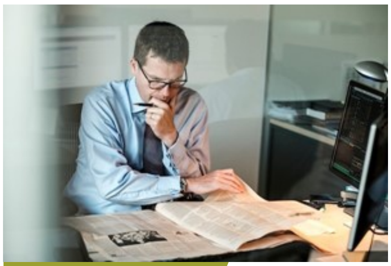

Friday Morning Coffee

Nr. 108 — It does not always need to be Swiss chocolate

We have been writing in previous morning coffees about our investment in the Swedish confectionary producer Cloetta. Cloetta has a strong portfolio of leading local brands in confectionery, chocolate products, nuts, pastilles, chewing gum and pick & mix concepts. The company produced 106,000 tonnes of candy in 2019 – our favourite sin. While the main markets are in the Nordics and in the Netherlands, some brands like Läkerol and Sportlife are well-known across Europe.

Our investment case in Cloetta is built around three main points. **Firstly, Cloetta has strong earning power that is ensured by solid market share and customer loyalty towards its strong local brands**. This enables the business to generate consistently 3-4 times more cash flow than it needs to run the operation. **Secondly, the stock is depressed due to some operational headwinds the company has been facing in recent years. Thirdly, it is guilty of being a small-cap (market cap of 660 mil EUR).** All these points result into a significant valuation discount towards its peers like Mondelez, Lindt or Barry Callebaut.

The operational issues the company had been facing are mostly self-inflicted. In 2017, Cloetta acquired Candy King, the clear Nordic market leader in Pick & Mix who had 100% of production outsourced before being acquired by Cloetta. After the acquisition there have been lost volumes namely in Sweden. Management reacted by insourcing the production, investing to gain back market share and launching 3 different cost saving programs. The clear objective is to bring up the margin to 14% from 11% in 2019.

The left graph shows Cloetta in ECP's quality – value framework. **Cloetta is an above-average quality company today (red line).** Its quality score has been decreasing since 2018 for the reasons explained above. We are however confident profitability and hence quality score will increase going forward. **The valuation of Cloetta is surprisingly low for a company in an industry with such stable demand (green line)**. The company currently trades at a discount to the market overall despite the consistently higher quality, which is an anomaly in our view.

Cloetta versus Lindt

in the ECP quality – value framework

Source: ECP

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In order to illustrate the difference, we added on the right a graph with the quality-value scores of Lindt. Lindt is even more profitable than Cloetta and quality is improving. However this additional quality comes at a significant price tag: **value score is half a standard deviation higher than the market overall !**

The impact on Cloetta of the Covid-19 pandemic appears manageable. In the first quarter of 2020, Cloetta lost 4% in organic growth due to closed travel retail and cinemas. We are convinced the consumer will continue to eat candy during and after the pandemic.

For investors looking for opportunities in the confectionary space at low valuations, Swiss chocolate producers are not the only option.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
June 19th, 2020