Quality Cash Compounders

One deceptively simple investment philosophy has stood the test of time and served many legendary investors well – backing proven winners. 'Quality' is harder to define and measure than say value or growth – but we think it's easier to detect proven quality than it is to speculate on future unknown winners. We find that it most often comes hand in hand with high and sustainable cash returns on capital. The real difficulty with investing in quality is the discipline needed to buy these names at premium valuations, over lower quality but cheaper stocks. But when you find quality, looking at conventional valuation metrics can be misleading. First, the power of compounding over time has far more bearing on investment returns than entry valuation. Second, as demonstrated in Jeremy Siegel's analysis of the Nifty Fifty, even seemingly lofty valuations can double for a quality company. All this is what drove our hunt for Quality Cash Compounders, an evolution of our High Quality Growth Basket series that we have been running for six years. We present our top 50 names below, with further detail in the accompanying slide pack.

Backing proven winners

There is considerable merit in the simple philosophy of backing proven winners, as evidenced by many successful long-term investors. Valuation aside, it is much easier to identify companies that have already proven themselves than it is to pick the next, as yet unknown, winner from a fundamental perspective. One cannot argue with a long history of strong financial performance.

A natural question is: **what constitutes a 'good company'?** We can measure value and growth – but there is no universally agreed upon measure of quality. We think in many cases one key metric can in fact capture the result of various axes of quality – return on capital. High returns on capital may reflect a niche offering with high barriers to entry – think **Novo Nordisk**; it may represent an asset-light business with a dominant market position – think **Hargreaves Lansdown**; or it may just be a relatively simple business which is excellently managed – think **Next**. In all cases, consistently high returns on capital represent a company/management team which has repeatedly proven itself to be effective at deploying capital and compounding returns at a higher than average rate. In those cases, unless the opportunity for high returns looks to be under threat – which must be carefully assessed and monitored – then there is a strong case for investing. And when you find them, alpha generation over time is often equally impressive.

From HQGB to Quality Compounders

Quality has always been an important theme for us at Aviate – something that we sense is less pervasive in Europe than in the US, where many investors are indoctrinated with the works of Charlie Munger. That tenet underpinned our annual High Quality Growth Basket series, which has served investors well – four out of five full years materially outperformed the SXXR Index, and the sixth is c.10% ahead of market (SXXR) YTD. But with our last update in June this year, the number of qualifying names had dwindled from 40 originally to just 15. Many 'quality' candidates failed to meet valuation and/or growth thresholds, which led to an evolution in our thinking.

Focusing on top-line growth had become too constrictive. Against a weakening global growth outlook fewer companies looked likely to achieve decent sales growth (4% plus), and given that scarcity, the names that did were unlikely to be available for consensus Y2 FCF yields of 5% or higher (our valuation hurdle). As we then began to consider 'quality' in its own right, assessing returns on capital struck a chord. First, it certainly seemed to capture the notion of quality. Many of the names that have appeared in our HQGBs over time have consistently generated high returns on capital – and through this exercise we also discovered several previously unfamiliar or counterintuitive names (**Hexpol, WH Smith**). Second, it shone a light on companies which could continue to grow free cash flows even if a slower growth environment means lower headline sales growth. Lastly, a focus on return on capital highlighted the effect of compounding which, over time, is much more powerful than timing valuation.

Good company vs good stock

The struggle with investing in 'obviously' good companies is one of perception. They may often trade on premium valuations, especially on conventional multiples such as P/E and EV/EBITDA – as such, it requires an altogether different mindset and investor discipline to buy these names over stocks that appear optically cheap. But two illustrations should help dispel that challenge.

First is the power of compounding. See Figure 1 below which shows the returns from investing in two hypothetical companies. Company A is on offer for 1.5x book value and ends up seeing a 33% multiple expansion over 10 years; Company B is 67% more expensive at 2.5x book value and sees a 20% multiple *contraction* over 10 years. But Company B generates twice the return on capital of Company A – and because of that the result would be a 5x return on investment for Company B vs. 3.5x for Company A.

