Insight

Solid set of results from our core holdings:

QUALITY IN TIMES OF UNCERTAINTY

In the midst of the uncertainty around the COVID-19 outbreak, it is important to focus on the principles of investing in quality and value for the long-term, and the business models and the results of the companies we invest in. Quality is a gating condition for our investments. Companies can be as cheap as they want but if they do not have quality, we will not invest. Our 'checklist' for quality in companies has four criteria. The company must have; or be

- Based in a good and growing industry, with high barriers to entry, a consolidated structure, a long-term growth profile or positive secular trends;
- A strong and sustainable position in that industry, with enduring competitive advantage and a long runway of growth;
- A management team with a record of value creation; and
- A balance sheet strong enough to weather any kind of adversity

In looking for companies that fulfil our criteria and can provide value by generating returns of 8-10% p.a. or more, we care mostly about the business itself and the strategy its board and management have for it over the long-term. We do look at shorter-term data as well, of course, like quarterly reports or statements. They can provide important information and set expectations for the period.

In the following commentary we provide a number of examples of our analysis of earnings for companies that are in our World Stars Global Equities strategy that fulfil those criteria. They provide an insight into the strength of their businesses, the performance they had before the outbreak and their resilience going forward.

2019 full year earnings reporting has unfolded in the midst of the uncertainty. Outlooks for 2020 were necessarily cautious given the possibility of significant repercussions from the outbreak's impact on China and the global economy.

While we are vigilant about those impacts, as long-term investors we are most concerned about the performance and prospects of underlying businesses as they progress on their long-term growth path. That is why we have been encouraged to see the strong results and positive views coming from a number of our holdings in recent weeks.

Although the uncertainty in markets from the COVID-19 outbreak, upcoming US election and increasing geopolitical tensions, our companies' prospects for growth and value creation remain bright and we believe that their shares offer great value for long-term investors.

Alphabet

The fourth quarter of 2019 was another good quarter for Alphabet with revenues of $46bn growing 19% albeit slightly weaker than consensus. As we have advocated for some time, including in an interview we have to CNBC, Alphabet disclosed results for YouTube and Google Cloud as part of Sundar Pichai's strategy of giving greater disclosure in the reports as

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he moves from being CEO of Google business to CEO of Alphabet. The shares have performed very well in the past months as it became a trillion-dollar market capitalisation company.

The core advertising business remains robust with 18% growth and it quietened some concerns regarding slowing growth. However, the hardware segment was somewhat soft at 10% growth. Additionally, other bets (e.g. Verily, Calico, Waymo) are still small at just $172m of revenues but remain a very long-term investment opportunity.

Alphabet announced that YouTube generated $15bn in revenues on an annual basis and grew 31% in the last quarter. We believe that given the modest revenue per user ratio, there is substantial opportunity for monetization growth. Additionally, Google Cloud is on a $10bn annual revenue run rate and grew 53% growth this quarter. Management have not disclosed the cloud margins but did note a long-term commitment to the business.

Operating margin exceeded estimates, primarily driven by data centre cost savings. As a result, EPS was significantly ahead of consensus further benefitting from share buybacks of $6.1bn. With another $21bn left for authorisation and the $133bn cash on the balance sheet, Alphabet could finance an accelerated cash return to shareholders.

The stock fell slightly after the earnings. However, we are comfortable about the underlying fundamentals of the business and think that the share price reaction on the release was simply giving back a some of the substantial gains the shares have made over the last few months.

Amazon

Amazon reported a very strong quarter, growing revenues by 21%. Operating income was significantly higher than expected at $3.9bn. The shares climbed by 10% after the report sending Amazon's market capitalisation above one trillion dollars.

The company reported very good growth across each of its business divisions. It grew units by 22%, highlighting the strong demand for E-commerce. This was spurred by their one-day free Prime shipping, which saw a quadrupling in these one-day shipped items in the US. Across Amazon's 150m Prime members, this one-day shipping initiative has become very popular.

