HollAnd Advisors

Holland Views:

In search of Nirvana – Supernatural Compounders

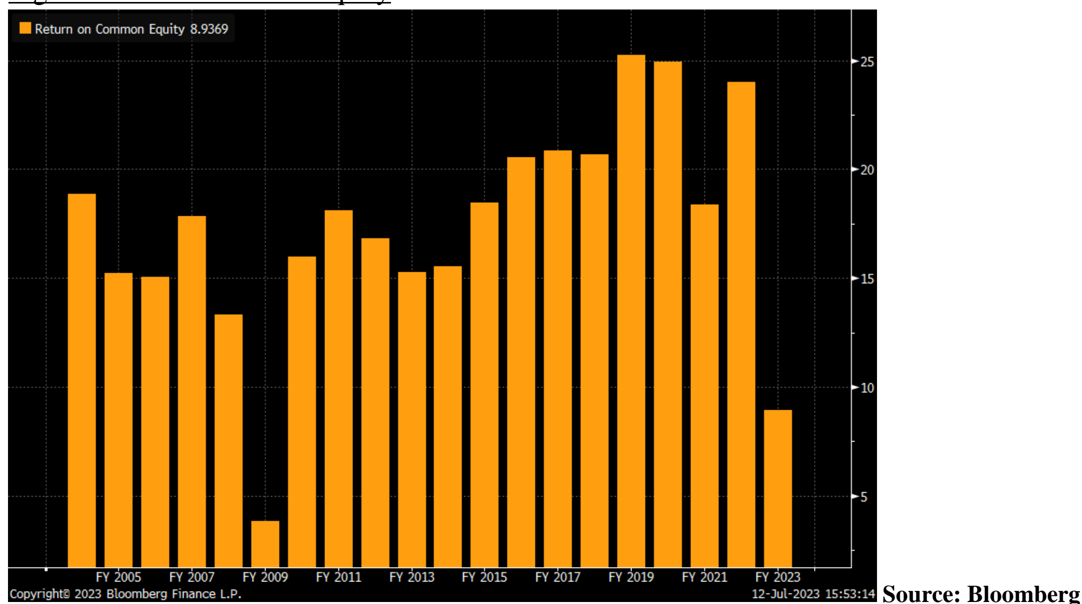
We think we now have a decent mouse trap for finding good businesses when markets dislike them. More recently we have also spent a more time thinking about the very best compounding companies, how to identify them and value them. We'll call them **Supernatural Compounders**.

Preamble: Cyclically depressed compounders

The work we undertake to seek out better compounding investment opportunities often sees us look at businesses going through a period of flux. We try to only assess businesses that are **profitable** and **proven** when we look at their past compounding. Hopefully we assess them as likely **probable** to return to that compounding power/rate in time also. Examples of this trait we have looked at are now numerous (**Ryanair** and **Jet2** come to mind). Another one we wrote on last year, that is still at the depressed stage of its return cycle, is shown in the chart below: **CarMax.**

CarMax, as a proven long-term compounder offered at a great price, remains in our sweet spot.

Fig.1: CarMax Return on Equity



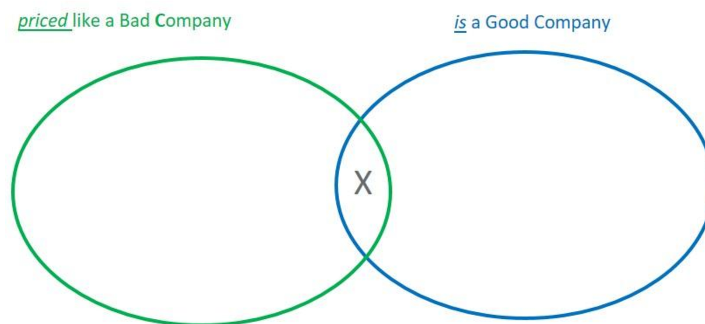
Source: Bloomberg

> *"For 26 years CarMax's focus has been making car buying more ethical, fair and stress free by offering a no haggle experience and an incredible selection of vehicles."*
>
> **Harvard Business Review report on CarMax, 2019**

When assessing cyclically depressed compounders our thinking is along these lines. The proven growth in intrinsic value that we assess as likely to soon return gives us the long-term compounding we are after. The depressed starting price provides our margin of safety.

