

Magellan – In The Know: Episode 58

The art of the turnaround: investing in companies at a crossroads



Announcement ([00:00](#)):

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Host ([00:14](#)):

This is In The Know, a monthly investment podcast brought to you by Magellan Asset Management.

Emma Henderson ([00:20](#)):

I think it's very fair to say that investing in turnarounds isn't easy. If we can find a high quality company that has been mispriced due to shorter term executional challenges, and it passes through our turnaround analysis framework, the reward for investors in picking a successful turnaround can be outsized. So it's not unusual for those rarer success stories to rally 50% or higher in a very short period of time once the turnaround does begin to turn.

Host ([00:50](#)):

That's Magellan Investment analyst, Emma Henderson, explaining the potential of successful turnarounds when a high bar of strong fundamentals and a clear path to recovery is met. Welcome to Magellan In The Know. So what separates a successful turnaround from a value trap? This month, sector head of franchises and healthcare, Hannah Dickinson, and investment analyst Emma Henderson, sit down for a fascinating dive into consumer sector turnaround opportunities. Focusing on household names like Nike, Estee Lauder, Gucci, and Starbucks, all of which have hit temporary roadblocks, they explain Magellan's disciplined four pillar investment framework covering fundamentals, leadership, strategy, and timing, and they examine how to navigate the risks, behavioural traps and complexities involved. First, here's a warm welcome from Hannah Dickinson.

Hannah Dickinson ([01:49](#)):

Hello and welcome to Magellan's In The Know podcast. I'm Hannah Dickinson, head of the franchises team here at Magellan. With me is my colleague, Emma Henderson, an analyst in our team. Hi, Emma, thanks for joining us.

Emma Henderson ([02:02](#)):

Hi, Hannah. Great to be here. Looking forward to today's topic.

Hannah Dickinson ([02:05](#)):

So today we are going to discuss the consumer sector from a bit of a different lens, company turnarounds. We'll talk through how we assess turnaround stocks and share some examples from our experience. Think of names like Estee Lauder, Pepsi, Unilever, Nike, Adidas, Kering, and Starbucks. There are a range of consumer companies that have recently hit some bumps in the road. Turnarounds can offer amazing idiosyncratic or uncorrelated returns for investors, but they do come with some unique

risks that we want to explore today. So we want to explore what separates a successful turnaround from a value trap using a framework we've developed and highlight some real world case studies.

Emma Henderson ([02:47](#)):

That sounds great, Hannah. As you've already mentioned, there are a number of pretty high profile consumer companies working through turnaround situations as we speak. So I think this is a very timely discussion. But before we go any further, I think we should really clarify what we mean when we call a company a turnaround. Turnarounds can mean different things to different investors. Given Magellan's strict quality universe, we don't invest in highly leveraged distressed assets, startups or companies with existential competitive or disruption threats. So the company turnarounds that we look at will be a little less dramatic, but nonetheless can present attractive opportunities. Would you agree?

Hannah Dickinson ([03:25](#)):

Definitely. So I guess I would define a turnaround as a good company that is undergoing a strategic or operational reset. So that means to meet our definition, the problems must be temporary, they must be company specific, and they must be material enough to drive a significant repricing because I guess that's what makes it interesting and attractive to look at. So why does our definition matter? Well, I'd say that categorising the problem correctly is a really important first step because it tells you how you might think about duration of the investment case, understand and frame the risks you might be taking on, and then where you should focus your due diligence.

([04:05](#)):

I also think it goes to, it's making sure that you're being consistent with your own investment philosophy and style. So at Magellan where a quality focused, long only investors, we have a three to five year holding period, and our number one objective to clients is really protecting against permanent capital loss, so protecting against the downside. So it's important that the company retains its core quality characteristics. For example, its durable competitive advantage and its potential to generate attractive returns on invested capital. So Emma, with that definition in mind, can you maybe give us some examples of names in the consumer space at the moment that might meet our definition? Or maybe names that don't?