Figure 1: Illustrating the power of compound returns

	Company A	Company B
Book value	100	100
Return on capital	**10%**	**20%**
Valuation year 0 (multiple of book value)	1.5x	2.5x
Valuation year 10	2.0x	2.0x
Multiple expansion/(contraction)	*33%*	*(20%)*
Value year 0	150	250
Value year 10	519	1,238
Multiple on investment	**3.5x**	**5.0x**
Annualised return	**13%**	**17%**

Source: Aviate Global

Next, consider Jeremy Siegel's analysis of the 'Nifty Fifty', to which we have referred in the past. It is a striking reminder of how basing investment decisions on conventional valuation metrics can be very misleading in the context of quality companies. For one, he calculated that the basket's valuation peaked at 42x in Dec 1972 – that compares with our basket today trading on a 12 month forward P/E of 22x (based on Bloomberg consensus). Furthermore, he showed that the basket went on to outperform the market over the next 25 years even from that peak valuation point. We are by no means price-insensitive and there is of course an upper bound to

valuation. But next time you consider passing on a quality business because it appears rich on conventional measures, consider Siegel's work.

And to illustrate the potential effect of that, if in our analysis above we kept valuation multiples static rather than converging them, Company B (the compounder) would generate a 6.2x return on investment over 10 years vs 2.6x for Company A – or an annualised return of 20% vs 10%.

That's why we view quality cash compounders as attractive investments through the market cycle. They should certainly be on investors' lists when exogenous events drive risk premiums higher and these names lower in sync – to use a betting analogy, identify the winners and wait for the book-maker (the market) to misprice the odds. But even outside of periods of market volatility, a high quality compounder can be a great long-term investment even on a seemingly high entry valuation.

Measuring returns – focus on cash

We are deliberate in our focus on returns on *capital* as opposed to returns on *equity*. The latter can be inflated through financial engineering, which does not in itself indicate a high quality business and could in fact mask deteriorating returns on capital. Second, note that our focus is on cash returns rather than P&L-based returns on capital. The traditional ROCE/ROIC metrics upon which companies and investors alike seem to focus can be flawed, in our view. P&L-based measures can fail to capture the true underlying picture or miss potential warning flags: e.g. unjustified capitalisation of costs, capex which is consistently higher than depreciation, changing working capital trends, to name a few. But companies can't fake cash, at least not without extreme levels of effort.

Our principal screening measure is therefore based on CROIC – cash returns on invested capital (details on our methodology and definitions are provided in the appendix).

Top 50 Quality Compounders

Our target universe for this exercise is the Stoxx 600 ex-banks and insurance (for which returns on capital are not meaningful). We first rank all companies by their average CROIC over the past three years. We then remove names where historical returns have been overly volatile, or where we think there is a threat to sustainability of returns going forward, from disruption or otherwise. Finally, we have also applied a market cap and liquidity threshold, $5bn and 30-day average daily volume traded of at least $7m, respectively.

Through this process, we narrow down on 50 names. The lowest 3-year average CROIC among these names is 12.7% — a threshold we think most investors would agree is an excellent return on capital. We have intentionally excluded valuations in filtering the top 50. For all the reasons discussed above, we want this list to represent a valuation-agnostic basket of high quality compounders first and foremost. Then comes the question of when and which to add to or trim.

From a valuation perspective we focus on 12 month forward equity FCF yields, consistent with our focus on cash returns and representative of what can be re-invested at high returns and/or given back to shareholders. The table below highlights those trading on a 12 month forward FCF yield of 4% or cheaper – but arguably the yield should really be considered in conjunction with the actual level of returns and a company's growth outlook. All of that info is shown in the table below, along with 1, 3 and 12 month performances relative to the Stoxx 600

Index. Today's accompanying slide pack includes all this along with a one-page financial snapshot for each company showing, amongst other things, historical CROIC charts.

With a focus on returns on capital, it is imperative that we assess sustainability of those returns on an ongoing basis. As such, we step away from presenting this as an annual basket of stocks. Instead, we will send out an updated version of today's slide pack on a monthly basis, highlighting names that look particularly interesting based on recent performance and, importantly, flagging any that may need to be reconsidered from a longevity perspective.

For now, the initial top 50 names are presented in Figure 2 overleaf.