This balance of a forgotten past compounding ability vs near term uncertainty results in Mr Market seeing such companies in a bad light. This is what sits behind our favourite investment pictorial shown once again below. We think this is the essence of our job as investors and custodians of other people's money, i.e. to invest in great companies when they are not priced as such.

Fig.2: The best chart in investing..!



Source: Holland Advisors

Sometimes these marked-down businesses we are assessing are **Dream businesses** (i.e. high ROIC with little capital required to grow). More often they are **Compounder businesses**. i.e. ones making good, rather than great ROICs/ROE's but where more capital can be deployed to grow further.

Compounding vs Franchises

Hopefully the above paragraphs act as a short summary of how we have spent our time in the last five years. Recently however we have been thinking a little harder about some of the very best companies that might fall outside this remit of 'depressed compounder'.

Indeed, with our focus on 'compounding' vs other investors sometimes being more obsessed with 'franchises' there is maybe a perception that we don't like companies with great economic models. This could not be further from the truth. What we don't like is overpaying/fully paying vs the likely compound growth rate we are most likely to get.

> *"Pay only a reasonable price, even for excellent businesses"* **Lou Simpson**

Let us consider three companies whose returns and valuations are not depressed and whose outlooks are different but seemingly predictable:

- Company A – likely 12% intrinsic value grower priced for 25x earnings,
- Company B – c.12-15% grower priced at 16x earnings,
- Company C – c.25% grower priced at 30x earnings.

Looked at in this light we found many companies in the Company B camp in c.2010-2014 that we liked (**Unilever**, **Becton Dickinson**, **Diageo**). However, as the trickle of people looking for such franchises became a flood these companies became more highly rated. This resulted in higher PE multiples, reducing margins of safety and lower rates of intrinsic value growth due to less ability for enhancing share buy backs.

In short, we like companies in the Company B group, less so Company A. We accept and observe that companies such as Unilever, Becton Dickinson and Diageo are more interesting today than they have been for many years. This is either due to absolute share price falls or due to their growth having caught up with once elated valuations.

In hindsight we may have been foolish to move on from these high quality businesses too early in the 2014-2018 period, as they re-rated higher. That said we are pleased that our valuation discipline held/holds. Also, to have used our time in other investments to learn more than just a need to 'pay up'. This maybe updates our thinking on 'what price to pay' for semi-predictable quality growth (i.e. Companies A and B), but it is not what this research piece is about.

In search of Nirvana – Supernatural compounders

At Holland we are mean-fisted investors, always wanting value even when we are looking to invest in a great company. Consequently, pricey newly formed growth companies can sometimes pass us by. If this growth is outside our circle of competence and is largely unproven, we are relaxed about such misses. That said we need to accept that our desire to pay reasonable (read low) look through multiples can mean we have missed investing in some wonderful understandable businesses. A good example might be **Costco** as we reflected on last year.

We are always wanting to learn, however. As such we have spent a little time reflecting on what we describe above as Company C. I.e. to consider how in the past we would have, and now should be, thinking about the very best businesses in the world, even if they are seemingly expensive to purchase.

> *"At Berkshire, we particularly favor the rare enterprise that can deploy additional capital at high returns in the future. Owning only one of these companies – and simply sitting tight – can deliver wealth almost beyond measure. Even heirs to such a holding can – urg! – sometimes live of lifestyle of leisure."* **Warren Buffett, Berkshire Hathaway 2023 annual shareholder letter, published 25th February 2024**

> *"This may be a good place for me to share a semi-philosophical thought: The ideal business is one that earns very high returns on capital and continues to generate high results on incremental capital. But businesses of this sort are exceedingly rare, and it is even rarer to purchase one at a reasonable valuation.* **Sadar Biglari, Biglari Holdings 2023 annual shareholder letter, published 25th February 2024**

The above quotes were both published on the same day this year (25th February) each without sight of the other. The first quote all readers will hold in high esteem, the second many may dismiss. Both however speak to the point we are interested in and were made by people who have thought very hard about this subject. A business that not only makes a high return on capital today, but also can keep deploying future capital at that rate is highly valuable. Just how valuable we will come to shortly. A bit like our past observations on compounding it is easy for us all (readers and writers) to conclude that we know all this. Maybe we do..? More likely we don't understand it quite as well and fully as we should. Some of our discussions in such areas might be seen as ladybird in style, but we think that serves a purpose.