Amazon Web Services (AWS) grew by 34% which is still very healthy growth as it compounds its significant revenue base. It is double the size of its nearest competitor Microsoft Azure and four times the size of Google Cloud. AWS also grew operating margins, dispelling fears over slowing growth and higher competition. We believe that the cloud computing market is so large that it can support both leading players as enterprises continue to move workloads onto the cloud.

The company reported much higher than expected operating margins as both advertising and AWS contributed meaningfully to results. The operating income margin of 4.4% again showed that the company are able to grow revenues and margins at scale. They also gave good guidance for the next quarter showing momentum across the company.

Jeff Bezos' willingness to invest into new projects whilst at the same time significantly supporting Amazon's existing businesses shows no sign of slowing. It is this approach that

entrenches their competitive positions whilst also making bold moves into new trillion-dollar markets such as healthcare and grocery.

Eaton

Eaton delivered a good quarter with EPS at $1.46 against street expectations of $1.41. Highlights of the quarter included once again the exceptional margin delivery for three divisions, Electrical Products, Electrical Systems & Services and Aerospace, as well as good order trends for its long-cycle businesses.

Organic growth at -2% was affected by weaker trends in the short-cycle Vehicle business but margins were up by 40bps to 17.8% underlining the operational flexibility and ongoing focus on cost control.

By division, the Electrical Products business was up 1%, excluding the recently sold Lighting business, and orders at -2% with healthy trends in the residential and construction markets in the US, offset by weaker trends in the industrial end-markets. Both Electrical Systems & Services and Aerospace grew by 2% on a 12-month rolling basis. Hydraulics was down 13%, on the back of weakness in the global mobile equipment market. Similarly, Vehicle declined by 18% due to the weak, global light-vehicle production and a 6-weeks workers' strike at General Motors. The newly formed eMobility division is showing good progress on bidding activity for new programs.

More importantly, the company realised a key milestone in its portfolio restructuring story with the sale of the Hydraulics business for $3.3bn to Danish player, Danfoss. This was the most economically sensitive, lowest margin part of the portfolio. Last year, the company sold the Lighting (for $1.4bn to Signify) and Auto Fluid Conveyance businesses (terms undisclosed). The disposals were complemented by three tuck-on acquisitions in its Electrical and Aerospace businesses. With this transformation, the company has become a streamlined industrial franchise focused on the structurally most attractive segments, namely Electrical and Aerospace.

The management highlighted ongoing good trends in order flow for the Electrical and Aerospace businesses providing confidence looking into 2020, whilst again emphasised its significant cost flexibility which will shield margins irrespective of revenue developments. We believe it is a cheap asset with many self-help catalysts in the long-term.

LVMH

LVMH reported another solid quarter with 8% organic revenue growth amid disruptions in Hong Kong and sales decline in Japan, highlighting the strong fundamentals of the business. Recurring operating income and margin were in line with expectations at €11.5bn and 21.4%, respectively. The stock fell due to the concerns around Coronavirus, however, the long-term growth story is intact with ongoing momentum in the Fashion & Leather Goods division and the completion of the strategic acquisition of Tiffany later this year.

Wines & Spirits showed modest revenue growth (3%), as a result of destocking in the US in the quarter. Destocking is largely over and underlying demand remained healthy. Notably, Hennessy became No.1 cognac brand in the world.

Fashion & Leather Goods grew by 15% despite disruption in Hong Kong (-40%) and the Japan consumption tax increase in October which shifted demand towards Q3. Both Louis Vuitton and Christian Dior did very well, driven by new products and innovation.

Perfumes & Cosmetics sales were up by 9% with continued strength in Dior, Guerlain and Givenchy.

Watches & Jewellery had 3% sales growth with mixed brand contribution. Bulgari performed particularly well, while Tag Heuer suffered from the impact of revamping distribution.

Within Selective Retailing (5% sales growth), there was strong performance in Sephora, but the division was impacted by disruption in the duty free shops in Hong Kong.

Prior to the COVID-19 outbreak, management noted that 2020 had started well. Although near-term disruptions may weigh on financials and stock performance, LVMH continues to be our core holding given its brand quality and desirability as well as its resilience in time of uncertainty. We view this short term volatility as a buying opportunity for long-term investors.

