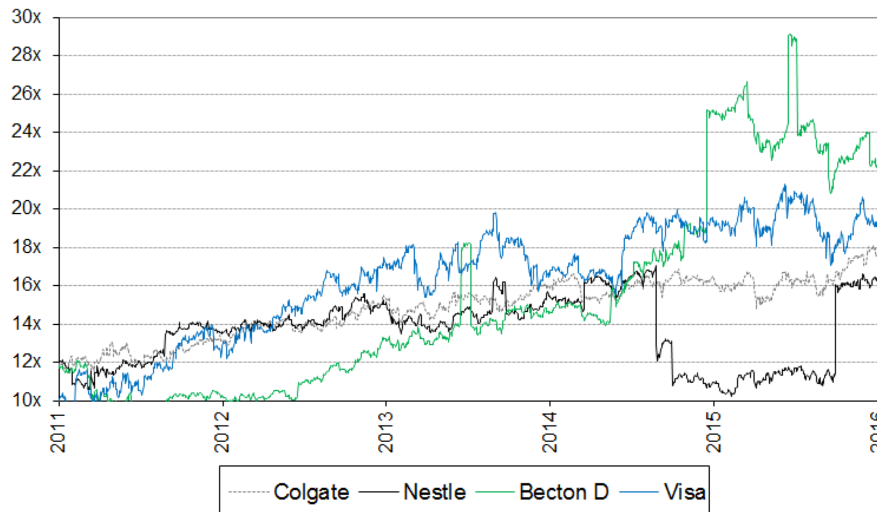
HollAnd Advisors

Holland Macro Views

What would Billy Beane (or Ranieri) do?[1]

We write, as ever, as die-hard fans of franchise businesses and their compounding power. We also write as ones who have studied the best investors and tried to learn whatever we can from them. In that light, we repeat our longstanding mantra that the best investments typically have the following six traits: 1) very high returns, 2) excellence in their field, 3) growth, 4) great management; 5) capital allocation prowess, and not least, 6) their starting price being cheap. Getting the first five traits in a single company is one thing, but in today's market, finding an undervalued, high quality franchise is a herculean task. We suggest an alternative mindset.

Fig.1: No FANGS here! EV/EBIT progression for four 'boring' franchises



Source: Capital IQ

It is not that terribly long ago when one could be contrarian and still find both quality and value (Holland Views – *Better get a bucket* – July 2010). As we write in May 2016 however, the fact of the matter is that post-significant re-ratings, the best global franchises are expensive. Leicester City and before them Oakland Athletic, have shown that paying up for the best does not always guarantee success. They found value in the outer edges of the league tables but still performed brilliantly. Later we propose some out-of-favour areas of the market and specific stocks that we think offer real value – a 'Leicester City' portfolio perhaps.

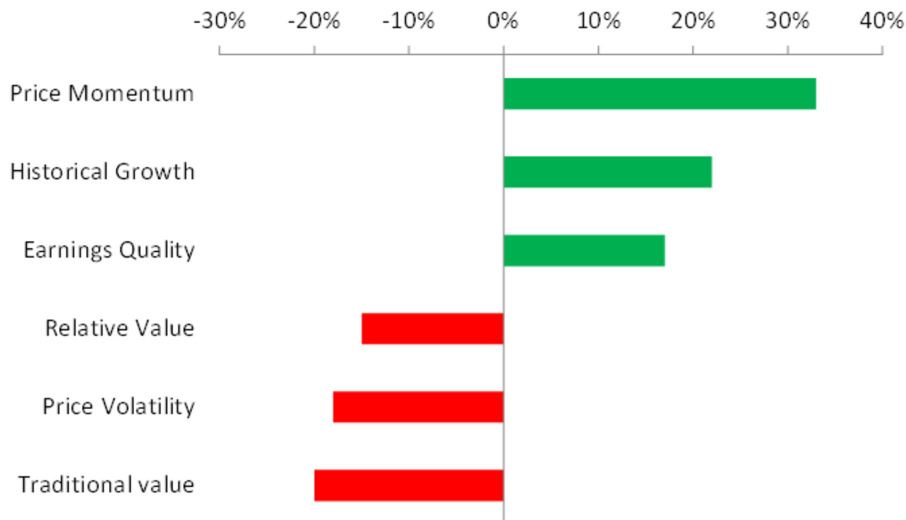
The outperformance and re-rating of quality franchise business, those that enjoyed growth and compounding characteristics, was entirely appropriate. Our point is that from today's starting point, a continuation of that re-rating is impossible (or at least unjustifiable) meaning that future returns will inevitably be linked *solely* to underlying growth. Your time (and clients' money) we suggest should also be looking elsewhere.

[1] Billy Beane was the manager of the Oakland Athletics – a mid-ranking US baseball team - made famous in the movie Moneyball for his shrewd buying of cheap athletes. A value investor in the sporting world!

Now is not a time for filling buckets

Lately, we have been wondering whether franchise investing has fallen in love with itself? In stark contrast, we observe that deep value investing has rarely been so out of favour. We do not write to call the market or even to suggest that the re-rating of quality companies ought to necessarily stop in its tracks. Rather, just to observe the distance of opinion which now seems to exist between 'quality' and 'value'.

