Market News with Rodney Lake
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Pricing Power

Note: This transcript has been edited for content and clarity.

Rodney Lake: On this episode of Market News with Rodney Lake, we're going to cover pricing power. This is an update from a live show in February. We're also going to talk about the Fed's decision to raise interest rates by 25 basis points and the impact on the markets. Here we go. Thank you for joining Market News with Rodney Lake. This is a regular show of the GW Investment Institute where we discuss timely market topics.

I'm Rodney Lake. I serve as vice dean for undergraduate programs at George Washington University School of Business. I'm also a teaching instructor, finance and the director of the GW Investment Institute teaches students how to think about investing in how to invest. Our undergraduate and graduate students learn by doing. They serve as analysts and portfolio managers, managing approximately $8 billion in university endowment funds. Across four student investment funds covering equities, real estate and quantitative investing. We also teach a class on venture capital investment in futures, market insights and research, and links students to industry and industry professionals.

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Welcome back to Market News with Rodney Lake. I'm your host, Rodney Lake. On today's agenda: pricing power. What is it? Examples of pricing power that are in the news currently? We'll talk about the economic environment and the Fed's decision to raise the interest rates. So, let's get started with a definition of pricing power by Warren Buffett. I admire him as an investor. “The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business” -

Mr. Buffett. So, pricing power is super important and it's even more important during these times of inflation. And we'll talk a little bit about that. A specific example of a company that has pricing power and one of the larger holdings for Mr. Buffett is Apple. Can Apple raise prices? So if input prices, for example, go up 10% on Apple, can it protect its margins, its net margins? And starting really with the gross margins, can it protect those? Well, what does it have to do? It has to raise prices by 10%. Then Apple does that and does not lose business to competitors as pointed out in the quote. So if you're an iPhone user, are you going to switch to Android because prices went up 10%? I would say probably not. I think that gap there, that's pricing power and the intensity of which companies have pricing power is not infinite and it's certainly determined by the strength of their brands and the moat around their business as well as many different factors. Apple's brand I think is quite large. The moat around their business is quite big. The switching cost is probably very high for people. At a 10% increase in cost customers are probably not going to switch. At 20%, maybe they'll consider switching. At 30% - we don't necessarily know until we see that play out into the market. But I would give Apple very high pricing power strength. Now, what's the opposite of that? A company that's a price taker. So think of a commoditized business. So any commodity you can think of, oil, gas, agricultural, commodities, metals, minerals, any of those commodities that have no brand are very fungible. You can switch one from another. You know, that really has no pricing power and it's really a price taker.

Now, that can be useful during an inflationary period for other reasons. Because those products tend to go up, but they're not going to have pricing power by themselves. It's going to be more determined by the economic environment behind them rather than the ability for the company to say, I'm setting prices. And if I think my inputs are going up because raw materials are going up during the inflationary period, I'm going to pass those on. So, Apple would be a great example of that. So just a little bit more about pricing power. UBS has good research around this. The research about sectors that actually have pricing power. So I think consumer staples and consumer discretionary, as well as industrial and materials, energy. Those sectors are not going to have pricing power. So you really also want to be thinking about the sector and then the specific companies. Again, if it's a commoditized business or commodities industry, as an investor, especially during inflationary periods, you want to stay away from those types of companies. The next thing just to think about is, what does that translate into returns? So you further work here around how these companies that have pricing power performed during inflationary periods and they tend to be a source of outperforming during those periods. And we can talk more about that in what we're seeing in some of these examples, but they tend to outperform again during inflationary periods when they have this ability to pass on the price increases.

That intuitively makes sense. So let's get into a couple of examples of this at work in the news. So number one, Chipotle. Chipotle’s CEO, if you look up the earnings transcripts, has a quote in there that they think that they have pricing power and possibly better than anyone else. I'm paraphrasing here, but that would be a great example of pricing power. The cost to make a burrito has gone up 10%. They have passed on a 10% increase to consumers and consumers are paying it and they're not switching to other burritos. They keep coming back and buying Chipotle's burritos, burrito bowls, whatever you like. The point is, the demand has remained constant, possibly increased pricing power. Further just a couple of snapshots, revenue rose 22% during the last quarter and as you know same store sales increased 15% and they're planning on raising prices again. So again, Chipotle would be a good example right now something that's in the news has pricing power input prices have gone up. They're passing those on to customers.

