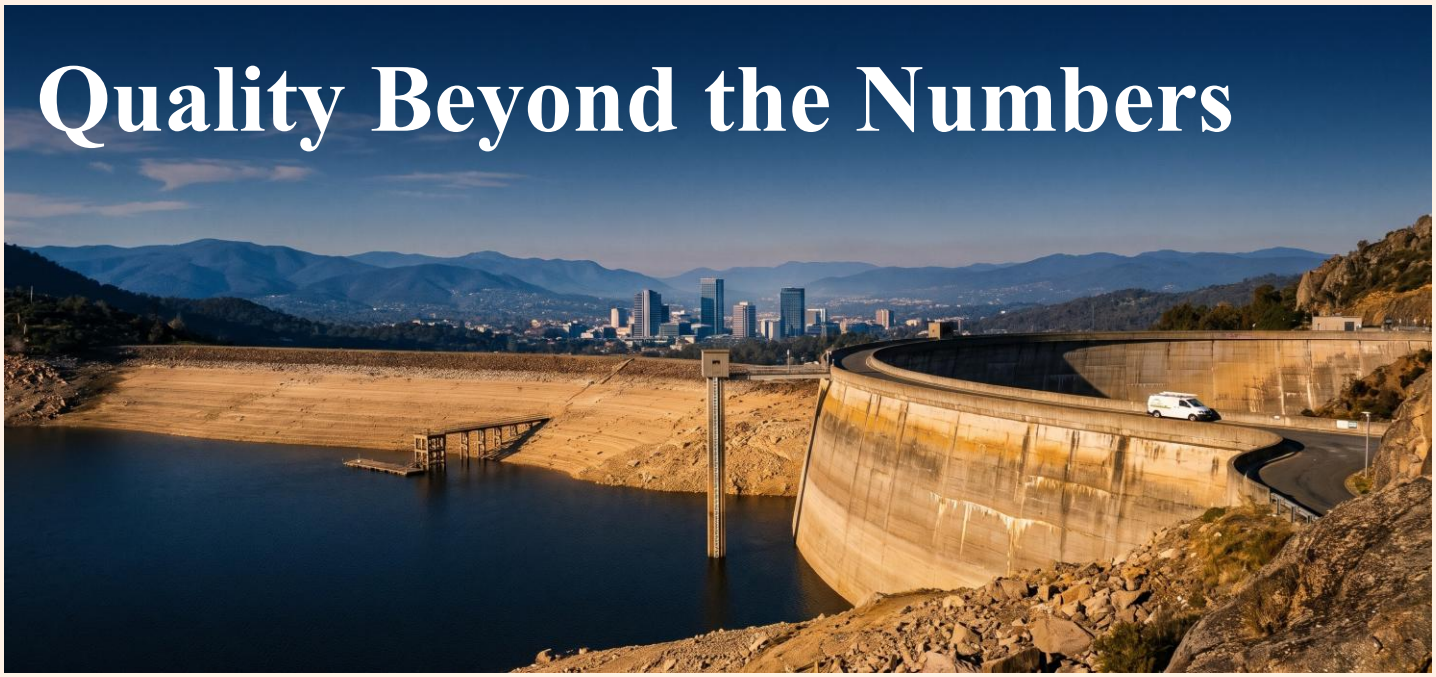
THE QUALITY PULSE

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Quality Beyond the Numbers

When apparently strong businesses conceal deteriorating economics

A familiar brand, a healthy profit margin and years of dependable earnings can make a company feel easy to own. They can also make it harder to notice when something has changed. Customers begin buying less, growth becomes more expensive to sustain, or new investments earn less than the businesses built years ago. The accounts may still look reassuring while the foundations of future returns are weakening. That gap is the quality trap:

Investors keep paying for durability that the business is no longer demonstrating. Quality remains a useful starting point. MSCI, for example, assesses it through return on equity, earnings stability and low financial leverage. But these measures largely describe reported performance. They cannot, on their own, establish whether customers will remain loyal or the next investment will be as profitable as the last. [1]

A business can remain highly profitable while becoming less valuable. Its earnings may still be strong, but the growth ahead may require more spending, face stronger competition or last for fewer years than investors expected. This is different from simply paying too much for an excellent company: in a quality trap, the assessment of the business itself has become too generous.

Academic evidence offers a reason to be sceptical of extrapolating strong profits indefinitely. Fama and French (2000) documented mean reversion in corporate profitability: competition and changing business conditions tend to pull exceptional returns back towards more normal levels. This is a population-level finding, not a prediction that every outstanding company will lose its advantage. The investment question is what allows a particular business to resist that pressure – and whether those defences are still intact. [8]

INVESTMENT PERSPECTIVE

Reported ratios such as margins and returns on capital describe what a business has already achieved. For investors, it is equally important to follow customer demand and the returns on new investment, which shape what those ratios can look like in future.

