Lindsell Train

May 2015

Evaluating Valuations

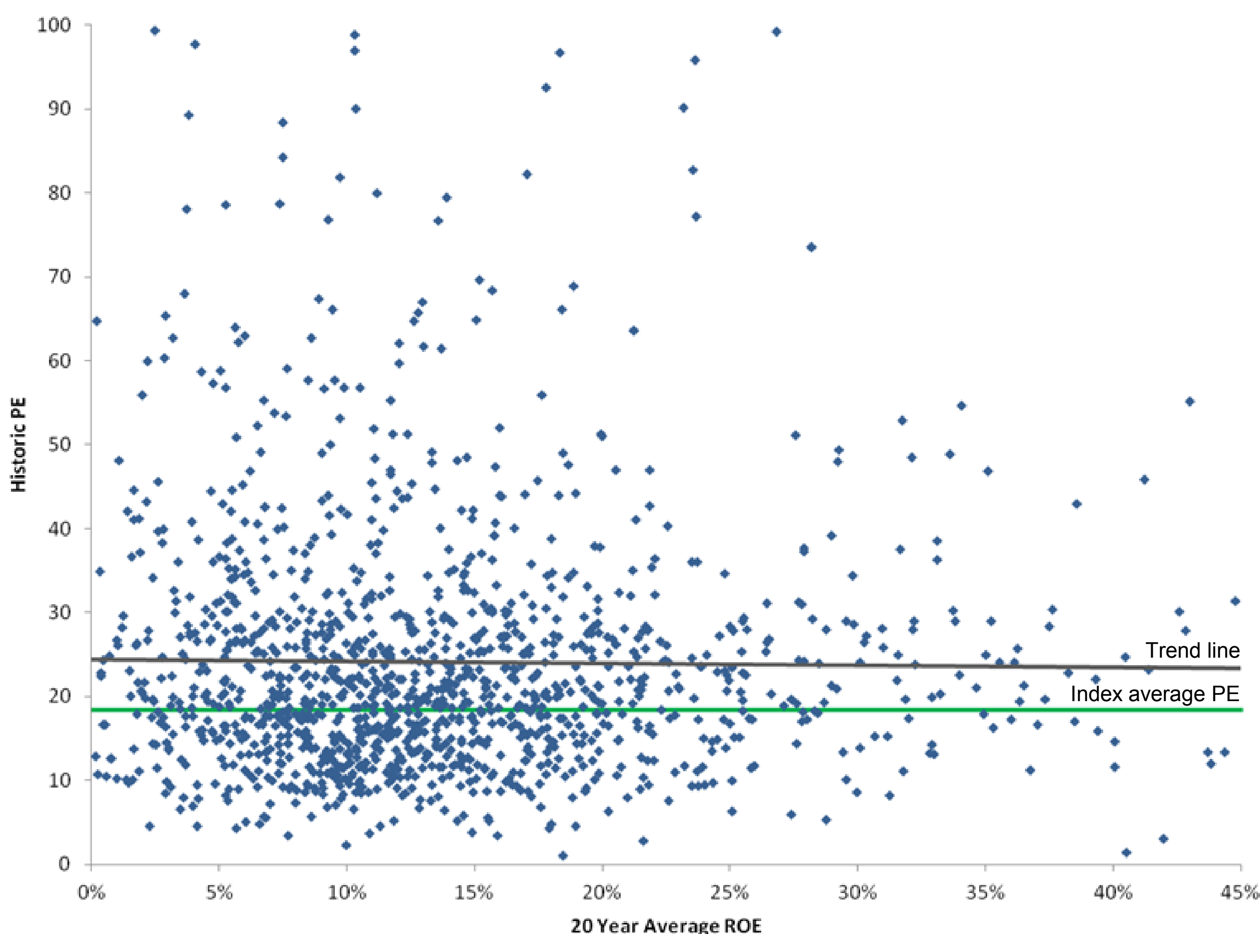
Other investors persistently underestimate quality, resulting in unduly low market valuations for the very best companies. This is the core proposition of Lindsell Train's investment approach and one that provides us with an enduring market inefficiency to exploit. In theory it also makes picking stocks 'simple' - in the words of Warren Buffett all you need do is "buy shares in a great business for less than the business is intrinsically worth". In reality, the challenge lies both in identifying these great businesses and in working out said worth. A truly fantastic business can come in many guises but by and large we look for enduring enterprises earning extraordinary returns for extraordinary periods of time. The sustainability element is critical. It implies a defensible business model (or 'economic moat' in Buffett parlance), allowing a company to protect its abnormal returns from the unrelenting assault of its competitors. Hence, the more repeatable and defensible a company's earnings, the easier they are to predict far into the future. These are the sorts of companies we like - otherwise we can have no hope of achieving the second objective; ascribing anything like true intrinsic value to the sum of these cashflows. Sustainable business models are surprisingly rare and those familiar with our approach will know that experience and first principles have encouraged us to spend most of our time looking for them in a few select industries (e.g. branded consumer goods companies and must-have media content owners).

