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Mackenzie Global Equity & Income Team

Global Equities: The case for compounders

For institutional use only

Introduction

As institutional investors continue to navigate an environment of low interest rates and weak economic growth globally, the hunt for sources of alpha has become more important. Even though the global equity universe (valued at roughly US$70 trillion) provides a vast field for investors to choose from, securities that offer attractive long-term risk-adjusted returns without excessive downside risk are somewhat more elusive. Active management remains key in this regard. Skillful stock selection has the potential to add considerable value, provided managers are using the right lens – one focused on companies that can add value no matter where they are in the world.

A "compounder" approach has the potential to deliver what institutional investors are looking for: a source of enduring and accretive returns in their global equity portfolio. By zeroing in on business models that are resilient, adaptable and hard to replicate, investors can tap into growth through the best companies in their respective industries. However, it isn't always about the stock price. Investors typically succeed when they focus on businesses that generate high free cash flow and strong returns on invested capital over the long term. "Compounder companies" with these characteristics are likely to contribute to the risk-adjusted returns over time that institutional investors seek.

This paper takes a closer look at what makes a compounder company and why these businesses may be a good fit for institutional investors who require durable alpha over longer time horizons. From moats to capital structures, what factors contribute to a company's compounder value?

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Compounders – a moat against disruption

Low interest rates, coupled with economic uncertainty and high market volatility, have created new challenges in the search for suitable risk-adjusted returns in the equity space.

To determine whether a company in any industry is going to be a long-term compounder, it starts with a moat, which is a critical factor that protects its business model and margins from competition.

Compounder companies are great businesses found in all corners of the world that share a set of common characteristics and sources of capital growth. These companies can be relatively small and unknown, possessing unique, tangible or intangible assets that drive healthy margins – or they can be well known with incredible scale.

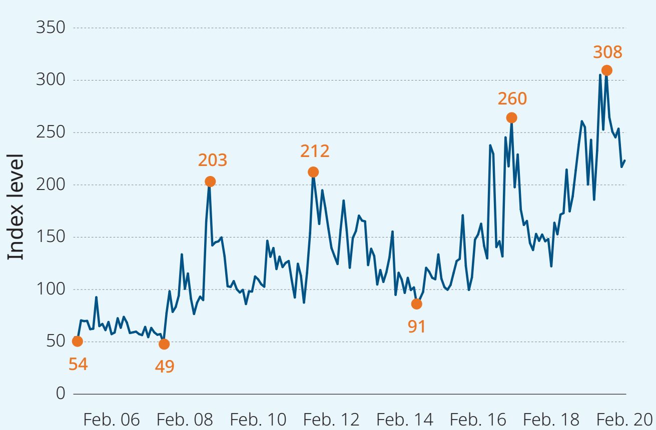
It's also important to evaluate the industry in which a moat company operates and whether, in this era of disruption and economic transformation, it's benefiting from strong thematic tailwinds.

For example, consider the trend toward healthy eating. Demand for salmon proteins has seen annualized growth of 8% for the past 20 years as people around the world look to improve their eating habits and overall health, especially those in countries with a growing middle class. The world's largest producer of salmon is servicing this trend through large scale sustainable salmon farming. There are only a handful of regions in the world where salmon can be farmed due to natural and ecological requirements. It is also a highly regulated industry with a finite number of farming licenses and where operations are strictly monitored. It's an industry that benefits from multiple protective moats and strong tailwinds.

The precipitous fall of interest rates

Source: Bloomberg, August 31, 1990 – January 31, 2020.