> *"Everything should be made as simple as possible, but no simpler."* **Einstein**

Raffle tickets and secret prizes

Last week I hosted my village quiz, and we had a raffle. Imagine yourself buying a raffle ticket. You know the price of the ticket and you know that someone will win. You can maybe even judge the odds of winning by looking around the room at how many tickets are being sold. But imagine I had the prize table covered up. You don't know if the prizes include a week in Barbados or just some soap on a rope. If the prizes were amazing chances are we would sell a lot more tickets and/or could raise the price of them.

Eighth wonder of the world

Let's now return to the idea of our supernatural compounders. Few great companies today can deploy all of their retained profits for future growth, but let us assume four of them can, companies W, X, Y and Z. We also assert that future Returns on Equity will match those of today.

They make Return on Equity and have PE's as follows:

- Company W: ROE 10%: PE 12x
- Company X: ROE 20%: PE 15x
- Company Y: ROE 30%: PE 20x
- Company Z: ROE 40%: PE 30x

Finally, we will tell you that each of these companies in ten years' time will be valued at the same PE multiple it is today. How much do you want to invest in each company?

Hopefully we have made this quite simple. Cleary Company Z will grow the fastest so that's our best investment, but the absolute outcomes are worth seeing. Here is the end value of each company ten years from now if it rolls forward as we observed above, redeploying all profits at its current ROIC/ROE rate:

- Company W: 10% grower – valued at 2.6x current value
- Company X: 20% grower – valued at 6x current value
- Company Y: 30% grower – valued at 14x current value
- Company Z: 40% grower – valued at 29x current value

Maybe these outcomes surprise some readers, maybe not. All they are is the outcomes of constant compounding (see 8th Wonder of the World on Holland Advisors website). Today when investors discuss PE multiples, they are discussing the price of the raffle ticket. Doing so without a consideration of the potential chances of winning the raffle is foolish. I.e. Is this company likely to have a positive outcome ten years from now (is it a safe or risky venture)? What we are interested in in the case of supernatural compounders is the size of the prize offered to us in ten years (the Barbados holiday raffle prize if you like). If there is a chance of making c.15x our initial investment, we need to think hard about both the traits that produce such outcomes and the price we might pay for them in today's money.

Back to our reality

Quite a lot of the companies we look at might have ROIC/ROE's of say 20-25%. The good ones can maybe re-deploy 60% of their profits to grow. If reproducing past returns on capital, then they are growing at 12-13% pa and maybe paying us 2-3% pa in dividends/buybacks. As such we are owning companies that will likely beat market returns by offering +/-15% pa growth in intrinsic value.

What we need to be doing however is reacting correctly and thinking harder when we are being offered a raffle ticket with a potentially far greater payout. This likely comes from a business making ROE/ROIC of 20-40%, but importantly one that can redeploy almost all of those profits in future growth capital.

Is c.20% long term growth actually possible?

Clearly many company and analyst forecasts have growth rates of c.20% built into them. Our job as seasoned investors is to realise:

- That, in most cases, the probability of such forecasts being worth the paper they are printed on is very low indeed
- That very few companies in the course of history have ever compounded at such rates
- That those that did, had some powerful driving forces that enabled them to do so:
  - These are likely either secular or structural in nature
  - Also, with a human backup, i.e. most likely headed by a highly talented Owner Manager and strong company culture.

We consider a few businesses we know that have compounded at such rates.

- **Amazon** sales grew at a 26% IRR from 2010 to 2020
- **Berkshire Hathaway**'s book value per share rose 20.2% between 1965 and 2010
- **Danaher**'s EPS grew 19% pa from 1993 to 2013

The first conclusion we would make is that something very special was going on at these companies either structurally or where new secular growth was occurring. There was also a strong culture at work. These traits are easy to see after the event. But a good analyst at the time could have got a sense of these drivers:

- By 2010 Jeff Bezos was articulating a clear vision and was showing the drive to achieve it. Amazon's online offering and consumer obsession was powerfully differentiated.
- Buffett was clearly an exceptional investor, and importantly the insurance float structure Berkshire possessed gave him a structural ability to outperform others who were investing non-float capital.
- The Danaher Business Systems implemented by Rales Brothers was a whole different approach to cost budgeting and efficiency that was being rolled out across acquired companies.

Where to find supernatural compounders

Reflecting on these and a few other companies we observe a few areas where we think supernatural compounders (i.e. 20% pa growers) can emerge.

