MARKET INSIGHT

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Redmayne Bentley

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2023: The Year Ahead

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2023: THE YEAR AHEAD

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With the year fast coming to a close, financial market participants will likely consider 2022 one most preferably forgotten. Having experienced an extended bull market in the wake of the global financial crisis and a further extension upwards post-COVID, the common questions for investors had surrounded when it might end and the manner in which it might end. Year to date, many have experienced significant declines in portfolio valuations with the perceived safest asset classes, such as government bonds, performing poorly. Few assets managed to generate positive returns; the US dollar and oil to name two. The latter, however, has given back nearly all returns and currently trades just above the turn of the year price.

With attention moving to expectations for financial markets in 2023, things may not seem so bleak for the upcoming year and beyond. Bond markets, both corporate and government, have experienced a painful time during the year with prices coming under downward pressure. Unlike an equity where cash flows and earnings have the potential to grow, bond cash flows are fixed, making valuation all the more important. Valuations within corporate credit now sit at attractive levels, offering income investors attractive yields in excess of current market expectations for inflation for the first time in a long time.

Long-term growth trends present over recent years persist, especially within cyber security, luxury goods and healthcare. Cyber security spend shows no sign of slowing. Research firm Garner highlights the increase in remote and hybrid working and a shift towards cloud-based delivery models as two key drivers of an industry where 2023 spending is forecast to hit US$188.3bn, rising to US$262bn in 2026, a compounded growth rate of 11% from the 2021 base. Even with larger tech names signalling slowing growth and employee layoffs, pockets of strong underlying growth remain within the sector.

On the more tangible side, the luxury goods sector remains robust in the face of inflation. High-end luxury products are a prime example of Veblen goods, where demand increases with price through the exclusivity phenomena and practices such as conspicuous consumption. So strong are the industry fundamentals that the global luxury market is expected to grow 21% in 2022, normalising down to a mid-single digit growth rate through to 2030. Europe is awash with luxury brand focused companies, from Kering, owner of brands such as Gucci, to the widely known LVMH Moet Hennessy Louis Vuitton, both of which are likely to crop up in most European equity funds, another reason to focus on the companies, not the economies, in equity allocations.

The healthcare sector looks to maintain a continued growth path as populations age and the complexity of disease increases. Diabetes management remains a key growth area, with the American Diabetes Association declaring the disease a nationwide epidemic estimated to affect one-third of Americans, with approximately another 38% in a prediabetic state. For the few companies operating in the sector, earnings tailwinds look especially strong and market positions solid, with one name in particular producing over 50% of the world's insulin supply.
Overall, 2022 will remain etched in memory as a particularly difficult year for investors, but there remains plenty of attraction within financial markets to remain sanguine about the outlook for 2023.

STOCK FOCUS

NOVO NORDISK

OSCAR SHEEHAN | INVESTMENT EXECUTIVE

Let's not sugar coat it, 2022 has, for the most part, been a dreary year for markets across the world. COVID-19 and the war in Ukraine continue to tragically claim many victims while also wreaking economic havoc to such an extent that we will likely be dealing with the fallout for years to come. Against this backdrop there may appear little to be thankful for this holiday season. However, much like Rudolph's nose on Christmas Eve, there have been a few beacons shining in the night, guiding us through the darkness. Companies such as Novo Nordisk in the healthcare sector have performed excellently; it has seen its share price climb by almost 26% despite the challenging environment. A primary driver of growth for the company has been its product line that targets diabetes care and obesity. It has been able to increase sales in this department year-on-year while carving out

an ever-larger share of the market. While it is not the only company to have experienced growth this year, what makes Novo Nordisk particularly interesting is how it has used the revenue generated by its obesity care treatments to diversify and expand its product range with a focus on rare and chronic diseases. The company's investment in its pipeline of new drugs has put it in a strong position as we enter the festive period.