Global economic policy uncertainty



Source: Policyuncertainty.com, February 2005 – February 2020

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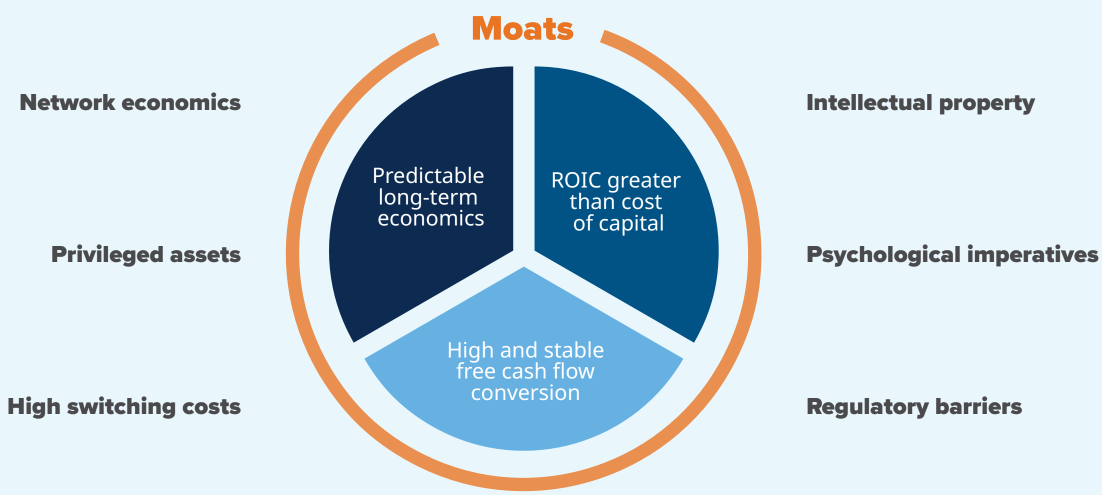

Source: Mackenzie Investments

Another moat can be found in the booming semi-conductor industry, where economies of scale in manufacturing and strong investment in research and development have given rise to multiple compounder companies that can serve a market that now goes beyond mobile devices. Today, semi-conductor technology is used in industrial production, automobiles, appliances like smart fridges, and home assistant devices that eagerly answer our questions about the weather every morning; and the content per device is increasing. The rise of 5G wireless technology and artificial intelligence will only accelerate this demand.

While moats are important, they aren't everything. Compounder companies must also display three other important elements that are central to generating risk-adjusted returns.

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Beyond the moat: 3 compounder characteristics

What else makes a compounder company great? It's all about the numbers, whether it's predictable economics, higher returns on capital or strong cash conversion. Here's how they contribute to risk-adjusted returns:

1. Predictable economics

Compounder companies are more likely to be in predictable, stable industries where businesses face less uncertainty and have a lower risk of potential disruption from outside forces.

Microsoft is a great example of predicable economics. This company has transitioned its legacy perpetual software license business into a cloud-based subscription model. Cloud services like Azure and Office 365 are recurring in nature and easier to predict, given that customers pay ongoing monthly usage fees. As the installed base of users grows, it also attracts developers to create applications that are compatible with Microsoft products, making the platform more attractive to new users. This type of dynamic can be referred to as a "network effect." Additionally, once companies integrate these services into their operations, the switching costs can quickly become prohibitive – another factor that bolsters the company's position as a market leader. Businesses like Microsoft can offer investors a higher level of confidence in their valuation models and decision-making.

2. Higher return on capital

Compounder companies should also sustain a return on invested capital (ROIC) well in excess of their weighted average cost of capital (WACC). In order to deliver significant compound growth in earnings, companies need the ability to deploy capital at high incremental rates of return over a longer timeframe.

A good example of this is the factory automation sector, where companies are developing the sensors, vision systems and complex robotics needed to perform essential tasks such as inspection, counting and measurement of goods. While these tasks were traditionally performed by human factory workers, global labour shortages and the rising cost of labour at factories around the world have led to rapid uptake of automation in recent years, fueling demand for such products and solutions. Some companies operating in this sector have been able to achieve profit margins reaching 50% and ROICs that exceed 100%. To identify which companies have compounder potential, look for those with highly differentiated and innovative products that also control their production and distribution costs.

While high industry-relative ROIC can be evaluated in isolation, a stronger compounding signal is found in companies with a high, consistent spread between its ROIC and WACC. Investors should look for such companies operating in markets where other investors may systematically undervalue and under-appreciate the long-term earnings power of high ROIC businesses. Since their business models allow them to reinvest capital at high rates of return, these companies can often out-invest their peers while still providing their shareholders with higher free cash flow.

In general, investors would also be wise to find management groups with a demonstrated track record of prudently allocating capital by reinvesting it in projects

