June 11, 2014

Framing Broadly and Thinking Globally

What's a valuation conscious investor to do in the face of markets hitting all-time highs on an absolute basis, and expensive valuations on a relative basis? This is a fair question to ask, though we think it also falls victim to the framing effect. There are several implicit points embedded in this statement, one of which has serious consequences for the ultimate answer—you see, not all markets are hitting all-time highs, nor are all markets expensive. This statement implicitly assumes that the investment pool is restricted to the United States and the United States alone. While many institutions are restricted via mandates to put their investment dollars to work in the United States, and/or U.S. markets, not everyone suffers these restrictions. Yet, many subconsciously end up the victims of what the investment community calls the "home country bias."

European markets in particular remain some of the cheapest in the world today. We all know that the Eurozone went through an existential crisis of sorts, and some might argue that this particular crisis is far from over. Further, some might argue that European demographics are a concerning headwind to long-term growth (and thus equity returns) amongst other problems. While these are valid concerns, there remains a safety valve investors can use to their advantage in making a foray into Europe more palatable. We have discussed Europe several times in this forum, starting with our July 2012 commentary, continuing with our Preview for 2013, and most recently with our August 2013 note.[1] [2] [3] One of the most important points remains how global European businesses actually are. The companies that populate both our portfolio investments and European watch list make plenty of money outside of the Eurozone to the point where it mitigates the risk of Eurozone disintegration, and makes the demographics fears largely irrelevant.

Why do we think it necessary to make this point yet again? While the Eurozone's problems remain a concern, we think right now is a crucial inflection point where policy imperatives shift from preservation of the "Euro project" to fostering a recovery environment. Since our first investments in Europe, the focus of the policy community on both the monetary and fiscal side has been taking steps that build confidence amongst Union members with competing interests, and building the institutional structure necessary to take the Euro from a largely fragmented collection of nation-states, to a true Union of integrated economies.

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[1] http://www.rgaia.com/july-2012-commentary-bulls-and-bears/

[2] http://www.rgaia.com/december-12-year-end-investment-commentary-looking-forward-to-2013/

[3] http://www.rgaia.com/july-2012-investment-commentary-europe-one-year-later-our-conviction-remains/

Hints of stronger action had been growing throughout the early part of this year, as inflation was decelerating and Mario Draghi was looking for more creative policy measures to boost Eurozone economies.[4] The firmest sign that monetary stimulus was imminent came when the Bundesbank, Germany's own central bank that exercises considerable control over the ECB, shifted its stance from resistance to acceptance.[5] Although during the month of May, the precise actions to be taken remained unclear, everyone in the investment communities marked June 5th on their calendar as the date when it all would take place.

Two key objectives are improving the corporate lending market and weakening the Euro, both of which would be extremely positive for European multinationals.

To that end, we commenced a position in a company we had followed since we first started looking at Europe: Groupe SEB. We think Groupe SEB in particular has a confluence of favorable traits that standout amongst European companies. These are worth highlighting, below:

- The company is owned and operated by its founding family, collectively owning over 40% of the stock. This has fostered an environment of long-term, strategic thinking, with the owners acting like and protecting the interests of shareholders.
- Groupe SEB is number one, two or three globally in most of its key product segments from pots and pans, to bread makers, to coffee machines and waffle makers. Their products include a broad array of householder essentials, everyday appliances, and premium accessories.
- The company owns some of the most recognizable household brands in the world, like All-Clad, Krups, Tefal and Moulinex.
- With its leading brands, and global positioning the company is able to grow consistently without spending a lot of money on capital expenditures. CAPEX amounts to a mere 3.2% of revenues annually, on average.
- 36% of their sales are in the Eurozone, with the remainder around the world including large presences in Asia, North America and Latin/South America.
- Going back to 2007, the year before the Great Recession began, revenue growth has averaged over 7.5% annualized, EBITDA growth over 10% annualized, and book value has compounded at over 10%.