You can't write about Novo Nordisk without drawing attention to the astounding success of its diabetes and obesity treatments. These are likely to continue to be key drivers of structural growth for the company given that obesity rates around the world are skyrocketing while the prescription industry that treats the condition is still in its infancy. Semaglutide, a drug that helps increase the body's production of insulin, accounts for around 70% of Novo Nordisk's projected sales until 2030. This treatment is, and will remain, the cornerstone of Novo Nordisk's success as the number of people living with diabetes is expected to rise to 784m globally by the year 2045. The company controls 46.8% of the global insulin market and 56% of the global GLP-1 (drugs that help regulate glucose production) market and as such is set to substantially benefit from the increasing prevalence of diabetes. Despite this pre-existing dominance, it has been able to increase its market share in diabetes treatment by 1.7% over the last year with sales growing by 16% and 72% of sales in the US consisting of products released since 2015. The company's consistent investment in new products is paying off, and as a result it is not only benefiting from the expansion of the overall market but are also demonstrating its ability to stay ahead of the competition.

Novo Nordisk's flagship weight loss drug, Wegovy, works in hand with its diabetes treatments and is based on the same underlying drug, Semaglutide. The drug also targets sectors of the brain that are responsible for a patient's appetite. Once again, this market has huge growth potential with only 10% of the 764m people living with obesity globally currently seeking treatment. 75% of patients who are prescribed Wegovy are new to anti-obesity medication and, given that the drug helps people to lose up to 18.2% of their body weight, there is enormous growth potential here for the company. The obesity market is indeed experiencing a surge in growth and perhaps we shouldn't be surprised at this given that people have been confined to their homes for much of the last two years. The market has grown 110% since August 2019 and Novo Nordisk has captured 86% of this growth due to the effectiveness of this drug. Once again, Novo Nordisk is not simply benefiting from the expansion of the sector, its products are driving this expansion.

> *"It has been an excellent 12 months for Novo Nordisk, but more importantly it has successfully set it up for what should be a long period of growth and success."*

You might be thinking that it is a little concerning for a company to have 70% of its predicted sales dependent on one drug, and this would be a fair criticism. However, we must also recognise that Novo Nordisk is investing heavily in the diversification of its product line. It recently acquired the biopharma firm Forma for US$1.1bn in order to increase its exposure to treatments for sickle cell disease and rare blood disorders. Among the most promising drugs acquired by Novo Nordisk through the acquisition is Etavopivat, a drug that hopes to significantly boost the health of patients red blood cells and as such could be of great benefit to those suffering with sickle cell disease. During the first nine months of 2022, the sale of Novo Nordisk's rare disease treatments rose by 2%. The company is also now investing heavily into other chronic illnesses such as cardiovascular disease (CVD), seeing this in particular as a prime opportunity as 70% of people living with diabetes also suffer from CVD, meaning the patients are substantially more likely to have been exposed to other medications manufactured by Novo Nordisk and so are more likely to have fostered a relationship with the brand.

It has been an excellent 12 months for Novo Nordisk, but more importantly it has successfully set it up for what should be a long period of growth and success. While many companies have struggled this year, Novo Nordisk has made the most of the structural opportunity that has presented itself. It is using the profits generated by its obesity and diabetes treatments to diversify the business and has pursued exciting mergers and acquisitions opportunities, such as the one offered by Forma, to expand the pipeline of new potential drugs. All in all, the positive performance generated by Novo Nordisk has been a welcome Christmas present to many of us this year. ■

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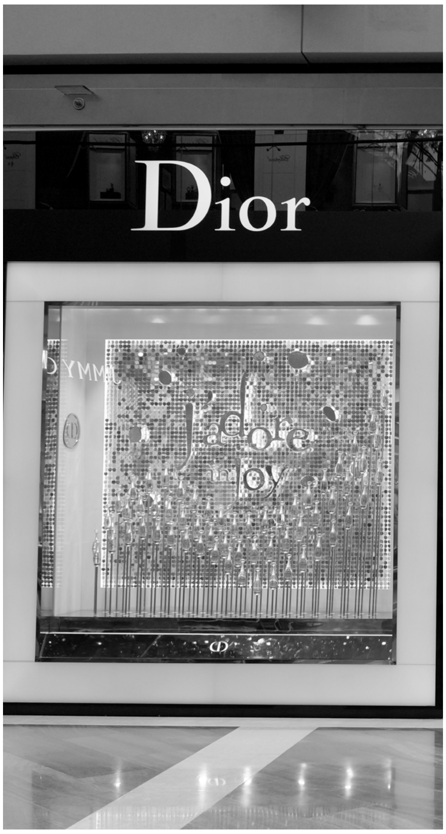
INSIGHT

A VINTAGE YEAR FOR LUXURY RETAILERS?