Figure 2: Top 50 Quality Compounders in the Stoxx 600 (ex banks and insurance)

			3YR AVG	12 MONTH FORWARD		PERFORMANCE REL TO SXXP		
	COMPANY	TICKER	CROIC	FCF YLD	REV G	1M	3M	12M
1	Rightmove plc	RMV LN	**220.2%**	3.2%	11.6%	7.4%	5.8%	81.2%
2	Hargreaves Lansdown plc	HL/ LN	**61.5%**	3.0%	-3.1%	3.8%	30.4%	48.6%
3	Novo Nordisk A/S	NOVOB DC	**39.6%**	3.7%	9.6%	7.1%	4.0%	36.2%
4	Paddy Power plc	PWL ID	**28.3%**	3.6%	13.4%	16.9%	20.6%	79.4%
5	Betfair Group PLC	BET LN	**28.1%**	3.2%	10.9%	19.9%	19.6%	151.7%
6	Coloplast A/S	COLOB DC	**27.7%**	2.7%	8.4%	7.5%	20.8%	2.4%
7	Pandora A/S	PNDORA DC	**26.9%**	4.3%	19.9%	11.8%	7.9%	56.2%
8	Partners Group Holding AG	PGHN SE	**25.1%**	4.1%	17.8%	0.8%	5.5%	21.4%
9	Orion Oyj	ORNBV FH	**24.4%**	4.4%	1.2%	(1.1%)	(15.3%)	7.5%
10	Roche Holding AG	ROG VX	**24.4%**	5.5%	4.4%	3.8%	1.9%	(13.2%)
11	Sky plc	SKY LN	**24.0%**	5.5%	12.1%	4.4%	4.7%	11.6%
12	Next Plc	NXT LN	**23.9%**	5.5%	4.9%	1.0%	1.3%	14.8%
13	Micro Focus International plc	MCRO LN	**22.8%**	7.2%	18.0%	8.5%	6.6%	9.3%
14	Geberit AG	GEBN VX	**21.7%**	3.8%	8.1%	6.3%	8.0%	(6.1%)
15	Kone Oyj	KNEBV FH	**21.6%**	4.6%	4.7%	(0.0%)	10.8%	(3.9%)
16	Hexpol AB (Publ)	HPOLB SS	**21.5%**	5.0%	3.2%	4.1%	(3.5%)	20.6%
17	Swedish Match AB	SWMA SS	**20.7%**	5.0%	3.8%	9.6%	16.7%	13.3%
18	EMS-Chemie Holding AG	EMSN SE	**19.7%**	3.3%	5.8%	1.7%	(5.7%)	(2.3%)
19	Hermès International Société en commandite par actions	RMS FP	**18.2%**	2.9%	9.0%	(1.7%)	4.6%	9.9%
20	Novozymes A/S	NZYMB DC	**17.7%**	2.6%	7.5%	6.4%	10.0%	17.3%
21	H & M Hennes & Mauritz AB (publ)	HMB SS	**17.4%**	3.1%	11.3%	(2.8%)	(3.7%)	(6.6%)
22	Hugo Boss AG	BOSS GY	**16.9%**	5.2%	5.5%	(10.7%)	(23.9%)	(29.7%)
23	Auto Trader Group plc	AUTO LN	**16.5%**	3.3%	8.0%	12.2%	23.3%	n/a
24	British American Tobacco p.l.c.	BATS LN	**16.4%**	4.8%	-0.3%	3.6%	9.7%	(1.8%)
25	Fuchs Petrolub SE	FPE3 GY	**16.4%**	3.7%	11.0%	6.8%	10.1%	22.5%
26	Howden Joinery Group Plc	HWDN LN	**16.3%**	3.4%	8.7%	9.4%	6.2%	26.6%
27	ProSiebenSat.1 Media SE	PSM GY	**15.7%**	5.1%	11.7%	4.1%	9.9%	39.0%
28	ARM Holdings plc	ARM LN	**15.7%**	3.0%	15.2%	6.1%	11.7%	8.2%
29	Hikma Pharmaceuticals PLC	HIK LN	**15.5%**	3.0%	49.5%	10.7%	(11.2%)	1.1%
30	Intercontinental Hotels Group plc	IHG LN	**15.5%**	4.1%	-0.5%	(5.1%)	3.3%	(7.7%)
31	Reckitt Benckiser Group plc	RB/ LN	**15.4%**	4.1%	3.1%	3.4%	7.4%	16.8%
32	Experian plc	EXPN LN	**15.4%**	5.7%	1.0%	11.7%	11.4%	8.9%
33	Atlas Copco AB	ATCOA SS	**15.4%**	5.8%	-0.3%	(0.6%)	4.6%	(1.1%)
34	WH Smith PLC	SMWH LN	**15.1%**	5.4%	1.0%	8.7%	16.1%	28.5%
35	Booker Group PLC	BOK LN	**14.7%**	4.5%	7.3%	2.1%	(0.4%)	20.0%
36	BT Group plc	BT/A LN	**14.6%**	3.3%	-18.2%	5.5%	7.7%	8.8%
37	Burberry Group plc	BRBY LN	**14.5%**	5.5%	4.6%	(9.6%)	(15.7%)	(34.4%)
38	Industria de Diseno Textil SA	ITX SQ	**14.3%**	2.8%	11.3%	4.8%	14.4%	38.4%
39	Bunzl plc	BNZL LN	**14.3%**	4.8%	3.5%	3.7%	6.9%	(0.9%)
40	freenet AG	FNTN GY	**14.0%**	6.9%	0.8%	1.6%	1.0%	22.8%
41	Halma plc	HLMA LN	**13.9%**	4.0%	6.9%	11.2%	11.3%	20.8%
42	Nokian Renkaat Oyj	NRE1V FH	**13.9%**	4.0%	4.6%	4.0%	30.5%	48.2%
43	Bureau Veritas SA	BVI FP	**13.7%**	5.9%	2.6%	1.2%	(4.3%)	(1.5%)
44	William Hill plc	WMH LN	**13.7%**	6.7%	5.4%	13.2%	0.0%	(3.0%)
45	Sage Group plc	SGE LN	**13.5%**	4.4%	3.5%	16.7%	19.7%	32.6%
46	Croda International plc	CRDA LN	**13.5%**	3.1%	4.4%	4.3%	(0.8%)	6.0%
47	Imperial Tobacco Group PLC	IMT LN	**13.4%**	7.2%	-56.5%	4.6%	8.6%	20.3%
48	SGS SA	SGSN VX	**13.4%**	4.2%	4.2%	5.2%	10.7%	(10.4%)
49	Koninklijke Ahold N.V.	AH NA	**13.1%**	6.6%	3.7%	5.3%	8.7%	30.8%
50	RELX Group plc	REL LN	**12.7%**	5.5%	3.7%	6.0%	10.1%	2.4%