Much of what we do is qualitative and based on the collective experience and ideas of the investment team; however, where possible we supplement this with quantitative analysis. How then do we put into numbers the resilience and sustainability of a business franchise? No statistic is perfect but we think a company's long-term return on equity (ROE) serves as a useful tool. As discussed above, exemplary returns on capital imply a business model with a genuine competitive advantage, enabling it to eke out more than the meagre existence allowed for by 'normal economic profits' (i.e. the equilibrium point when there is no incentive for firms either to enter or leave an industry). The key again is sustainability - it's one thing to earn high returns for a year or two, quite another to maintain them over a 10 or even 20 year period. Whilst the past can never provide any guarantee of the future, any company that's posted two decades of high ROE is to our minds immediately worthy of note. It's worth adding at this point that we don't as a habit run numerical screens to search out these stocks and nor do we demand immaculate ROE records for every investment (there are far too many other company-specific factors at play to do this). Nevertheless, it comes as no surprise to us to note that combined, the companies in our global equity portfolio have a 20 year weighted average ROE of 17% and operating profit margins (OPM) of 17% compared with 11% and 10% respectively for the MSCI World index.

The next step is valuation. Now while we fully subscribe to Keynes's 'roughly right vs. precisely wrong' philosophy, it's also true that without an attempt at valuation one is speculating, not investing. It seems logical to us that the earnings streams of exceptional businesses (e.g. those with notable ROE histories) deserve higher ratings than the rest of the market. After all, it is these companies in which we have the most faith when looking to the future. For example, we feel certain that the best branded consumer goods companies (we own several including Diageo, Unilever and Heineken) will still be earning decent returns from their products 20 years from now, just as they have for the previous 20. It is harder to be as confident about many of the other, lower quality concerns that populate the index which frankly may not even exist two decades from now. In practice we express this confidence in one of two ways; by using a lower equity risk premium in our DCFs (we will go as low as zero for the very best businesses) or through the application of a higher valuation multiple to a company's earnings. In contrast we think other investors, by failing to recognise the importance of a sustainable competitive advantage, unfairly penalise high quality, repeatable earnings with excessive risk premiums and low multiples.

Here I present some recent work seeking to provide evidence for this claim. The chart below plots every company listed in the MSCI World index ranking each one's current market price-earnings (PE) multiple against its 20 year average return on equity (allowing for the availability of data and excluding negative values). The green line gives the current market average PE of 18.4x. These are diverse companies and clearly there is a lot of dispersion, however I'd make one principal observation - there's no positive correlation between the long-term return on equity and the PE multiple. Perhaps this is evident from the plot (the black linear fit gives in fact a downward sloping line, pointing towards if anything a negative trend) but if not then it's confirmed mathematically by a zero value correlation coefficient and a non-significant statistical test for positive correlation. Taken as a whole, market prices support our general proposition that companies with better long-term ROEs do not command higher valuations than their less sustainably profitable peers.