GREG LODGE | PERFORMANCE & RISK ANALYST



If you are fortunate enough to own a luxury watch or handbag, or are planning to indulge in a bottle of something decent over Christmas, it's quite possible that your brand of choice is part of the sprawling LVMH empire. LVMH Moët Hennessy Louis Vuitton is Europe's leading luxury goods manufacturer. Founded in Paris in 1987, today the company owns 75 brands, which it refers to as 'houses', across six core sectors. These include well-known brands such as Dom Pérignon, Louis Vuitton, Christian Dior and Bulgari. It has over 175,000 employees and 5,556 stores worldwide.

The company is something of a family affair; co-founder Bernard Arnault remains CEO and four of his five children has a role in one of the brands he controls. Forbes' real-time billionaire list estimates that Arnault is currently the richest man in the world, having overtaken Tesla and Twitter frontman Elon Musk.

Paris, the city of lights and elegant boulevards, has established itself as the undisputed home of luxury goods. LVMH rivals Hermès, known for its signature silk scarves and Birkin handbags, and Kering SA, owners of Gucci and Yves Saint Laurent, are also listed in the French capital.

In the face of soaring inflation and a looming recession, shares in LVMH have fallen by 16% and Hermès have fallen about 19% this year, while Kering is down 37%. Historically, the luxury goods sector has contracted during a recession and investors have sold down in anticipation of a gloomy outlook. Third-quarter results have defied these pessimistic expectations, however, with Hermès announcing a 24%

like-for-like rise in revenue to €3.1bn, compared to analyst expectations of 15%. LVMH also shrugged off these concerns, with core brands Louis Vuitton and Dior continuing to expand.

Chief Finance Officer at Hermès Eric du Halgouet revealed to Reuters that the group has plans to increase prices between 5% and 10% next year. This is due in part to inflation, but also to maintain an air of exclusivity. Hermès is known to intentionally keep supplies of its handbags low and has barely increased the number of storefronts over the previous decade, despite the fact that sales have doubled in that time.

This artificial scarcity may continue to benefit the company, even despite a global downturn. The ultra-wealthy are largely untouched by the economising necessitated by the cost-of-living crisis. Partner at Stanhope Capital, Pierre Mallevays, observed that “The rich remain rich, even in a recession.” This assertion may be tested, as the S&P global luxury index has fallen by around a third this year.

Having set out its stall as a one-stop shop for all the luxury brands a well-heeled customer could want, 2022 has seen a surge in shoppers, especially from the US. The extraordinary strength of the dollar this year has been a great benefit to Americans in Europe, with the dollar close to parity with the euro. Bank of America analysts reported last month that American shoppers in Europe were paying an average discount of 38% on luxury clothes and accessories compared to what they would pay at home. Compared to 2019, American tourist spending in Paris increased more than 40% during the week of Black Friday.

While Paris has benefitted from this spending boom, the phenomenon has been patchy elsewhere. Thierry Andretta, CEO of British designer handbag manufacturer Mulberry, noted that visitor numbers in London plummeted as tourists from the US and Gulf states abandoned the capital for other European cities. Regarding its Bond Street shop, he said “We are losing 45-50 per cent of our potential business due to the end of the tax free”. VAT-free shopping in the UK was scrapped last year. Former Chancellor Kwasi Kwarteng had announced its return in his ill-fated mini-budget, whereupon it was promptly reversed again by current Chancellor Jeremy Hunt. Mulberry Group recorded a loss before tax of £3.8m compared with profits of £10.2m the year before.