Proctor and Gamble would be another company where people might not think of pricing power. But when you start thinking about the products, you start thinking of Tide as one example. Well, if the price of Tide goes up, many people are not going to switch. They're not going to switch to a competitor because they think, well, Tide is the only thing that gets my clothes clean. And right now, they have been able to pass on that price increase. So their input, their raw material prices have gone up and Procter and Gamble has increased the price to consumers. And consumers have been willing to pay that increase. And they're not switching and they're not going down brand. There's a quote also in their transcripts from their CEO talking about, at this point, they are typically seeing in the past people switching to private labels and switching down in product categories. And really, that's not happening right now. So, again, another company, Procter and Gamble, would be the first example that I'm using here that you're getting good pricing power with that. Next would be Walt Disney. So Disney has a great brand, and has a great moat around its business. If people want the Disney experience, whether you want to go to California or Florida, you're not going to be able to replace that with another park. If your kids want to go to Disney World, for example, you're not going to be able to say, let's go to this Six Flags or whatever it happens to be. And it's going to be equivalent to Disney. It's not an equivalent and they know it's not. So, despite the rise in room rates and the rise in ticket prices, they have seen demand coming back very strong in the living with COVID environment. So again, Disney, another example there. So you can already see some of these factors that are included in these companies, which would be a great recognizable brand. I mentioned Apple. I mentioned Tide that's part of Procter and Gamble, and I mentioned Chipotle. People seek these companies out. People want to buy their products and they're willing to pay up for those. And if they raise prices by 10% to protect their gross margins while their price inputs have increased 5% - with that example, they've actually increased gross margins by 5%. And so as an investor, that's great news for us. If we're invested into these companies and we're not advocating investment into any one company in particular, including these. But that's the point here about protecting those margins.

Another example from Adam Jonas, an analyst for Morgan Stanley, who wrote a report about five takeaways from Tesla's Fremont Plant Tour. So Adam toured the plant out in California, and wrote up this report. The second key takeaway was Tesla's demonstrating strong pricing power. And if you look at the data they selected, one of the data points was if you just picked the basic trend model three year over year, prices have increased. 30%. Demand does not seem to be slowing down for Teslas. And so again pricing power a 30% increase year over year demand is probably rising. We'll see order numbers come out of the first quarter here. But it looks like at least anecdotally that demand is doing just fine for Tesla. So another current example of pricing power, their inputs including lithium (correction: *nickel*) if you're tracking what's happening in Russia and Ukraine is going off the charts but they're able to pass along these price increases. That's only one component for batteries. We'll get into that. But in any case, their raw material costs are going up, including lithium for batteries, and they're able to pass that along. 30% price increases to the vehicles and demand has not slowed down at all. So let's now talk a little bit about what's happened broadly in the market.

So as we've all seen that inflation is in the system, the Fed has been called to action here to say, how do we stamp this out? And if I remember back, Paul Volcker really had to squash inflation in the early eighties for the U.S. But now we see a spike in the fourth quarter of last year 7.6% for the last month and compared to January over January. That's a significant increase for inflation, the highest really since 1982. So you're talking about a couple of decades here. More than a couple decades. So history hasn't happened in 40 years. Now we're going into this inflationary environment. So certainly the Fed is going to have to to move and we'll talk about what they're doing now. So just a couple of things that are out there in the environment so we've seen an increase in wages which obviously can be inflationary. We've seen these supply chain issues which companies have had difficulty with because when COVID shut down the world, that really tied up a lot of those supply chains that we're used to running very fluidly. But now some of those had to get resorted and possibly it will look different moving forward. But things are definitely on the mend here. And then let's talk a little bit about the Fed increasing the interest rates and the impact on the market. So you have increases in wages here. So wages and benefits increase 4%. Average hourly wages increased 5.7% in January. Year over year. And consumers seem to be more willing to pay for these increases, at least right now. But in general, prices have stayed ahead of wages, which is inflationary and a potential problem for consumers.