Emma Henderson ([04:45](#)):

Sure. I think it might be easier to start with companies that don't meet our definition, and I'd classify those into two buckets. So the first bucket would be companies that are undergoing performance fluctuations, but those are driven by external macroeconomic or cyclical factors that the whole peer group is experiencing, such as a broad based pullback in consumer discretionary spending. So global fund holdings like LVMH and Chipotle can see their performance fluctuate with these trends, but if we're confident that the brand and the strategy remain on solid footing, we wouldn't classify this a turnaround. The second bucket of companies that don't meet our definition are those that are undergoing longer term structural challenges or existential disruption threats that are not company specific. So a clear historical example would be department stores and other legacy retail formats that have been disrupted by Amazon and e-commerce. And perhaps a more recent topical example would include creative companies like Adobe and advertising agencies that are seeing their business models face disruption threats from their developments with generative AI.

Hannah Dickinson ([05:52](#)):

The classic disruption example I always think of is Blockbuster in the age of Netflix.

Emma Henderson ([05:57](#)):

Exactly. So turning to companies that do meet our definition, I think there's four interesting recent examples we could share. So the first is Nike, the world's largest sportswear company. Estee Lauder, the world's second-largest global beauty player behind L'Oreal. Kering, which is the Italian owner of the Gucci brand that has been around for over a century, as well as some other high profile luxury brands, and then also Starbucks, the US's largest coffee house by a wide margin. We'll talk more about each of these situations further in the discussion, but all of these we would consider quality companies, but they've all seen their share prices fall between 40 and 80% from peak to trough over the last three years due to company-specific performance issues. But before that, Hannah, I think you'd agree that those names that I just battled off represent an unusually high number of companies going through a turnaround for our quality universe. Why do you think now is an environment that's so ripe for turnaround stories?

Hannah Dickinson (06:54):

Yeah, it is an unusually high number. In any given year, we'd probably see one or two turnarounds in our universe. I think it's been a really complex operating environment for companies with an accelerated pace of change. So there has been some major structural shifts in the global economic environment and operating environment over the past few years since COVID. So we've had digital disruption, the rise of omnichannel shopping and AI. We've had major policy changes under the Trump administration and linked to that some real geopolitical shifts and decoupling away from China. And also consumers are under a lot of pressure from inflation and higher interest rates. So these factors taken together, they do impact all players to some extent, but I'd say some companies haven't kept up with the pace of change or managed through this change as successfully as others. So some companies made big bets on markets or channels that failed.

(07:50):

Maybe they underinvested in critical infrastructure to support agility, or maybe they became bloated and complacent and lost a bit of an innovation edge. So what we're seeing across our universe is a real bifurcation in valuations. So investors are really willing to pay up for what they would consider to be safe haven quality names like L'Oreal, but then they're massively repricing these ones where the outlook is less certain. And when it comes to turnarounds, you do often see optically cheap multiples or you see this massive share price revision, which makes them look interesting and potentially compelling.

(08:27):

But the real question that we have to ask ourselves is what are you underwriting if you buy a turnaround story? If you're betting on margin recovery or brand revitalization, you need to be really confident that it's achievable and you're not just banking on a reversion to old highs, otherwise the stock might look cheap, but it might still disappoint. So I guess with all of that background, the question that I always ask myself really is why do we bother? This seems really hard. It sounds more challenging than normal investing. So what's your take, Emma?

Emma Henderson (09:01):

Sure. I think it's very fair to say that investing in turnarounds isn't easy. To use a famous Warren Buffett quote "turnaround seldom turn" and backing that up with some data studies from McKinsey, Boston Consulting Group and Harvard Business Review have found that only 20 to 30% of corporate turnaround succeed. So here at Magellan, we are very conscious of these risks, and as a result, turnaround investment opportunities only make up a small subset of the investment opportunities. We are analysing on a daily basis, and we have a very high bar for what turnarounds would make it into one of our portfolios. However, if we can find a high quality company that has been mispriced due to shorter term executional challenges, and it passes through our turnaround analysis framework that we will talk through later, the reward for investors in picking a successful turnaround can be outsized. So it's not

unusual for those rarer success stories to rally 50% or higher in a very short period of time once the turnaround does begin to turn.