Luxury retailers are also considering how they will remain culturally relevant, and how to market to the next generation. Brand advisers Équité reported that 15% to 20% of worldwide luxury purchases are now made by the under-25s. Increasingly, they have been looking to the booming global popularity of South Korean pop culture to target this demographic. K-pop and drama have millions of young fans both in Asia and worldwide and correspondingly have enormous social media followings. Several high-end jewellers, including Cartier, Bulgari and Tiffany, have been using these young singers and actors as brand ambassadors, particularly at launch events. Bulgari Chief Executive Jean-Christophe Babin explained their reasoning: “The Asian market differs slightly from those elsewhere as the luxury industry there tends to lean more to a younger crowd. So, it is essential for Bulgari to be inspirational and make them fall in love with the brand through storytelling, which is in line with their values.”

With another turbulent year nearly over, the demand for luxury goods shows no sign of abating. It may be accelerating even further. According to research by consultants Bain & Co, the luxury goods sector is expected to grow between 3% and 8% next year. They reasoned that this is due to an increased portion of sales from the ultra-wealthy, who can shrug off an economic downturn. As China looks increasingly likely to reduce its strict COVID controls and open up travel, this will also give luxury retailers a boost as well-heeled Chinese consumers return to the boutiques of Europe. If 2023 does indeed turn out to be a vintage year for luxury retailers, they have all the champagne they could possibly need to celebrate it. ■

TOPIC OF THE MONTH

CYBER SECURITY

JAMES EADES | INVESTMENT RESEARCH

The world has become more connected than ever before, but the nature of its connections has changed in a fundamental way. The process of digitalisation has given way to a new era of global flows with the digital trade now generating more economic value than the global goods trade.

Despite the exponential growth of digitalisation, it hasn't come without its problems. Cyber-attacks and cybercrime have emerged, partly caused by a lack of high-quality cyber security, the complexity of data making it hard to secure and easy access to personal information. Cybercrime has created a new dimension where companies and individuals can affect, disrupt and demolish systems that comprise our entire day-to-day life. Both cyber-attacks and cybercrime have increased in both intensity and frequency, with hackers typically attempting to gain access to personal or businesses information with a purpose to exploit.

Recent data suggests that globally, cyber-attacks are now the fastest growing type of crime, with the average overall impact of an attack costing a company US$3.86m. Organisations have subsequently incurred significant losses in terms of loss of revenue, brand reputation, unplanned workforce reduction, and business disruptions due to data breaches. Therefore, the need for cybersecurity has never been greater with data reports suggesting that combined spending within the cyber security sector will total US$172bn 2022. Following a steady increase over the last five years, as individuals and institutions have ramped up the intensity of spending on security, with the aim to create a robust and safe online system which is extremely difficult to get into.

> *“As a result of strong industry tailwinds, certain data sources are suggesting that by 2025 there will be over 3.5m new job openings within cyber security, a 350% increase in eight years.”*

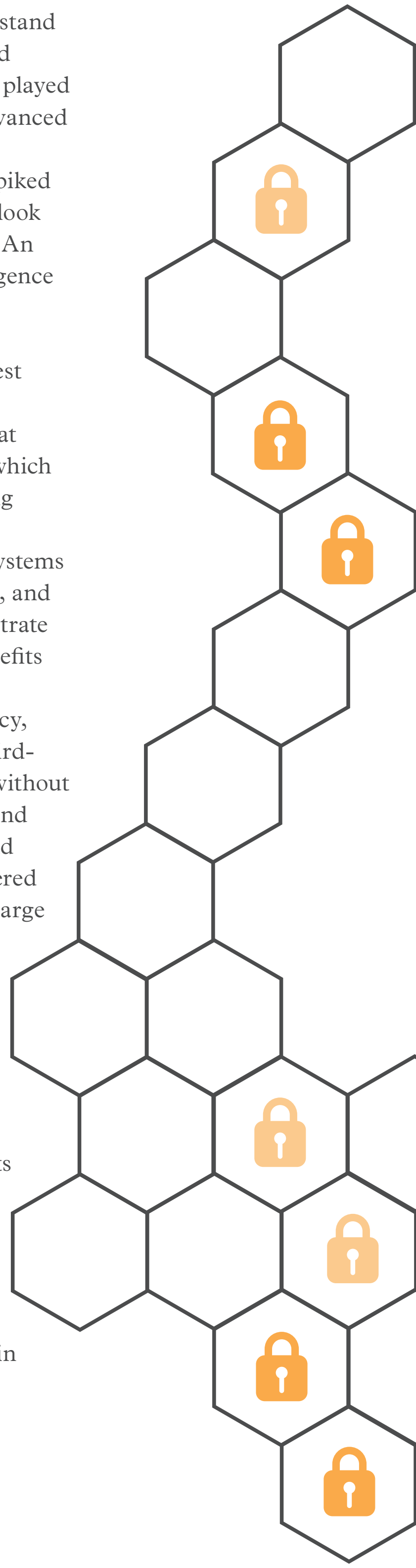
Fuelled by a need to double down on system control post the COVID-19 pandemic, the move to remote working has acted as a catalyst for firms investing in software. At the start of the breakout, employees used personal devices for business work while connecting through private Wi-Fi or anonymous networks, putting the company’s security at risk. As such, several organisations adopted cyber security solutions that manage and secure the increased number of devices used while also getting protection from network threats.