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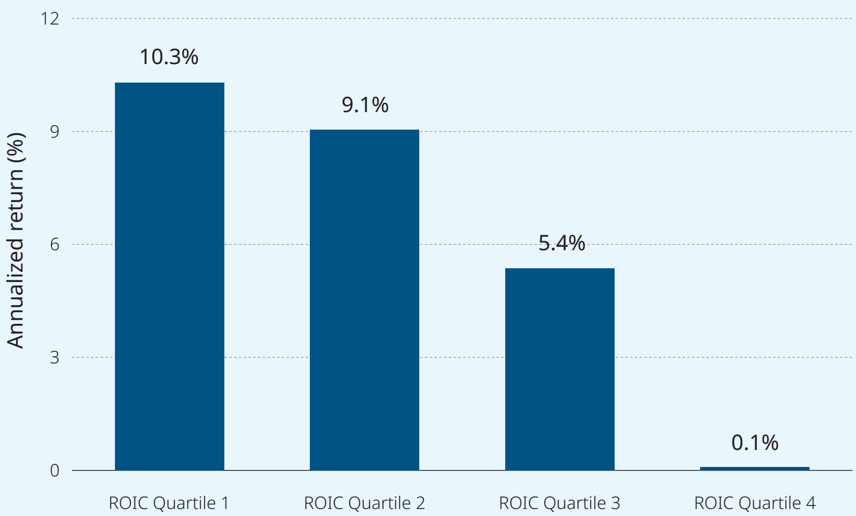
Performance of MSCI World Index companies by ROIC quartile



Source: Mackenzie Investments, Factset, 25-year period ended December 31, 2019.

Companies that can deliver high ROICs have shown to deliver stronger returns over time than those that cannot.

3. Strong cash conversion

Businesses with high free cash flow conversion, relative to their respective industry, are also more likely to be compounder companies. That's because they can generate cash well in excess of what the company needs to maintain normal growth of the business.

Case Study: Trading up – why exchanges are great compounders

Since the first stock was traded in the 1600s, formal securities exchanges have proliferated across many geographies around the world. More recently, these exchanges have benefited from regulatory barriers and scale, developed through network effects. As more investors trade on the exchange, volumes and liquidity go up, bid-ask spreads come down and, thus, it becomes an increasingly more attractive place to trade. Exchanges have also taken steps to monetize their proprietary data sets. As a result, exchanges have tended to be excellent compounders over time, with attractive margins and high returns on capital.

CME Group

Headquartered in Chicago, the CME Group is the world's second largest derivatives exchange and the dominant trading venue for multiple asset classes, such as interest rate futures. This monopolistic position acts as a strong intangible asset and creates a network effect as CME's dominant position in the trading of these securities allows it to develop other complementary products that attract additional investor transactions. Further, unlike shares of companies that can be bought and sold across multiple exchanges, futures are customized contracts that must be bought and sold on the same exchange and carry additional risks that are mitigated by the exchange, which acts as counterparty. As far as scale goes, the CME now handles more than half of all global trading of interest rate futures, giving it significant pricing power. Network effects and strong pricing power are two key compounder characteristics that may lead to consistent returns over the long term.

Deutsche Boerse

Headquartered in Frankfurt, Germany, Deutsche Boerse is the largest exchanges operator in Europe and owner of Eurex, Europe's largest derivatives trading and clearing platform, as well as Clearstream, Europe's second-largest settlement and custody platform. Relative to its competitors it boasts a more diversified revenue stream across non-transactional activity (selling of market data, indices and services) in addition to more traditional transactional services (trading, clearing, settlement, and custody).

As is the case with other exchanges, Deutsche Boerse has benefited from a post-financial-crisis era regulatory push for more transparent on-exchange trading, as opposed to riskier OTC trading. A tailwind that contributes to scale and network effects.

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The moat effect – a durable business model

A strong competitive advantage is the bedrock of a business model that can sustain attractive levels of profitability over the long term. Warren Buffett has called this a "competitive moat" – a durable business model that is resilient to change, hard to replicate and doesn't require disproportionate leverage to generate returns.

Compounder companies must have a strong competitive moat – and investors must be able to value it to determine what they're prepared to pay for it.

Identifying moats: 3 steps

1. Identify the source of a company's advantage

While Buffett has drawn attention to moat stocks for a period spanning several decades, investors today still appreciate the long-term ability of these business to be compounders of capital over time. The quality of a moat or competitive advantage can vary from industry to industry, but it is always tied to the business's underlying economics, the attractiveness of the industry and where the company sits in that industry's value chain.

For example, Nike spends more on its brand-building efforts than the annual revenue of some of its competitors. Its vast scale also gives it an ability to innovate, produce and deliver to market with exceptional speed. This is a recipe for a compounder company able to extract consistently higher margins than companies that supply its materials, or its competitors.

To identify companies like Nike, investors should thoroughly understand its suppliers, clients and competitors – and what the source of its advantage is.