(10:03):

Another reason turnarounds can be interesting is that they have an idiosyncratic risk profile, and what we mean by that is that their earnings performance and their share price performance will likely move quite differently to their direct peers and to the broader market, given that really company-specific nature of risks and challenges that you mentioned earlier. So this can offer diversification benefits that can be attractive for portfolio construction. So that covers why these are interesting investment opportunities as well as why they can be challenging. What hand do you think are some of the common mistakes when investing in turnarounds and how can we avoid them?

Hannah Dickinson (10:39):

Well, I think it's important for us to recognise that investing in turnarounds requires real patience and grit because in my experience, they often take longer than the market expects, and the recovery tends to be non-linear. So there's puts and takes. There might be two steps forward, one step back. There are a couple of classic mistakes that investors make when looking at turnarounds, and they're often behavioural traps that can cloud judgement. So one is anchoring bias, which might involve clinging to a past valuation margins or growth rates. You could have self-attribution bias where you are believing the thesis is playing out just because the stock rebounds, even though fundamentals haven't actually changed. There's also sunk cost fallacy, which is where you are holding on just to get your money back. And this is a classic one that happens when you have a thesis on a company and you might own it in your portfolio, but then it turns into a turnaround story along the way.

(11:36):

There's also confirmation bias, which is selectively looking for information that validates your thesis. So all of these can play out when you're investing in any circumstances. But I think they're particularly important to keep in mind when investing in turnarounds, and I think that's why we like to have a really clear process and framework to follow when we are looking at these kind of investment opportunities. So we really want to know at the outset what success looks like, what we are underwriting, and what specific milestones we are following that would indicate genuine progress. So we always ask ourselves, what's the thesis? What are the signposts that would change our mind or confirm that thesis? What's priced in already? And crucially, if we didn't already own this stock, would we buy it today based on what we do know? Emma, maybe could you give us an overview of this framework that we've been teasing and how we'd apply it when we are thinking about turnarounds?

Emma Henderson (12:33):

Sure. So when a company kind of comes up screens as a potential turnaround story, there's really four key pillars of the analysis framework that we apply. The first is company and industry fundamentals. The second is leadership, third, strategy and complexity, and the fourth is timing. So let me start with pillar one and we'll use some examples as we go here to try and make this real for the listeners. But the first pillar is company and industry fundamentals. This is a critical first screen or stage gate to a company. Then passing through the rest of our framework, this links back to Magellan's strict quality universe and our definition of a turnaround that we spoke about earlier. So the key questions at this stage of the analysis that we're asking ourselves is this still a quality company and an attractive industry?

(13:19):

Are these company specific issues or are these issues structural or cyclical or executional? I think any good example here to share is Nike, which is currently going through its own turnaround story. If we start with how do we think about the industry, so the sportswear category, we still view this as an

attractive growth category supported by health and wellness and casualization tailwinds. At a company level, we still believe that despite recent executional issues, that Nike has incredibly strong brand equity and enduring competitive advantages as a global sports marketing powerhouse relative to its many small peers in its category.

Hannah Dickinson (13:56):

I think Kering is another one that comes to mind. Similar to Nike, it's playing in the apparel space to some extent, but in a much obviously higher price part of the market. And we do really like the luxury category. It has great structural and attractive economics, and I do think Gucci still has real brand equity. The real issues here for Kering are strategic and executional. So right sizing the store footprint, clearing out wholesale exposure and improving the creative direction of Gucci from a fashion perspective. So I would say those are all kind of executional and company specific problems, and that means it does fall within our definition of a turnaround, one that is less clear and sits on the other side of those health and wellness tailwinds that you were talking about for Nike is Pepsi, which is the dominant player in salty snacks in the US.