As a result of strong industry tailwinds, certain data sources are suggesting that by 2025 there will be over 3.5m new job openings within cybersecurity, a 350% increase in eight years. Thus, it may come as little surprise that many investors have labelled 2022 as the start of the ‘Golden Age’ for cybersecurity stocks, with industry leaders such as IBM, McAfee and Check Point all showing double-digit share price growth for the year with very strong financial performance too.

Contributing to the success of many of the businesses within the industry comes from core technology provision, systems that can understand uncertain activities and trials and identify and detect uncertain threats. These systems have played a crucial role in limiting some of the most advanced hackers from gaining access to data. Further developments in software engineering have spiked excitement across the world as new products look to provide a new way of tackling cybercrime. An example of this includes both artificial intelligence and blockchain.

Blockchain has possibly been one of the biggest developments this year having revolutionised areas within cybersecurity. It is a database that securely stores information in digital blocks which are connected through cryptography, allowing information to be collected, but not edited or deleted. Therefore, it can be used to secure systems or devices, create standard security protocols, and make it almost impossible for hackers to penetrate databases. The method comes with great benefits to businesses, including better user privacy, reduction of human error, greater transparency, and cost savings by removing the need for third-party verification. However, it doesn’t come without its faults, due to its early-stage development and the complexity of blockchain, and the cost and inefficiency of the technology that have hindered its ability to be onboarded to companies at a large scale.

Despite global stocks and shareholders experiencing a tough year in 2022, cybersecurity companies have seemingly gone against the grain, providing better than average returns to investors. That being said, the idea that the sector could continue its momentum going into 2023 and beyond is a compelling one; structural tailwinds and advanced development of new systems could continue to push these companies in the right direction. It certainly will be interesting to see how the industry performs in 2023. ■



FOOTBALL CLUB VALUATIONS

STEPHEN DONE | INVESTMENT RESEARCH

Over the previous few years, there has been a significant ramp-up of investments by individuals or private equity groups in European football. In 2021 alone, there were 15 investments in clubs that play in the big five European leagues, with two-thirds of those coming from US investors, but what really is the appeal of owning a top-performing football club?

Football clubs for many years have been viewed as vanity investments by high-net-worth individuals, however, in recent years the attractiveness of the investment has increased dramatically with many owners returning large profits. The industry has seen nearly 20 years of consistent year-on-year growth of sports media rights values, which has been achieved despite multiple global recessions. The attractiveness of a recession-proof global brand that offers low-risk, high-reward returns while possessing an unfailingly loyal customer base cannot be disputed following expectations of an upcoming global economic downturn.

But the real question is how are these assets valued? When compared with other industries, the valuation process is quite complicated, and currently lacks a fixed valuation model. The discounted cash-flow approach is inaccurate due to inconsistent revenues, fluctuations in profitability and difficulties valuing the intrinsic quality of the community asset. The two most common approaches are to make both a relative and economic valuation of a club. A relative valuation incorporates prices paid for similar assets through analysis of revenue multiples, however, the lack of comparable assets can lead to misleading valuations. An economic valuation incorporates a backwards-looking valuation model that creates requirements for assets to justify the valuation price.