2. Valuation

Having identified a strong advantage, the next step is to determine what this advantage is worth. Valuation can be a nuanced process for compounder companies. An industry-leading company with identifiable advantages over its peers could be worth a premium over mediocre companies in the same industry that appear to be cheaper. Over time, however, the premium paid can be exceeded by the ability of an industry leader to compound at a much higher rate.

3. Monitor

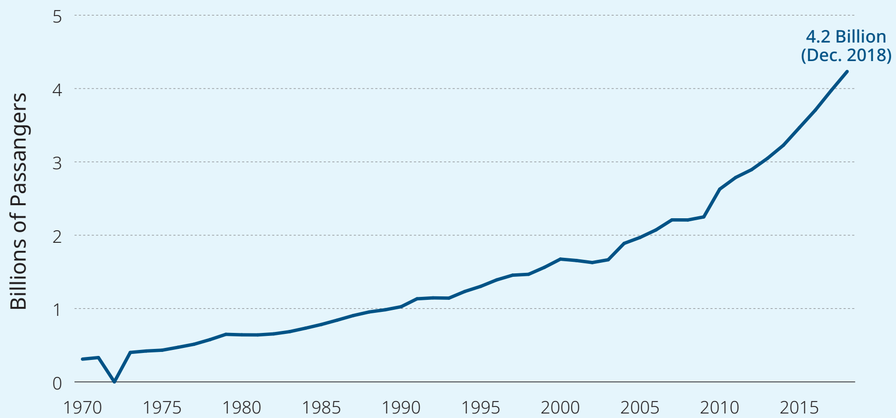
If the share price truly isn't attractive enough, then it could pay to tuck away the company for another day. Investors could be well served to keep their valuation models current and wait for the market to offer an opportunity to buy the company for less than they estimate it's worth.

Case Study: Above and beyond – high barriers to entry benefit Safran

A Paris-based commercial aircraft manufacturer, Safran operates in a four-player oligopoly in an industry with tremendous barriers to entry. This is defined by decades of cumulative investment in engineering expertise, scale, brand, supply chain complexity, regulation and the need to be designed into massively complex programs that have high technical and procedural requirements. These factors create a steep business moat that's hard for new entrants to overcome.

While Safran earns a modest profit on its engines (which is highly unusual as engine makers usually sell these at a loss), it produces as much as 40% earnings before interest and taxes (EBIT) margins on service and spare parts, where it has material pricing power. It is estimated that for every \$1 in revenue generated by an engine sale, \$4 to \$5 are generated on a net present value in service and parts over time.

Growth in global air travel passengers carried



Source: The World Bank

Strong air traffic growth globally bodes well for Safran in the future.

Finding compounders – China's changing economy

In today's globalized economy, borders have become less important than business models in determining long-term return potential. That's because the key characteristics of compounder companies – strong capital growth and moats of resilience built into their business models – extend beyond sectors, geographies and styles.

While compounder companies often position themselves to benefit from global thematic trends or changing consumer demand, some opportunities in China stem from its transition from a state-run economy to a market-based one.

As of 2018, state-owned enterprises (SOEs) still accounted for 49% of revenue among the top 500 corporations in China. SOEs' issues around corporate governance, capital allocation efficiency and/or alignment with minority shareholders have given many foreign investors pause when it comes to investing in China. This hesitation exists even though many SOEs possess quality underlying assets, such as the world's largest telecommunications operator or a Chinese medicine brand that has been around since the Ming dynasty. In addition, given the country's unique cultural and economic structure, business models that fare well in the developed world may not always be applicable in China, and vice versa. In fact, there are entire industries that only exist at scale in the country.

Such factors pose a great challenge to foreign investors who must appreciate and understand the nuances of localized business practices to identify the best potential compounders. For example, in the case of SOEs, not all are created equal.

State-owned companies that operate in capital-light consumer industries and are protected by strong brands or economies of scale can be excellent investments.