(14:47):

It's facing some executional and strategic headwinds, but some of the issues are also cyclical, taking a lot of price during COVID and that price washing through the system. But also there are some complex structural headwinds that are associated with the rise of anti-obesity medication and also new policy developments in the US So it doesn't fit as neatly into our turnaround framework. And I'd say the issues are just more complex for Pepsi. So the second pillar of our framework is leadership. So we've just talked about industry fundamentals and the category. Now we move on to more of the specifics of the company.

(15:25):

So when we look at leadership, we're looking at who is steering the ship and we're asking ourselves, "Is this the right person, the right team for the task? Does the company have the right governance systems and incentive structures in place?" And I'd say generally we prefer to see an outsider CEO appointed that comes in with a full mandate and full autonomy. And what I mean by that is governance structures that aren't imposing a particular set of ideals or systems on the CEO, so they have a real pathway to actually improve the company.

Emma Henderson (16:02):

I think the Starbucks turnaround can offer some really valuable insights on this pillar and how leadership and governance can significantly impact the pace of business recovery and the ultimate returns to investors backing that turnaround story. So for some historical context, Starbucks begun experiencing performance, some performance issues in late 2021. In the US, it's had some company specific issues stemming from poor customer service and operational inefficiencies. And in China, it was facing some aggressive competition from low cost players like Luckin Coffee as well as a weak consumer environment. So as we see in many turnarounds, this led to the ultimate removal of the then CEO, Kevin Johnson in April 2022. But I think what's been most interesting is that now three years later, we've passed through three different versions of a turnaround CEO. First was the company's founder, Howard Schultz, that actually returned for a third time in the CEO role who sought to stabilise operations and set a turnaround strategy.

(17:05):

He was then followed by an outsider, Laxman Narasimhan, who came from consumer products company Reckitt Benckiser. However, his tenure was limited to just 12 months, and we'd always had quite a few concerns with that appointment, namely his limited autonomy given that Howard Schultz was still

actively involved, Laxman was executing on a strategy that had been set by Schultz himself as well as a lack of restaurant industry experience and experience leading a turnaround at the scale and complexity that Starbucks was going through. So fast-forward to today, we now have Brian Nicoll in the CEO role at Starbucks who they poached from Chipotle, who does bring strong restaurant industry experience and turnaround credentials along with more decision-making independence with Howard stepping back and giving him more freedom to roll through with his strategy. So ultimately this was a story where Starbucks got there, but it took them three years to assemble that right team with the right structures in place that you mentioned.

Hannah Dickinson (18:03):

It really shows why patience and grit is so important in this process. I think the Starbucks example was also an example where we saw the market get really overexcited by the appointment of what we would kind of say was a star CEO. So the share price rose over 20% on the day of Brian Nicoll's appointment. Although since then, it's underperformed as the extent of the challenges and the reinvestment requirements and also the turnaround timeframe have become a lot clearer. Kering's another example where we've seen puts and takes a bit of excitement and then maybe disappointment, but most recently the share price jumped after the appointment of Luca de Meo as CEO. So he's an outside hire, again viewed as a bit of a turnaround guru. It does signal an improvements in governance for Kering, but I'm cautious that he still won't have full autonomy because the founding family still controls the board of directors and there's a dual deputy CEO structure sitting beneath him, which feels a little bit messy to me.

(19:03):

I guess the lesson from looking at the turnarounds that we've looked at is just because the CEO has a good track record or good experience doesn't mean that the turnaround will be straightforward. The context is really important. So a few words of caution or things that I would note often after a new CEO is appointed, there is further management change to follow, which can create some internal instability over the next few months. And the other thing is the new CEO is often motivated to reset investor expectations in what we refer to as a bit of a kitchen sink event. So we are cautious of jumping in before this point and before we have a good understanding of the CEO's strategy.