WHEN THE NUMBERS LAG THE BUSINESS

The problem often begins inside an otherwise respectable result. Sales can rise because prices increase even as customers buy fewer products. Passing on higher costs may be necessary, but its success depends on the demand that remains afterwards. Customers may initially accept higher prices, then buy less often, switch brands or wait for promotions. The damage can emerge gradually. A price increase that protects this year's margin while driving customers away can weaken next year's earnings base. The useful question is how much growth survives once further price increases become harder.

Pricing power is not a permanent attribute that can be inferred from a strong margin. Research by Gielens and Steenkamp (2025), using household purchasing data across more than 16,000 brands in 34 countries, examines how consumers' responses to price, assortment and distribution change over time. Its relevance here is methodological: demand sensitivity must be monitored, not assumed constant.

Margins need similar scrutiny. Efficiency improvements can strengthen a business; cutting the advertising, product development or service needed to retain customers can temporarily produce the same financial result. Cash generation can also improve when investment is postponed. McKinsey's research links value creation to returns on capital and revenue growth, while warning that improving current profitability at the expense of future growth can undermine long-term value. [2]

Even a high return on invested capital can give false comfort. It measures profit against the capital committed to the business, but a successful legacy operation may conceal disappointing returns on new factories, acquisitions or products. What matters is whether fresh investment can still earn more than its financing cost. Meanwhile, share buybacks can lift earnings per share by reducing the share count, without increasing total profit. None of these measures is useless; each needs an explanation of what is driving it. [2]

The distinction matters because a business can keep reporting attractive average returns while its profitable reinvestment opportunities shrink. It may still generate substantial cash, yet have less scope to compound earnings. Investors should then reconsider the growth rate and valuation they attach to that cash generation.

There is a further caution in interpreting an impressive track record. Denrell (2004) showed theoretically that persistent differences in profitability can arise even without durable, systematic advantages at the outset. Past persistence is therefore evidence to investigate, not proof of a lasting moat. The more demanding test is whether customer behaviour, competitive position and returns on incremental investment continue to support future profits. [10]

THE PREMIUM MAKES THE DISAPPOINTMENT BIGGER

A demanding valuation adds a second vulnerability. Investors may lower both their earnings expectations and the price they will pay for those earnings once dependable growth looks less dependable. In a simple illustration, earnings rise 5%, but the valuation falls from 30 to 24 times earnings: the share price still declines 16%. The business need not collapse for shareholders to suffer.

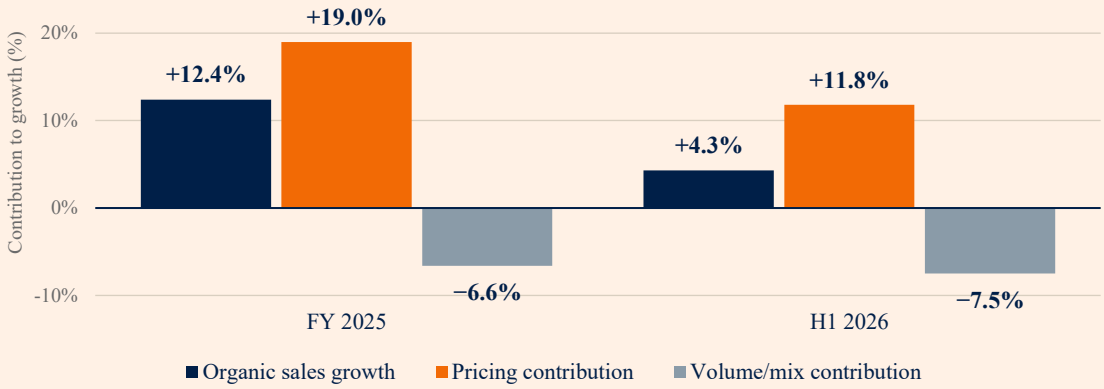
A lower share price therefore does not automatically make the shares cheap. If restoring growth requires more spending or lower prices, future earnings may also need to be revised down. The previous valuation becomes a poor reference point when the economics that supported it have changed.

A weak quarter alone does not establish a trap. The stronger warning is a repeated divergence: margins hold up while demand weakens, cash improves while necessary investment falls, or reported returns remain high while the next source of growth becomes less attractive.