Fig.2: Most/least successful investment strategies in 2015



Source: ISI Evercore/Bloomberg

It was not always thus. We do not need to delve into ancient history to see that much has changed quickly. In 2010/11 we wrote two pieces of research: the aforementioned (*Holland Views Better get a bucket – July 2010*) and another on Unilever (*Holland Views - The hard way but the right way – March 2011*'). Both reports were intended to highlight that quality companies were on offer at reasonable prices. For context, at that time, Coke was valued on a PE of 17x, Unilever 13x and Diageo on 14x. Today those same company PE's are 22x, 23x and 20x respectively.

The following are further examples of the wider PE multiple expansion that has occurred on just a sample of what we might call 'predictable' franchises:

- Mastercard 2011 PE was 16x: now 27x, Visa was 20x: now 33x
- Heinz/Kraft 2011 PE's were c.15x: now 27x, Campbells Soup was 13x: now 22x
- Becton Dickinson was 15x, now 23x, Colgate was 16x, now 25x

You get the picture. In our 'bucket' piece, we illustrated the power of compounding showing that companies such as Coke or Becton Dickinson had provided investors with compound annual returns of c.13-14% pa. for c.20 years, but importantly had done so without their shares being re-rated. We might point out too that at that time it was not an easy sell to clients. Prior to this period market falls had taken all stocks down with premium-rated ones falling hard too. Then in the 2009-10 recovery, any stocks that had a near-death experience but were revived, rallied hard and outperformed anything so pedestrian as a 'franchise'. Maybe that was the franchise bear market out of which the recent performance was born (and what performance it has been).

The Fund Marketing man's dream

Franchise investors have not needed to just content themselves with merely the underlying companies compounding power however, as PE re-ratings have in some cases doubled or trebled the return from internal company growth. Careers have been made, investment heroes created and companies named on the back of such a strong consistent outperformance of this group. What has made the message so powerful to the end customer of these funds is the combination of an excellent investment process identifying a great company, the compounding powers these companies deliver, (as we often try to demonstrate) and the ballistic outperformance that has come from powerful re-ratings. 'Lollapalooza' as Munger might call it. So the smart manager, who owns the best stocks has outperformed royally. It is such tri-factors that Fund Marketers dream about.

Do frogs notice when the water is warming up…?

Today it is interesting to hear some franchise investors speak, as all are keen to reiterate the same views on Nestle and Unilever they had 10 years ago – and as fundamental investors, they are right to do so. But few seem to see the good fortune that has swung their way, believing instead that the market has finally come to its senses after all these years and recognised the quality they always saw. "Come in…" say the frogs, "the water is lovely…."

Indeed the rationale for the re-rating of such high quality earnings streams is well understood and in no small part justified by 'lower for longer' interest rates and the resulting lower risk-free-rate. One of the reasons for our enthusiasm in older research pieces was the very fact that we thought the starting PE's of the likes of Unilever or Becton Dickinson too low. However, we think it worth now observing that:

a) Such re-ratings (and the resulting performance) cannot be repeated.

b) Higher ratings reduce company compounding power and offer little margin of safety.

c) Over many decades of investing it was not always this way i.e. sentiment can change.

There have been booms before in paying up for quality, the best known of course being the 'Nifty Fifty' period of the 1960s and 70s but they were then followed by many a year where the market then thought differently once again. We must also remember that it is not just rational investors (thinking in terms of compounding etc.) that populate the marketplace. We are a small minority. There are of course, the growth junkies and momentum bunnies too. These groups were more than happy to ignore the likes of Diageo when it looked dull in 1998 (PE was c.13x) vs. the more exiting Nasdaq adventure then on offer. Today those same groups likely own more Unilever and Diageo shares than you do as they 'look good'. Whilst today's sentiment of needing to pay up for such quality companies does not feel like it will change anytime soon, history suggests otherwise.

> *"However beautiful the strategy, you should occasionally look at the results"* – Winston Churchill

Right now the 'results' of franchise investing have been very impressive, the danger perhaps lies in too many people expecting them to be repeated.

Like all market phases, you can look back and think 'I really should have done better with that'. The key trick is not to go all in at the very point that Mr Market changes his mind. That is why absolute value in franchise investing matters, because it takes the vagaries of Mr Market out of the equation. The days of being able to buy quality dollar bills in plain sight for 70c seem long gone. Many now trade at $1.30 and if they execute perfectly may indeed grow into such valuations, but execution stumbles may have expensive repercussions for those falling short.

You can learn a lot in 50 years

Buffett and Munger's actions are certainly worth considering in this vein as they, after all, were arguably the fountainheads from which all franchise investors learnt their trade. Perhaps more importantly they have also been looking for the six traits we highlighted up front for over 50 years. We also observe that in all of our studies of their many purchases, we rarely found a case where they paid over 15x earnings for anything, ever.

