in our numbers. But if we do our jobs right and we get involved with those customers from the ground up, that should translate into the numbers in the coming quarters."
        - "The world is beginning to migrate to a new normal now, moderating inflation, stabilizing supply chains. This becomes the next natural evolution in the story. So what we're going to be looking to do is we're going to be looking at our assortment. And you're going to not see us deviate from our idea of having a really broad and really deep product assortment that's very important to our customers. But what we are going to do is look for opportunities for efficiencies. I think you can expect to see the benefits accrue in the form of purchase cost improvements. And that could either be the straight price we pay for products. It could be in the form of rebates or other adjustments, but that's certainly one area. I would expect to see benefits accrue in the form of operational efficiencies. To the extent we see potential to collapse at the fringe, at the margin, collapse some product lines or suppliers, et cetera, that they'd be operational, whether that's inventory savings or some OpEx and productivity improvements through our supply chain, that would be another area where I would expect to see benefit."
        - "So nothing different than what we've been experiencing for the last few quarters. We're not seeing any deviations there. And we do -- that is kind of one of the things we tend to watch for any early leading indicators. So nothing notable to report there. . .the macro sentiment, pretty consistent. We're looking more for pockets of softening per end markets at this point. But generally, still feeling good about the year, solid about our expectations and within that 5% to 9% ADS guidance range."
- Healthcare
    - IDEXX Laboratories, Inc. (IDXX)
        - "So from Q1 of 2020 to Q1 of 2021, we saw clinical visit growth of 13%. Typically, if you go back over history and look at trend lines, clinical visit growth pre-pandemic average 2% to 3% per annum. So you saw a 4, 5x plus type of clinical visit growth. From a pet adoption standpoint, dogs and cats, but the majority of which were puppies and kittens, by the way what we saw was 10% increase in overall pet population."
    - Walgreens Boots Alliance, Inc. (WBA)
        - "I think the shrink is built in the forecast. We're probably -- maybe we cried too much last year when we were hitting numbers that were 3.5% of sales. We're down in the lower 2s, call it, the mid 2.5%, 2.6% kind of range now. And we're stabilized."

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