Source: Aviate Global, S&P Capital IQ, Bloomberg

Appendix: Methodology

The raw fundamental data underpinning our analysis is provided by S&P Capital IQ. For the purposes of this exercise, we focus on CROIC – cash flow returns on invested capital – which we define as:

$$\frac{\text{(A) Unlevered FCF}}{\text{(B) Average Invested Capital}}$$

Where (A) is:

	Cash flow from operations (post-tax)
plus	interest costs (added back)
plus	operating lease charges (added back)
less	capex (tangible plus intangible)
plus	cash from PPE disposals
=	**Unlevered FCF**

And (B) is the average of period beginning and period end invested capital, defined as:

	Total assets
less	accounts payable
less	accrued expenses
less	unearned revenue
plus	accumulated goodwill impairments
plus	capitalised operating leases (operating leases x 8)
=	**Invested Capital**

Conceptually, our definition of invested capital is a firm's total assets less non-interest-bearing current liabilities. On one side of the balance, that represents all the assets – physical through to working capital – that is required to run the business. On the other side of the balance sheet, the same number essentially represents the financing of those assets through equity and debt. To that, we add back (i) accumulated goodwill written off, so as not to benefit companies which might acquire then write-off goodwill and (ii) capitalised operating leases, which we view as form of financing. The numerator in the CROIC calculation is effectively the cash flow measure consistent with that measure of Invested Capital.

On a separate note, the models and tools we built for this analysis culminated in a Dashboard which we have found very useful in screening for and quickly assessing companies. We are in the process of making this available to clients, but please let us know if you would like to test a beta version in the meantime.

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