We now note from our trip to Omaha this year that Buffett is admitting a need to pay up (just a little) with rates being as low as they are (Precision CastParts buyout PE was 18x, BNSF was 16x). The difference for them is maybe they pay up for a few new buys for a while when interest rates look to be staying super low, but with internal cash being generated annually they can quickly adapt back to a lower multiples later if they so choose. This is a very different from today owning, or buying a whole portfolio of shares on higher multiples. The 'low growth' and 'hold forever' mentality combining with a little 'success' bias suggests to many that predictable stock X on a PE of c.20-25x should not be sold for something inferior. But we should also remember that in a low growth world it takes a long, long, time to get back in earnings growth what you can lose from a >25% de-rating.

There is a distinction between a great company and a great investment – the determining factor is price. Andrew Hollingworth!

Some stock ideas (a tale of two City's)

The above comments are not to dismiss franchise investing. Rather, this ramble is to remind ourselves that value has been a valuable tool in successful investing over the last 100 years.

What has recently piqued our interest is a few opportunities that we feel egregiously cheap, but where there is scant investor interest. As a result, we wonder whether there is a Leicester City portfolio approach that could be currently considered (as opposed to say the Manchester City one!). A Man City portfolio has many quality players/stocks purchased for, or now trading at very high prices. The underlying player/stock quality suggests the team should perform well, but price paid is no guarantee of that outcome. In contrast, a great team can be made with a selection of perhaps mispriced stocks/players that can still achieve a surprising result. This suggests to us that investors spend a little more time on Templeton-like contrarian value investing, as this is the area we currently see the greatest absolute value.

Below we provide some sectors and stocks that we think fall into this (ahem) bucket! We have done much work on each and are happy to share it on a case-by-case basis.

- **The hated, 'never going to own it' sector:** is epitomised by **US Banks** and indeed **Autos**. Absolute valuations of many leading US banks remain very cheap and the sector is still dismissed by many. Many have excess capital and look set to pay significant dividends. **General Motors** trades on a PE of 5x, for a ROIC of 27% and will buy c.7% of its stock back this year. **Fiat** is cheaper still.

  In the US retail sector **Office Depot**, whose wedding to Staples was dashed by US regulators now trades on an EV/EBIT of 3x with an excellent CEO. In the hated world of energy, **Suncor** – with an oil reserve life of 35 years (and hence no more oil searching costs) is offered for a FCF yield of c.16% at $60 oil, and c.6% on $40 oil.

- **'Blood on the streets':** In Greece, we have a bank we think John Templeton would have liked (**Eurobank**) and a wind farm business (**Terna Energy**) whose cash flows dwarf its reported profits.

- **'Beat the Fade' Franchises**: perhaps life might not be as bad as the market expects for **Apple** (PE ex-cash of 6.5x (on 2013+2014 profits, not on the 2015 boom year). **Next**, **Burberry** and **Sports Direct** all make high returns on capital, all have limited to no financial gearing and good track records. All have also historically been loved by investors, for good reasons – but not so today.

- **Well run asset owners dismissed due to complexity**: **Exor**, **Melrose**, **Jardine Strategic** and **Leucadia.**

Todays 'Black Swan' – Unexpected better growth

The other interesting point about a value/Leicester City portfolio is that it might do really rather well in a world of modestly higher interest rates (which of course is never going to occur..?). The banks of course are direct beneficiaries of higher interest rates. The other beneficiary is anyone with a long-term liability – the biggest of which are pension funds whose discount rates have been slashed for a decade leading to higher and higher provisions. This is a big feature for GM and for Fiat as their EV valuations today are calculated with these liabilities shown in full. Such liabilities would fall very fast with higher interest rates. It is also a feature of a number of other deep value shares as it is the worry about such long tail liabilities that often keeps buyers away (Premier Foods is a good example in the UK – its PE is 5x, but its pension fund is 13x its market cap). Additionally a slightly more normal stable economic world has less of a need for investors to pay up for safety. Lastly, businesses on PE's of 25x can, and do, see those ratings move with interest rates. Businesses on PEs of 5x do not – they move, often sharply, on whether things are as awful as originally expected, or not.

Beware the warmth of the water you are in + Do not dismiss value

Our use of the franchise approach to help identify the best quality compounding franchises will not cease – we are hugely proud of this approach that we have learned and adapted. But today we see real merit in a barbell portfolio owning the rare bird Franchises at one end that Mr Market for whatever reason mistrusts or misprices (**Wells Fargo**, **Sports Direct**, **JPM**, **Berkshire, Goldman**) whilst at the other end now looking at wider array of deep value on offer (**GM**/**Eurobank**/**Office Depot**/**Suncor** etc.). There is also plenty of scope for misunderstood or mispriced managers too. The good ones of course, like good value investors, will use the same value offered to improve further their reputations (**Exor**, **Melrose** & **Leucadia** all spring to mind).

That such a blend of value from different sources is perhaps hard for your marketing team to sell or your corporate message to encapsulate, we do not think you should apologise for. Jamie Vardy after all was playing non-league football four seasons ago, now he has a Premiership medal, and was the league's second top goal scorer. Our bet is that a careful selection of value beats the loved franchises from today's highly handicapped starting point – not forever maybe but for long enough to matter and possibly hurt.

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