[4] http://www.bloomberg.com/news/2014-04-30/euro-area-april-inflation-quickens-less-than-estimated.html
[5] http://www.reuters.com/article/2014/03/25/us-ecb-weidmann-idUSBREA2O1K320140325

- Today the company is trading at around 8.0x EV/EBITDA and 9.8x EV/EBIT. Similar companies in the U.S., like Williams-Sonoma, Jarden, Newell Rubermaid all trade at double-digit multiples EBITDA multiples and over 10x operating income.
- This growth was consistent and persistent through the Great Recession and beyond, as have returns on equity and returns on invested capital. ROEs have consistently been in the low teens and higher, while ROIC has consistently been in the double digits, and above the company's cost of capital
- Groupe SEB's balance sheet is as de-levered as its been, with the company considering possible buybacks, while also leaving ample room for accretive acquisitions—the kind of which Groupe SEB has an excellent track record of pursuing.
- Many operating expenses are fixed in Euros, and the rising price of the Euro combined with the global sales base suppressed growth and made the company's actual performance look less impressive than it truly was. While actual revenue grew 2.5% annualized, organic revenue grew at 5.4%. With the ECB taking aim at weakening the Euro, the benefits here will all flow through to operating profit. This has been a headwind to profitability for two years now.
- This is a heads we win, tails we don't lose situation, for should the Euro rise, our position denominated in dollars would increase in value, while the company's performance would continue apace. Meanwhile, were the Euro to fall in value, our dollar-based position would decline, but the operating leverage to the Euro would greatly accelerate growth in profitability translating to a higher price in Europe and a higher multiple.

It's very hard to find companies in the U.S. today with products that are not subject to the disruptive impact of the app economy, that are sold globally, capable of generating persistent and high margins for their owners, who also have really cheap prices. In targeting a holding period of three to five years (or longer) in the companies we buy, cheap valuation is an important criteria in achieving our return objectives. We have often emphasized the two key sources of returns in our timeframe as being the cash flow yield of the equity and the change in multiple over our holding period. When you can buy cash flow yields well into the double digits, you simply do not need multiple expansion to achieve good returns. However, if multiple expansion does work out in your favor, than "very nice" returns can become exceptional.

In our work on the company-level, we aim to identify situations where our confidence in the cash flow yield is high. What we cannot do is define an exit multiple. Mr. Market is far too temperamental in this respect.   We can, however, identify situations where: a) a given multiple is simply too low today; and b)

where the market should assign a higher multiple in the future were it to treat the equity more rationally.

Consider: if you buy a stock with a 15% cash flow yield for half of its fair value multiple, then in five years, were the multiple to stay exactly the same, you would expect a 15% annualized return. Were you to get a fairer exit multiple, your annualized return would be 32% over your holding period. To get this 32% we assume one buys $1, that compounds in value at 15% annualized, which can then be sold dollar-for-dollar at the end of $5 years. There is an embedded assumption here: that the company can continue to invest the proceeds of the 15% annualized cash flow return to generate those very same returns moving forward as it has done in the past. This is where our qualitative analysis becomes extremely important and is one of the focal points of our analysis. Taken altogether, this illustration shows how over five years, an investor can take a position that should reasonably earn 15% annualized, or double over five years, into one that quadruples. This by no means serves to suggest that we expect to earn these kinds of returns in this position, or any position for that matter; but we do spend considerable effort trying to find situations where if things go wrong, we fare well as investors, but if things go right we can earn outsized returns.

Multiple expansion is a true performance enhancer (though its opposite, multiple contraction is a huge detractor). Multiple contraction is exactly what people are referring to when they say that any one market is overvalued, and thus forward returns will be suppressed. --The assertion of overvaluation is merely the argument that the multiple coefficient of returns will be a drag over your desired holding period. Though this may be a problem in the U.S., first, it does not necessitate negative returns; second, it does not mean that each and every security will suffer from the drag; last, and most important in our eyes, it does not suggest that one must invest only in the U.S.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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