Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

In Praise of Tortoises… and Compounders

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In Aesop's original fable, the tortoise took on the hare. The hare's raw pace took it into a substantial lead, but a complacent nap meant that the tortoise plodded past to victory. The investment variant of the fable is somewhat different. Once again, the hare races off into an early lead and is presumably awarded an eye-wateringly steep multiple by the market. Sadly, the flying four-legged furball is likely to come to an unfortunate end, picked off by a farmer or some other predator, frozen to death in a cold recession or just running around in frenzied circles. Meanwhile, the tortoise just trundles along steadily, perhaps pulling its head in when times get tough.

The tortoise is not a perfect analogy for a compounder, as we like to think of the companies we own as somewhat more dynamic than the sluggish shell-bearing reptile. Nevertheless, the secret of compounding lies in steady modest growth, at sustained high returns. A company growing at, say, 4% a year, adding another 1% to earnings growth from incrementally improving margins, combined with a free cash flow yield of around 5%, should compound at close to 10% over time. This would not only provide an excellent absolute return, doubling one's capital every seven years, but it is unlikely to be matched by lower quality companies, as bad things happen to bad companies at bad times… as many hares discover sooner or later. Slow and steady wins the long-term race in the markets as well. The problem is that these compounders are very rare beasts and rather tougher to pick out than tortoises, so here's a spotters guide.

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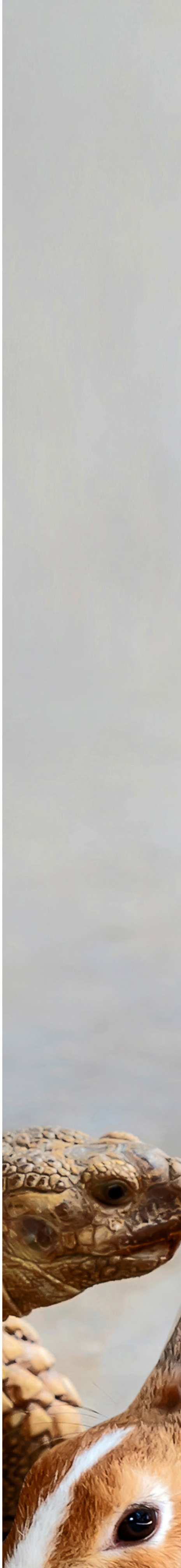
"Slow and steady wins the long-term race in the markets as well"



What is the essence of a compounder?
At the core of the compounder are powerful and hard to replicate intangible assets, notably brands or networks. These help deliver pricing power. Compounders have decent growth prospects together with predictable sales, often driven by recurring revenues. Crucially, management must be shareholder friendly. Being careful stewards of capital and investing sufficiently in innovation and advertising to help perpetuate the franchises are essential management hallmarks.

Where is the compounder found?
It is easier to describe where the compounder will not be found; banks, utilities, telecoms (even if rebranded as communication services), miners and energy companies are all low-return, cyclical price-takers and thus unable to compound. The two richest hunting grounds for compounders are consumer staples and the software and IT services sub-sector of information technology, effectively 'the brands consumers choose, the software and services businesses need and the networks people trust.' Our commentaries from May and June 2017, "Information Technology – Winners and Losers" and "Amazonians at the Gate", discuss what the team looks for in these two sectors.

> "The two richest hunting grounds for compounders are consumer staples and the software and IT services sub-sector"

What do the compounder's financials look like?
They possess powerful intangible assets to drive high returns on operating capital, plus demonstrate robust, steadily growing earnings, even in tough times, as pricing power and recurring revenues protect the fat gross margins and stable sales, respectively. The high returns on operating capital help drive strong free cash flow generation, as earnings actually turn into cash. Finally, we prefer to see cash flowing back to shareholders, rather than wasted on poor acquisitions, and a balance sheet that is robust for the long run, rather than 'efficient' for the short run.

What is the main challenge in deciding whether a company is a compounder?
It is easy to tell whether a company is profitable today and whether it has compounded in the past. The challenge is to work out whether this will continue or whether the high returns and growth will fade. The first step is to work out why the company has high returns, i.e., what the key intangible assets are. Having done that, the crucial analysis is around the myriad threats to those assets, be they fashion, technology, environmental or social issues. Even if the conclusion is that the returns are likely to stay high or even improve and the growth should be steady, the governance side needs checking, as management can easily foil compounding, either by underinvestment in search of short-term profits or by poor allocation of capital. Meeting management and understanding their incentives can help mitigate the risks of poor management, but as in all human endeavours, it is far from fool-proof.

Can tobacco companies still compound?
The key asset of the tobacco industry has been pricing power. An addictive product, a concentrated industry and steadily rising taxes that make up most of the purchase price have all combined to drive circa 5% per year pricing. As such, the price rises have more than made up for the impact of the tightening regulatory environment over the last 50 years. Our view, for now at least, is that the recent regulatory noises in the U.S. around reducing nicotine in combustible cigarettes and banning menthol are not a break with this long-term pattern, as any implementation is likely to take a long while, if it occurs at all.

> "The current late-cycle environment may be particularly favourable to compounders"

What has changed is the introduction of new technology, the 'next generation products,' be they vaping or 'heat not burn.' While this change may embolden regulators to take firmer action against traditional combustible cigarettes, given the availability of alternative nicotine delivery systems, the main impact is on competitive dynamics. The new products can upset the historically stable market shares, be it Philip Morris International taking 16% of the Japanese market with IQOS or JUUL's vaping product threatening the U.S. incumbents. Our belief is that those with good next generation products should gain share and therefore can compound, but that other players cannot. As a result, the investible universe within tobacco has shrunk, meaning for us that it has fallen to below 10% of the portfolio from its peak of around 25%.

Is this a good time to invest in compounders?
Our view is that compounders are a chronically undervalued asset class thanks to the market's short-term and relative focus. If one is taking a medium- or long-term view, we would argue that it is always a good time to invest in compounders. That said, there is a case that the current late-cycle environment may be particularly favourable, since a compounder's ability to preserve earnings in a downturn may become especially valuable.

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