Emma Henderson (19:43):

So I think that flows nicely into our third pillar in our analysis framework, which is really focused on strategy and the complexity of the turnaround. So at this point, we're asking ourselves how simple or complex are the strategic issues that the right management team needs to solve, and are these being adequately addressed by the turnaround strategy? Once we understand what needs to be done to fix these problems, we're also asking ourselves how much CapEx or OpEx reinvestment will be required to support the strategy? And is this understood by the market? What we like to see from management teams executing a turnaround strategy is really strong reinvestment in a company's core competitive advantages or its sources of economic moat. And where we can be more cautious is when we see executives come in and drive a turnaround strategy that is really focused on short-term cost-cutting to drive up margins.

Hannah Dickinson (20:33):

That one is a big red flag. Estee is one that is an interesting case study here. I'd say it passes our test on category fundamentals. The beauty category is still a very attractive one, and we do have a new CEO in place. So it's a little bit further progressed along the timeline, but what leaves me cautious here is I'm just not convinced that the plan and strategy that's been outlined goes far enough to address the issues. This is a large multi-brand, multi-market behemoth that is competing against an incredibly agile set of

challenger brands that are bringing new products to the beauty market at an incredible pace. The strategy that has been announced so far is focused on what I would call easy wins. So downsizing headcount, simplifying organisational structures, moving towards new channels like Amazon Premium Beauty Store. And I think those are all important parts of the strategy, but I just don't think it goes far enough to address the core problems.

(21:30):

I mean, this business has been losing market share in the US for a decade, so it's not just a matter of spending more on marketing or getting into the right channels. I think the innovation engine is fundamentally broken. I think its IT systems are slow and outdated and its supply chain is really complex and underinvested. The strategy really is only as good as the systems that support it, and I think there's larger reinvestment required here to drive sustainable long-term improvement. So the next pillar that we look at is timing.

(22:02):

And when we're thinking about timing, we are really not trying to predict peaks and troughs. It's more about understanding how progressed the turnaround is and whether we're in the early or later stages. So a couple of questions we ask. Has a new leadership team been appointed? Has the new team outlined a clear and appropriate strategy? Have investor expectations been sufficiently reset and have we started to see any tangible evidence of recovery? If the answer is yes to these questions and we've identified this to be a relatively simple turnaround, then we are probably in the latest stages.

Emma Henderson (22:38):

I think Nike is a good example here maybe to pull this all together of a company that we do think has moved towards that more attractive later stage of its turnaround. So quickly, we mentioned before that the sportswear category and company fundamentals are intact. When we think about the leadership team, Nike has a well-respected new CEO in place, Elliott Hill, who is a bit of a mix of an insider and an outsider. He hadn't been working with the business for a while, but he had previously had 30 years with Nike and has very strong employee buy-in. And importantly for this turnaround, very strong relationships with Nike's retail partners. In terms of the strategy and complexity, I would say that Nike's turnaround is towards the simpler end of the spectrum of turnarounds we look at, there's really two key strategic areas that the company needs to turn around. The first is their product offering.

(23:27):

So for any of those that are unfamiliar with Nike's current situation, they had become really overreliant on some of their key lifestyle franchises. So think Air Force One, Air Jordan and Dunk, which became overdistributed, lost their brand halo and really weren't refreshed with the exciting new innovation that Nike's been known for over time. The second strategic area that they need to solve is their retail relationships that became damaged over the last couple of years as Nike made one of those bets that didn't play out, which was an aggressive shift to focus on selling through their direct-to-consumer channels. Both of these issues we think are fixable. They're not overly complex to fix. We think they've got the right leadership team in place. So it then comes down to timing and valuation.

(24:11):

From a timing perspective, we're now into that execution phase. We've worked through some of the financially painful parts of the turnaround story, which involved them pulling back product from the marketplace. We've seen retail relationships begun to start being reinvested in and supported, and what we need now are green shoots on the product side that are likely to emerge over the next 12 to 18 months. So this is a much more progressed turnaround per se Kering, which you mentioned earlier, where we've only just had the CEO appointed and we're now waiting for his diagnosis of the situation and his strategy to fix it.