Now here it's important to qualify this as a broad observation about the market, that can't necessarily be applied verbatim to every individual stock. Clearly there will be specific examples of companies that are highly profitable yet deserving of low valuations, and vice versa. This is particularly true over shorter time horizons (e.g. a 'bad' business benefiting from an unusually benign economic environment) but it's perfectly plausible for 'short-term' effects to persist over many cycles. Hence even a multi-year ROE record must be viewed in context with the circumstances of each business. Equally a 'good' business can go though surprisingly lengthy periods of difficulty. Media content developers might be one example, where even the best can suffer lengthy gaps between hits leading to extended periods of low profitability. Yet, those with truly unique IP should find new avenues for monetisation, eventually hoisting returns back above the norm. One of our companies, Nintendo, is currently in such a situation, with dull sales from its



Plot showing the current PE ratios for the MSCI World index (using 31/03/15 market prices and the most recently reported FY earnings), plotted against each company's respective return on common equity. The constant line (green) shows the index average PE. The trend line (black) is calculated as a linear least-squares regression, excluding all negative values and any outlying PE ratios above 100x (gradient: -2.4, R^2: 0.001). The relation has a near zero Spearman's rank correlation coefficient of -0.004, shown to be non-significant via a one-tailed Student's t-test ($t_{1,381}$=0.2, p=0.4). All data Bloomberg/Lindsell Train.

most recent console failing to sufficiently recoup development costs. However Nintendo has such a valuable collection of iconic characters that we are confident it will find innovative new ways to connect with its audience (and indeed recent developments suggest this is happening already).

Sufficient numbers of these counter examples would justifiably weaken a positive correlation between PE ratios and ROEs, but are there likely to be that many? More often high and stable returns are fairly representative of a business's underlying strengths - making it deserving of higher valuations than the market ascribes to it (and as plotted on the above chart). Hence we typically dispute both the excessive optimism placed on run-of-the-mill enterprises and the pessimism inflicted on the very best. For example, untested technology 'growth' stocks with negligible profits often trade at very high multiples and can remain at such levels for long periods of time. Amazon, listed since 1997, still has an OPM of just 0.2% yet trades at nearly 700 times earnings. This is not to say such companies are always bad investments (Amazon's shares have compounded at +36% pa since listing!) but the winners are deceptively few and far between and much easier to spot in hindsight. The vast majority of promising upstarts will never build the moats needed to survive and never live up to market expectations, making them wildly overvalued (as perhaps illustrated by the dotcom crash). Even Amazon, an unquestionable force in the rapidly evolving world of ecommerce, still operates with a relatively unproven business model and still generates low returns (last year its ROE was 3%, this year it's negative). It's for this reason that in general we'd much prefer to own a company that already has a long history of high profitability and cash generation. eBay, arguably our biggest 'tech' holding would be the best comparator here, which with a 19 year average OPM of 24% trades on a far more modest PE of 23x.

At the other end of the spectrum, I reiterate our proposition that other investors are failing to properly appreciate the importance of predictable, compounding earnings from exceptional businesses. For example, we'd have no problem with a fantastically reliable company such as Unilever (with a 130 year heritage) - which has averaged a 40% ROE and 13% OPM for the past 20 years - trading on a PE of anything up to 30x (if this sounds imprudent, then bear in mind this still means a yield of over 3% for a stream of inflation-proofed earnings). Unilever is a deeply entrenched business with decades-old distribution arrangements and historic brands used by 2bn people on a daily basis (the majority from fast growing emerging markets). Yet despite delivering an 8.7-fold total return over the past 20 years (vs. 4.3x for the MSCI World index) the shares currently trade at 19x earnings, barely above the market average. At this level we are more than happy to add to our positions.

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Lindsell Train Ltd
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Source: Lindsell Train & Bloomberg

Risk

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