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Driving quality

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As a team, we've spent the last quarter of a century seeking out what we consider to be the world's best compounders. These are companies that we believe can continue to steadily—and organically—grow their earnings and free cash flows at an attractive rate over the long term.

Compounding is a powerful force. Grow $1,000 at 10% over seven years and you will have doubled your money. Continue for another 10 years and you'll have $6,000.

We have two principal tasks. One is finding the compounders. The second is striving not to overpay. If a company is too expensive, then it is too expensive—and you run the risk of the price receding to a fair and sensible level. The recently departed Charlie Munger famously said, "A great business at a fair price is superior to a fair business at a great price." We agree. In his inimitable style, Munger also said, "If you buy something because it is undervalued, then you have to think about selling it when it approaches your calculation of intrinsic value. That's hard. But, if you can buy a few great companies, then you can sit on your *** .... That's a good thing." Here, we are less inclined to agree. The truth is, you can't just sit and watch—it is essential to check and check again that the compounding potential is intact and not under threat, that there's no risk of fade of returns, and that the valuation remains reasonable. That's a challenge we meet with rigorous fundamental analysis and company engagement.

What tells us a company might be a high quality compounder? There are two measures that are part of our quantitative screen: the first is return on operating capital employed (ROOCE), and the second gross margin. ROOCE isn't a measure readily found in FactSet or Bloomberg screening tools; even if you Google it, the search will likely default to ROIC (return on invested capital). Yet ROOCE isn't an invention of ours. It is a subset of ROIC, which is also an important measure; it includes goodwill and accounts for past capital allocation decisions. Essentially, what ROOCE tells us is how much

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incremental capital is required to grow a business. Using a car analogy, if we think of ROIC as the quality of the car engine plus the driver's historical capability, ROOCE is the quality of the car engine alone.

Historically, our analysis shows that high-ROOCE companies have had a better annualised long-term return than low-ROOCE companies. Using 20 years of data from the MSCI World Index and dividing the constituents into five buckets, split highest to lowest by ROOCE, the highest ROOCE bucket returns 10.5% on an annualised basis, followed by returns of 10.2%, 9.5%, 8.5% and finally 7.5% for the lowest bucket.[1] At first glance, the spread might not seem that wide. But if we think of it in terms of compounding, $1,000 for 10 years at 10.5% rather than 7.5% results in $2,456 instead of $1,917—nearly 30% more. Compounding matters.

ROOCE explained

ROOCE is made up of two distinct parts. The return component of ROOCE, the "RO", is from a company's profit and loss account—specifically the EBIT (earnings before interest and taxes). Meanwhile, the operating capital employed piece, the "OCE", comes from the balance sheet and is the sum of the net value of the company's property, plant and equipment, plus its inventory, along with the trade working capital (the net of debtors and creditors). The best way to achieve a high ROOCE is to have a high level of profitability for the "RO" and a limited need for operating capital. Companies that exhibit these characteristics are therefore typically high-margin, asset-light operations.

Why high and stable gross margins matter

When we look for high margins, we're after high gross margins. Companies with a relatively limited cost of goods tend to have high gross margins and therefore high gross profits. Performing the same exercise for gross margin as we did for ROOCE, we split the MSCI World Index constituents into buckets from highest to lowest gross margin. The results are remarkably similar, with the highest gross margin bucket producing the highest annualised 20-year return (+11.5%), and the lowest gross margin bucket producing the lowest return (+8.5%).[2]

Essential in the context of high gross margins is pricing power, regardless of whether a company is facing an inflationary, disinflationary or deflationary environment. Pricing power means a company is able to pass on input cost inflation to customers. Should input costs then recede, pricing power enables these companies to hold on to the higher pricing. This is reflected in the long-term stability of high gross margins. In other words, a company can't sustain a high gross margin if it doesn't have pricing power.

Returning to our car analogy, high gross profits might be thought of as the fuel needed to run the engine—the force behind the organic growth. The greater a company's gross profit, the more it can spend on operating costs to organically drive revenues. These operating costs are typically talent (the workforce), research and development (R&D) and marketing. They help power the sustainability of long-term ROOCE, keeping the company and its brands, networks, products and services relevant to its customers, be they consumers or businesses. High gross margins also mean that a company is less vulnerable to any rise in cost of goods, which lower the percentage of revenues.

The average company in the MSCI World Index, represented by the index itself, has a 30% gross margin and a 20% EBITDA margin (earnings before interest, taxes, depreciation and amortization).[2] In between these two lie the operating costs. To put some numbers on this, if the average company had, for example, $20 billion of sales, using the average gross margin and EBITDA margin referenced above, $20 billion x 30% = $6 billion of gross profit, and $20 billion x 20% = $4 billion of EBITDA. With a difference of $2 billion between the two, that means 10% of these sales are operating costs. One of our high quality companies, a U.S.-based household products and personal care company with global operations and a host of world-leading brands, has a 50% gross margin and a 26% EBITDA margin. That's more than twice the average company's spend and investment on hiring talent, along with innovating, marketing and advertising at much greater intensity—overall, it's a substantial advantage.

We focus on ensuring that company management is efficiently driving operating costs and on understanding how they might allocate cash flows and possibly use the balance sheet (cash and debt) for acquisitions. As we discussed in our June 2023 issue, "To buy or not to buy", we are not averse to acquisitions; but if they come at the cost of reducing ROOCE, we believe it may signal that company management has misallocated capital and has potentially—and possibly permanently—diluted the quality of the whole company by buying a lower quality business. This is aside from the issue of overpaying, which is also discussed in our June 2023 piece.

[1] Source: FactSet, 31 December 2023

[2] Source: FactSet, 31 December 2023

Perversely, an improving ROOCE could also be a red flag to watch for, just as much as a decline. In the short term, higher ROOCE can easily be achieved simply by cutting operating costs, such as reducing R&D or marketing expenses. Profits rise, but in the long term the sustainability of organic growth at the revenue line will be challenged due to the underinvestment. The business will likely slow, and its intrinsic value might decline.

The investment road is very long. We don't need an on-trend, flashy sports car to whizz from A to B, or to go too fast and then run out of fuel. And we're not taking our chances on a cheap and cheerful runabout either. We're looking for reliable, sensible cars with decent performance that won't let us down, that don't cost a fortune to run and aren't complicated to drive; in short, cars we're happy to ride in for a very long time—on the right road, in all weathers. Existing high ROOCE and gross margins indicate which companies to look at closely. However, most of our research effort is spent understanding whether these measures will both remain high given all the challenges firms face—whether due to competitors, disruptors, regulators, fashions or economic cycles—when continuing to grow at high profitability. After all (and with apologies to Thomas Jefferson), "the price of compounding is eternal vigilance."

DEFINITIONS

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

Return On Invested Capital (ROIC) represents the rate of return a company makes on the cash it invests in its business.

Return On Operating Capital Employed (ROOCE) is a ratio indicating the efficiency and profitability of a company's trade working capital. Calculated as: earnings before interest and taxes/property, plant and equipment plus trade working capital (ex-financials and excluding goodwill).

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