Roche

Roche reported a solid quarter, closing a successful year with 9% revenue growth. They achieved a robust growth in new products (e.g. Tecentriq for cancer, Ocrevus for multiple sclerosis and Hemlibra for Haemophilia A), offsetting weaker than expected sales from older drugs such as Herceptin (for cancer) and Avastin (for cancer), both of which faced biosimilar competitions. Core operating income growth at 11%, was ahead of expectations, whilst EPS grew by 13% partly benefiting from a lower tax rate.

The pipeline continued to progress well during the quarter. Most noticeably, a positive phase three trial evaluating Tecentriq with Avastin in liver cancer, which showed overall survival benefits and a phase two trial of Gazyva plus standard of care for lupus that showed superiority versus the standard of care alone. Both diseases represent significant unmet medical needs and material market potential.

During the quarter, the company completed the acquisition of Spark Therapeutics, a gene therapy platform. In December, Roche boosted its gene therapy interest by announcing the acquisition of ex-US rights for Sarepta's micro-dystrophin gene therapy for Duchenne Muscular Dystrophy (DMD). These acquisitions marked the entry of Roche into the exciting field of gene therapy.

For 2020, the management is optimistic about the outlook of its existing growth drivers and pipelines but is also cautious about biosimilar competitions. They anticipate an additional $4bn sales decline for Herceptin and Avastin as a result of multiple biosimilar launches in the US. The guidance is low to mid-single digit revenue and EPS growth at constant currency which we believe is conservative given that the company has a history of guiding low at the beginning of the year. As a reference point, the guidance was raised three times in 2019. The company expects a number of regulatory filings and late-stage clinical trial readouts in 2020.

The stock is inexpensive. The low valuation mainly reflects the uncertainty from biosimilar competition as well as the market concerns regarding potential headline risks on the US drug pricing. Notwithstanding, we are confident about Roche's fundamentals and believe it is a great buying opportunity for long-term investors.

United Technologies

United Technologies delivered a solid quarter with EPS at $1.94 a nice beat against street expectations of $1.84, driven by a 1% organic growth rate (on an 11% comparison in the prior year quarter). They reported for the last time as a combined entity, marking the end of an era for the iconic US industrial conglomerate.

Within the Aerospace businesses, Pratt & Whitney, the engine manufacturer, was up 2% organically, with military up 12% and commercial aftermarket being flat. Collins Aerospace, which includes the acquired Rockwell Collins business, grew organically by 1%, driven by robust aftermarket services and stable defence spending.

Within the Buildings businesses, Otis, the elevator and escalator franchise, delivered 4% organic growth, with the service portfolio expanding by 5%. Importantly, pricing in the key Chinese original equipment market has stabilised, supporting margins in the medium-term. Carrier, the HVAC division remained the weakest spot with organic growth of -2% and order growth of -4%, reflecting the inherent volatility in the refrigeration business despite the positive trends in the global HVAC market.

Margins have been progressively inflecting for the business on the back of improving pricing within Otis, cost efficiencies within Carrier, synergy realisation within Collins Aerospace, and the GTF engine program moving beyond its initial ramp-up stage.

Guidance for 2020 was provided only for the aerospace businesses given the upcoming separation. Pratt & Whitney is expected to deliver mid-single sales growth, while slightly negative growth is anticipated for Collins Aerospace, reflecting the effects of two divestures and headwinds from the halt in production of the Boeing 737Max. More detailed guidance will be released after the spin-offs and the closure of the Raytheon merger. Early second quarter is targeted for the upcoming separation, with tax regulatory approvals in the key jurisdictions driving the ultimate timeline.

On the Coronavirus outbreak, the company noted that the SARS virus had a three-months impact on the industry. However, the global airline industry is at a much healthier state currently and passenger trends remained structurally healthy.

All in all, our thesis on United Technology is playing out. The aerospace business is showing good momentum and the merger with Raytheon will unleash further opportunities for technological and revenue synergies. At the same time, Otis and Carrier are emerging as industry leading franchises in their own right, with multiple self-help drivers. We believe the stock is well supported as the break-up unfolds and will continue to test new all-time highs.

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