LINDT AND THE LIMITS OF PRICING POWER

Lindt & Sprüngli illustrates how this tension can develop inside a strong franchise. Its premium brands and global distribution remained valuable, and its 2025 operating margin rose to 16.4%. Surging cocoa costs gave the company a clear reason to raise prices. Yet pricing more than accounted for organic sales growth in both 2025 and the first half of 2026. Customers were being asked to absorb substantially higher prices for a discretionary purchase. [3][4]

Lindt & Sprüngli: composition of organic sales growth | year-on-year contributions



Year-on-year growth contributions, as reported by Lindt & Sprüngli. Volume/mix combines quantities sold and changes in the product mix; it is not a pure measure of unit volumes. Organic growth excludes currency effects and changes in the consolidation perimeter.

SOURCES: LINDT & SPRÜNGLI [3], [4]

In the first half of 2026, the operating margin nevertheless increased to 11.2%, from 11.0% a year earlier. Then, on 29 September 2026, Lindt cut its full-year organic growth forecast from 4–6% to 0–2%, citing price-sensitive consumers, weaker European orders and exceptional summer heat. It retained its forecast for a 0.2–0.4 percentage-point improvement in the operating margin. Protecting profitability had not protected demand. [4][5]

16.4%
Lindt operating margin in 2025, up while volume/mix declined
SOURCE: LINDT & SPRÜNGLI [3]

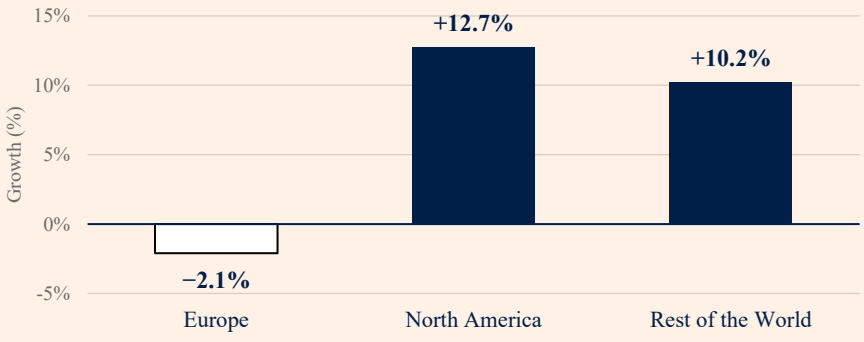
+19.0%
Pricing contribution in 2025, against organic sales growth of 12.4%
SOURCE: LINDT & SPRÜNGLI [3]

−7.5%
Volume/mix contribution in the first half of 2026
SOURCE: LINDT & SPRÜNGLI [4]

0–2%
Revised 2026 organic growth forecast, cut from 4–6% on 29 September 2026
SOURCE: LINDT & SPRÜNGLI [5]

The regional picture helps explain the problem. First-half organic sales fell 2.1% in Europe, while North America grew 12.7% and the Rest of the World 10.2%. These measure sales value, rather than unit volumes. [4] Even so, the divergence shows why group averages can mislead: growth in some markets can coexist with pricing difficulties elsewhere. A premium brand does not give management unlimited freedom to raise prices in every market.

Lindt & Sprüngli: organic sales growth by region | first half of 2026



Organic growth in sales value by region, rather than unit volumes.

SOURCE: LINDT & SPRÜNGLI [4]

Pricing misjudgments also had a leadership consequence. On 19 October 2026, Lindt ousted CEO Adalbert Lechner and appointed former CEO Dieter Weisskopf as interim chief. The board said new leadership was needed to restore consistent growth. Days later, chairman Ernst Tanner acknowledged that Lindt had overestimated how far it could raise prices without hurting demand, particularly in Germany. [6][7]

The response now includes selective price reductions, more brand investment and innovation. Management expects positive volume growth in 2027, helped by easing cocoa costs. [5][7] That remains a recovery expectation. Lower input costs could support margins before demand recovers, while price reductions could rebuild demand at some cost to profitability. The convincing outcome would be a sustained recovery in purchasing alongside attractive returns. Permanent damage to the franchise is unproven, but brand strength and resilient margins alone cannot establish that the repair is complete.

QUALITY HAS TO KEEP EARNING ITS PLACE

For investors, the response is to follow the business beneath the headline ratios. Examine whether customers are buying more, whether market share is holding up, and whether cash flow remains healthy after the investment needed to sustain competitiveness. Assess new investments alongside the returns of the existing business. Finally, ask how much recovery the valuation already assumes.

These checks also help distinguish a temporary setback from lasting deterioration. A company that retains customers and invests through a difficult period may be strengthening its future. Repeatedly defending today's earnings while the customer base or investment returns weaken deserves a different judgment. Quality investing requires confidence in a business, together with a willingness to revise that confidence when the evidence changes.



THE PULSE

Quality is not a historical ratio. It is the continuing ability to defend customer demand and earn attractive returns on the next unit of capital.

The useful question is how much growth survives once further price increases become harder.

Quality investing requires confidence in a business, together with a willingness to revise that confidence when the evidence changes.

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