Hannah Dickinson (24:43):

So you've talked about Nike and how it should be a relatively straightforward example. The next question that comes up for me is how you might translate that assessment into an actionable investment idea.

Emma Henderson (24:56):

Sure. So I think we've really covered the qualitative analysis framework that helps us classify or categorise what kind of turnarounds we are interested in. The next phase in executing these ideas is a really disciplined focus on valuation, which is critical given the inherent risks in investing behind a turnaround. What I found over the years is that in turnaround situation, some of those traditional valuation metrics you look at like a one-year forward price to earnings ratio becomes virtually meaningless when that one year forward earnings is deeply depressed as a result of the turnaround situation. I've also learnt that when you're focused on forecasting, you shouldn't be too focused on exact point estimates just given the range of outcomes and variables you're working with. So what we're really interested in is understanding the range of possible outcomes and whether the distribution curve is skewed to the upside or downside. So we spend a lot of time scenario testing and thinking in probabilities, which I think is really important in analysing turnaround situations.

(25:56):

We also like to invert the problem, so we're interested in what is already captured in the share price at different points of the turnaround cycle and what you really need to believe to invest at that point. Back to the points on timing, we mentioned earlier we're also conscious in the idea execution phase of where are we in the downgrade cycle. I think it's pretty clear that the first downgrade in a turnaround is rarely the last, and so we're focused on understanding market expectations and if they have been sufficiently reset, we always look at margin of safety, but I think that's particularly important in a turnaround the scenario and the earlier we are in a complex turnaround, the larger the margin of safety you'd want to see. So those are some of the key valuation considerations. Hannah, what else do you think is relevant in the execution phase of an idea, particularly from portfolio construction perspective?

Hannah Dickinson (26:45):

Yeah, I think we need to think about portfolio construction as no investment is made in a vacuum. So I would be thinking about position sizing. So we would usually start with a relatively small position size, just given the risks associated with turnarounds. We're also always thinking about diversification, so understanding what bets we are making and how correlated they are. On Nike, for example, you might be conscious of the fact that even though there are company specific factors that influence the turnaround, perhaps there are also factors that are outside of Nike's control and maybe those factors are correlated with other companies in the portfolio. And then the final thing is around sell discipline, which is knowing the thesis signpost monitoring. So if the share price goes down after we've bought, which often happens or occasionally happens, hopefully not too often, we've really got to be careful that we check that the new evidence is supportive of our thesis rather than challenging it. So if it's supportive, we'd consider averaging in at a lower share price. And this is of course where patience and grit comes in again.

Emma Henderson (27:51):

So on the topic of sell discipline, I think you touched on this earlier, but we've spoken a lot about analysing a turnaround from the outset, but what happens if we've already invested in the company and it ends up becoming a turnaround?

Hannah Dickinson (28:03):

Again, I think it's about always knowing why you own the company and being careful of those behavioural traps that we mentioned earlier, like anchoring bias and thesis drift. So what I would suggest is making sure you put it through your due diligence process and assess the company on the basis of whether you would buy it today if you were looking at it for the first time. So try to remove the fact that you own it already from your decision making process.

Emma Henderson (28:29):

Okay, Hannah. I think we've covered a lot of ground across a range of real time consumer turnaround examples that hopefully the listeners have found valuable. We've covered that investing in turnarounds can be challenging, that they're not necessarily for the faint-hearted, and that they do require significant due diligence in assessing opportunities. However, we've also shared that investors can maximise their chances of finding those rare successful turnarounds through a very strict focus on business and industry quality, deep research, and clear frameworks for analysis and decision making.

Hannah Dickinson (29:01):

Thanks, Emma. It's been a great discussion.

Host (29:03):

That's Magellan investment analysts Hannah Dickinson and Emma Henderson. We trust you've enjoyed this episode. For more information on previous episodes, visit magellangroup.com.au/podcast where you can also sign up to receive our regular investment insights program. Thanks for listening.

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