And we'll have to keep an eye on that. Now, let's talk a little bit about supply chain issues. So the Federal Reserve Bank of New York created a global supply chain pressure index to quantify disruptions. They have data going back to 1998 and they're saying that the peak of this index is October 2021. So at the end of last year and now they're saying it looks like it's starting to get better. The Financial Times reported from a McKinsey study at the end of 2021 that senior executives for supply chain management had said 92% of those that responded said they all took steps to improve the resilience of their supply chain. For example, they increased inventory and obtained raw materials from different sources and multiple sources. And so diversifying their supply chains and making them more resilient. As you can see, COVID has had a significant impact on the way that this world is looking. So just this week, the Federal Reserve approved the first interest rate hike in more than three years for 25 basis points. Some of this data is from CNBC just a shout out for them. Thank you. The Fed approved a 25 basis point increase that's since December of 2018. They indicated an aggressive path ahead and they're going to be six meetings that remain in 2022 and many people expect them to raise the rates at every one of those meetings and so we'll have to see how that goes. So you know the benchmark was set anchored near zero and now you're looking at taking the range to 25 to 50 basis points. And so we'll have to see how this unfolds again. Many are predicting that they're going to raise at every meeting this year at this meeting in the six more that they're going to have. So we'll have to see how that all turns out.

So again what's the impact on the markets here? Well, in the short term, the inflation is not going to be caused by a 25 basis point increase. But certainly if the market's been telegraphed to say hey, the Fed is taking this seriously, they're going to be raising interest rates for the next six meetings, that's going to start to be priced in. They're not going to price it in after. They're going to price it in before. So we'll have to see how that shakes out. Now, some of these growth companies that took a big hit are possibly getting some footing right now because people are getting some certainty around what the interest rates are likely to be. They're going to be the biggest impacted because they have the most to lose and gain from that type of environment. The discount rate use, which is the tenure, generally speaking, for how you discount the future cash flows, moves inversely. So as rates go up, the present value goes down and vice versa. And we know what that looks like when the economy is still growing, we're not going to kill the economy. These growth companies can do well and we'll do well into the future. So their valuations settle down a little bit. And obviously, there's a lot of factors going on in the market right now, not the least of which is Russia attacking Ukraine. And what's the fallout from that going to be? Because it's still uncertain how that's going to turn out. Everyone's hoping for a quick de-escalation of that attack, but it remains open and we'll have to see. Certainly, our hearts go out to the people of Ukraine for their situation. What we're focused on is, how do we anticipate further disruptions from the sanctions associated with that? Again, I mentioned lithium, which is connected to not lithium excuse me, nickel, which is connected to batteries. That's going to be, you know, an uncertain setup right there. And prices have been going limit up and they had to resort to how the London Metals Exchange was handling trades most of the nickel that's traded or on long term contracts probably something like 70%. So it has an impact certainly with the spot markets. But it's not as significant as the long, long term contract market. Where do we go from here for the overall market? Well, as interest rates increase hopefully it puts a damper on inflation. The growth metrics for the economy generally look good. Otherwise a lot of these companies continue to do well. So if you're looking at the earnings of different companies, a lot of these earnings are coming in with strength. And again, companies have good balance sheets, which is one of the things that we focus on at the Investment Institute. So if we're in a good cycle where we have good balance sheets, not for everyone, by the way, but for a lot of companies to be high quality companies and we have a growth forecast here moving forward and these companies can grow into some of these valuations. Well, maybe the market is going to do just fine over this next year. We'll have to see, again, there are many variables. And we're not trying to predict the market. In any case, what we're trying to do is find the best companies and invest in those companies for the long term. I want to say thanks. Stay tuned and stay connected to the Investment Institute.

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