Organic growers/Roll outs

A powerful new route to market or new product/cost offering is likely taking place. Clearly Amazon's online offering was a great example, but there are plenty of others. These might include the exponential rise in use of semi-conductors (**TSMC**) or the rollout of fast food/other retail formats across America (**McDonalds**, **Wal-Mart**, **Floor and Decor**). The quote from Peter Lynch, which we have used many times recently speaks to this. I.e. the idea of not having to be invested at the very beginning of such companies but seeing the success of the rollout then extrapolating further. Indeed, forcing ourselves to think afresh as to why a company with a

compelling cost/service offering cannot in time have a c.25% market share vs say c.3% today is a great exercise. Fast food/low cost airlines and maybe even **CarMax**/**Carvana** are all good examples of this exercise.

Crucially there probably has to be a step change in either the quality and/or price offering for the growth occurring to be lasting in tenure. There also likely has to be a long indefinable runway for the business to grow into and a strong leader/culture to keep the business focused on the right values to achieve it long-term potential.

A large part of the reason for our recent enthusiasm for **Nubank** is that we think it may well fall into this camp. It's offering is loved by consumers, its unit cost base very low vs any global banking peer and its business economics very good (>40% RoE in Brazil). Both in Latam and other banking markets worldwide it might have a long runway of growth to redeploy large amounts of future capital.

Ferrari is another such company, making c.50% ROIC's but also having a strong capital rollout potential. In hindsight **Chipotle** was also an organic super-compounder with rollout compounding potential when we looked at it some years ago. Not keeping our conviction on it was in hindsight a huge mistake. Maybe if then we had thought about 14x rewards we might have been more diligent/patient. That is what this exercise is designed to do, illustrate when/how supernatural outcomes can occur to make sure we give them due attention now and in the future.

Assets Managers/Conglomerates

A second potential source of super-natural compounding is Assets Managers/Conglomerates. I.e. those able to take capital from one area of business and re-invest it in another. In theory as investment managers ourselves we have the ability to do this, but to achieve 20% annual returns is very difficult indeed. For all of the trading abilities we think we have, in truth our returns will end up matching those of the average company we own over time. (NB: Finding 2-3 supernatural compounders is hard enough, finding 20-30 is maybe impossible). The only, and rare, examples of diversified fund managers achieving c.20% pa results were the likes of Anthony Bolton or Peter Lynch.

Conglomerates are effectively Asset Managers, and the very best managed ones do demonstrate an ability to redeploy capital in a sophisticated way. Unlike mutual fund managers, conglomerates can move capital between sectors and assets classes, i.e. public and private markets, equity and debt, globally. Also, they can use other people's money in their structure to boost returns further (deferred tax, debt and insurance float all being examples). Two examples of successful outcomes creating supernatural compounding are **Berkshire Hathaway** and **Bollore Group**. Our fund holding **Biglari** is aspiring to that ideal, moving capital between sectors and assets classes. As yet its outcomes of the last 20y (judged on book value per share) are a good clip below that 20% level. **Exor** is aspiring in this camp also.

Serial Acquirers

A segment amongst a third group of companies have shown the ability to compound at the c.20% rate also. These are serial acquirers. These businesses are either rolling up an industry or acquiring across different industries. Clearly the ability to keep deploying acquisition capital in such an astute and enhancing way is a rare and intangible skill. It is often only valued by markets after the event has taken place (i.e. after years of proven acquired compounding). Even after the concept is well proven and the shares *seemingly* fully valued the best of such business can still be excellent investments.

Constellation Software is the perfect current example, but others exist also such as **Heico**, **Danaher, John Malone's cable** assets and a few Swedish serial acquirers (e.g. **Lifco & Lagercrantz)**[1]**.** If an investor expects/assesses such companies can keep redeploying capital at c.25% return rate, then paying c.30x for such business is easily justifiable.

A few final reflections

The three buckets above are places we think investors should look for outstanding compounders. Each bucket can of course overlap, particularly in conglomerate/serial acquirer space. In such companies the future maybe hard to see, not just for the investor, but even for the company manager themselves. The decision to invest will often be in large part a play on the skill that person/team possesses and the structures they have in place around them to help them repeat past good asset allocation decisions.

On the organic grower side, we think the companies and roll-outs in front of them should be outstanding. Arguably they also should be 'stand-out' organisations that are obviously offering their customers something different.

The hunt for great compounding continues.

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[1] Two weeks ago we attended a Serial Acquires conference run by Redeye in Stockholm. We recommend it most highly to any looking at this space.

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