Earlier this year, Chelsea FC was sold to Todd Boehly's consortium for a lucrative sum of £2.5bn (US$2.94bn) – a price that could either establish a new benchmark for larger Premier League clubs or will be viewed as the peak of the market. The sale was prompted by UK Government sanctions placed on the previous owner, the Russian billionaire Roman Abramovich, which resulted in over 200 expressions of interest. The level of interest and the inflated valuation price have left many current owners considering their position.

As a result, Fenway Sports Group has placed Liverpool FC up for sale; having purchased the club for £300m in October 2010, Liverpool is now worth more than ten times that amount. The American group has won every top-level trophy available while maintaining its self-sustainability model, although there is now a growing private acceptance that it is getting harder to compete with the growing wealth of fellow owners. Last season, Liverpool earned £151.9m in Premier League prize money for finishing second, and a further £102m in earnings from UEFA after reaching the Champions League final. This additional income has boosted the projected annual turnover to £602m and a pre-tax profit of £76m.

In the following weeks, the Glazer family also placed Manchester United up for sale, having purchased it in 2005 for £790m in a deal largely funded by debt. Their reign has been dominated by fan protests and declining on-pitch performance, while the club's infrastructure has continued to decline. The Glazers are perceived to be benefitting personally from the ongoing commercial success of the business, but continually ignoring necessary reinvestments into the club's infrastructure and playing staff. The Glazer's ownership is estimated to have cost Manchester United over £1.1bn over the previous 17 years, including £743m in interest payments. The current economic climate has led to both increased interest rate risk and the continuing cost inflation of competing globally on and off the pitch.

With the extremely high valuations of the two clubs, the field of credible buyers is also limited, and concerns of the highest bidders going off the market have led to two of the biggest clubs in the world being up for sale simultaneously. It is also believed that football valuations are currently entering their peak, amid a depressed global financial market that's recovery is uncertain in the upcoming years. Both clubs' sale announcements have also occurred during a world cup fuelled by Gulf petrodollars, underlying the shifting financing of the sports entertainment industry.

Investors are typically looking for big global brands with very low-risk performance – continuously challenging for the league title and the Champions League to secure recurring broadcast revenue. Both clubs have a vast global fan base that can only be rivalled by Spanish clubs Barcelona and Real Madrid. However, due to the clubs being member-owned, they are widely considered too complicated for an investor to purchase. For both clubs, this creates significant scarcity value which is driving up valuations very quickly, with the opportunity to buy some of the biggest teams in the biggest sport extremely rare. Fan loyalty is another strong appeal for investors, with sports entertainment appealing to all people across the spectrum from all around the world. Fan loyalty in sports is unlike that experienced in any other consumer business, with fans continuing to support regardless of the quality of the current on-field performance. This extremely wide and incredibly loyal support business provides a consistent customer base that investors will look to monetize. Analysts believe that no current big club has efficiently converted a fan base into revenue streams, however through the use of commercial merchandising, bespoke advertising and sponsorship, new investors will attempt to solve this.

Another prospect of considerable growth in revenues for premier clubs is the prospective plans for the Premier League to become its own broadcaster and stream services direct-to-consumer. The streaming service built around live games would be projected to dwarf revenues currently earned, with 200m+ subscribers earning the Premier League north of £24bn, compared with the £3.5bn earned in 2021. However, it would likely take many years to accrue the subscribers and would have to incur the large initial associated costs of building out the necessary infrastructure. In the meantime, it is more likely for the league to adopt a mix of direct-to-consumer and media rights sales. However, the risk of this direct service will only continue to drive up the lucrative broadcasting rights with current broadcasters looking to extend contract lengths for an inflated price.

It is apparent that owning a top-tier Premier League club is becoming extremely attractive, and many private equity companies in the US have viewed football – in particular the Premier League – as undervalued. Both Manchester United and Liverpool are expected to receive vast interest from such companies. With the dollar being stronger than the pound and euro right now, there's obviously an opportunity to buy these big teams at a much more reasonable price. The news of this takeover has been greatly beneficial to investors in Manchester United. The share price has risen up 63% in recent months, taking the clubs market capitalism to US$3.56bn, a figure widely expected to be surpassed when a sale goes through. Sports teams may not be considered a traditional investment; however, this alternative investment is one of the top-performing assets of the year and highlights the need for diversification within a portfolio. ■

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