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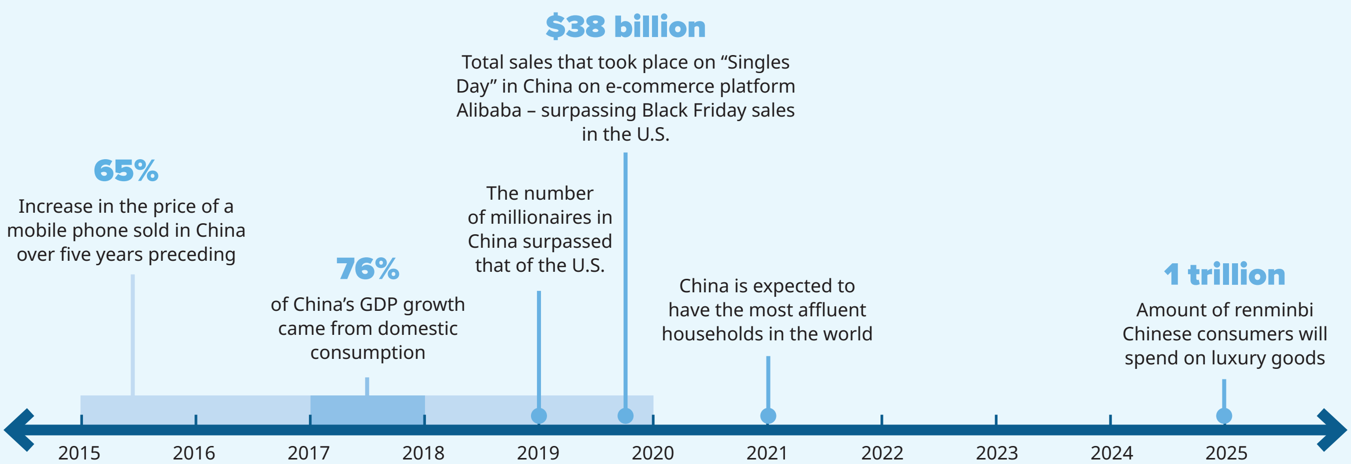
By the numbers: The rise of China's consumers

China is determined to grow its economy through internal consumption and ultimately become a world leader in manufacturing and technology. Investors should view this as a significant differentiator compared to other "developing markets," as most countries lack an engine for domestic capital formation in order to offset the shortage of foreign capital. And, while China remains constrained from a demographic perspective owing to its implementation of the one-child policy in 1979, it has an abundance of skilled labour given its substantial investment in higher education. This combination of skilled labour availability and domestic capital formation creates a productivity story that is unmatched in any major emerging market today and should provide a baseline level for economic growth.

Below are a few key statistics tracking the trends and drivers of the Chinese consumer today:



Sources: McKinsey, Credit Suisse

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Case study: Trading up in China

Businesses are reflections of the context in which they operate. China's distinct cultural backdrop and development model have created a number of innovative businesses that are unique to the country. Chinese consumers are leading the world in luxury spending, according to a 2019 study by McKinsey. Propelled by a rising middle class and rising incomes, China's spending on luxury goods is set to double by 2025.

Kwiechow Moutai

The premier luxury brand in China today, Kwiechow Moutai is a leading spirits company that makes baijiu, often referred to as China's "national liquor." It is an excellent example of a compounder company, demonstrating incredible brand and pricing power in 2014, when the luxury market in China slowed down. During this period, the company decreased Moutai's absolute price, but its price relative to other baijiu drinks increased as competitor products experienced deeper price cuts. Despite still selling at a significant premium over its peers, the result of the price cut was Chinese consumers abandoned rival brands to buy Moutai at what was then considered a bargain absolute price.

While competitors saw sales volumes fall, Kweichow's bottomed in the mid-single digits. In 2018, it raised the price charged to distributors by almost 20% – demand stayed strong and outpaced supply – the inverse of the typical trend where firms that raise prices experience declining volumes. The power of this brand has allowed the company to grow its free cash flow and market capitalization five-fold since 2014.

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Putting it all together

Near-term trade challenges aside, the world economy has become increasingly interconnected. Ongoing global political uncertainty, historically low yields and markets that metabolize headlines with immeasurable speed pose challenges for investors. Having a strong investment discipline is perhaps more important than ever. Identifying durable, protected business models that exhibit predictable economics and strong returns on invested capital is a framework that has proven itself prudent over time.

Companies that can consistently compound at high rates of return are found in multiple geographies; savvy investors tend to spend time identifying which industries and business models offer the best borderless opportunities.

China's disposable income per capita reached US$14,600 in 2018 and its middle class, according to McKinsey & Company, is on pace to reach 550 million people in just a few years – a number that is 1.5 times the entire current population of the U.S. This economy is likely to yield its fair share of compounder companies in the decade ahead.

Uncovering attractive compounder companies around the globe may be crucial to generating superior relative risk-adjusted returns in this increasingly challenging market environment. Active management, with a focus on proprietary research and a disciplined investment process, can be ideal for identifying undervalued businesses with strong moats where competitive advantages may be sustained over time.

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