February 2019

CORPORATE EXCELLENCE INSIGHTS

We are a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: TURNAROUND AFTER DECEMBER SELL-OFF

S&P 500 was up more than 7% in January – the best January performance in 30 years after December sell-off that was the worst month for stocks in nearly 90 years. Markets were boosted by signals from the US Federal Reserve that it would be more patient with further rate increases, as well as by improving relations between China and White House.

304 000

NUMBER OF JOBS ADDED IN JANUARY IN U.S.

The surge in hiring came despite the longest government shutdown in history in U.S. and the January figure is the 100th straight month of additions to the labour force.

6.4%

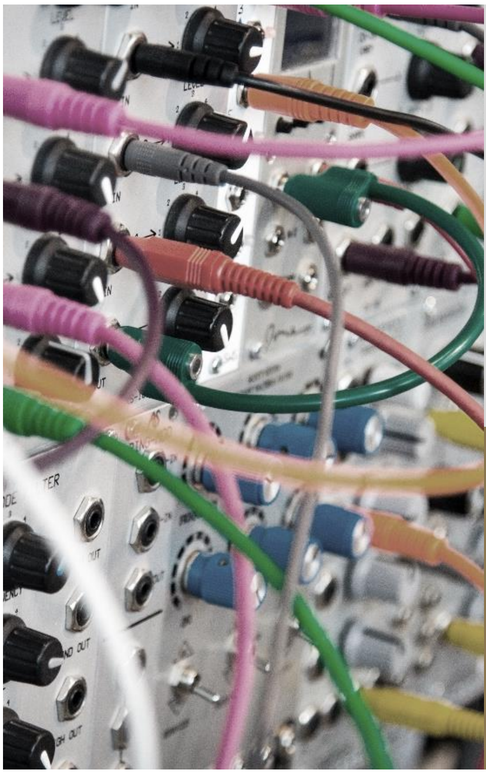
CHINA GDP GROWTH FOR THE FOURTH QUARTER

The September-December growth rate was the weakest expansion since the financial crisis, data published by the National Bureau of Statistics showed, adding to fears of a sharper slowdown in global growth.

50.5

EUROZONE PMI FALLING TO A NEAR SIX–YEAR LOW IN JANUARY

In France, the flash composite PMI fell further to 47.9, despite a slowing in the momentum of the "yellow vest" protests that have previously caused significant violence and disruption to the country.



MONTHLY TOPIC BUSINESS MODEL COMPLEXITY

Two most prominent investors, Warren Buffet and Peter Lynch, are famous for advising to 'invest in what you know' and so do many other investment advisors. Jim Collins' research showed that one of the prerequisites to company' long-term success is focus on the 'hedgehog' concept, i.e. focus on the competitive advantage. In our research, we have tested whether complex business models as proxied by the number of segments and the target customer groups (B2B vs. B2C) consistently have lower valuations and are favoured less by investors as compared to the companies with straight-forward business models.

The pattern in USA and Europe is similar: higher valuation is exhibited by the companies with more focused business models, i.e. having 1 or 2 segments, while the lowest PE levels can be found within the group of more diversified companies.

We found that Quality companies in average are a bit less fragmented in their operations as compared to the Non-Quality peers. In terms of the business model specialization and target customer group, we saw differentiation as well. In Europe, more than half of Quality companies have B2C type of business model.

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BUSINESS COMPLEXITY AS AN INVESTMENT CRITERION

'Invest in what you know'

It can be argued that Alibaba or Amazon, whose growth is fueled by global hi-tech hype, are attractive targets for thousands of institutional and private investors also in part because they run business models that are relatively easy to understand. This sharply contrasts with considering for investment B2B focused industrial conglomerates such as Illinois Tool Works that simultaneously operates seven business segments. Same applies to chemical companies like Covestro or Bayer, the analysis of which requires certain efforts to understand the products per se, their end-markets, competitors, and industry specifics.

Two most prominent investors, Warren Buffet and Peter Lynch are famous for advising to 'invest in what you know' and so do many other investment advisors. Naturally, there are certain failures of this approach, such as missed opportunities of being invested in small, not yet well known, companies with high growth potential.

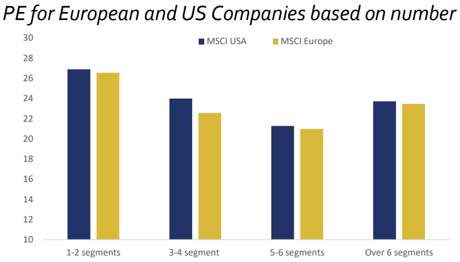
Complex business models can keep investors away from investing in a particular company and just a minority will consider investment outside their spectre of competences. Jim Collins' research showed that one of the prerequisites of company' long-term success is its focus on the 'hedgehog' concept, i.e. focus on the competitive advantage. In our research, we have tested whether complex business models are consistently having lower valuations and are favoured less by investors as compared to the companies with straight-forward business models. The complexity of business model was determined by two factors: 1) the number of segments (defined as reported segments in ARs) and 2) the target customer groups (B2B vs. B2C).

Premium for focused business models…

Complex business models not only obscure understanding of the company for investors and analysts, but also might make the company more volatile when it comes to earnings announcement. As Barinov et al. (2018) argue, companies with many segments, which obviously are more often characterized by lower transparency as compared with the companies having 1-2 segments, experience more tangible price movements due to higher deviation from the analysts' forecasts.

Acknowledging the amount of effort that is required to understand business model with multiple segments, one would agree with A. Damodaran that a discount should be claimed for higher complexity. To see whether this holds true, we grouped the largest EU and US companies according to the number of segments they operate and looked at their valuation levels, based on 10Y average Price-to-Earnings (PE) ratio.

Fig. 1: 10Y PE for European and US Companies based on number of segments



Source: Hérens Quality Asset Management, Reuters

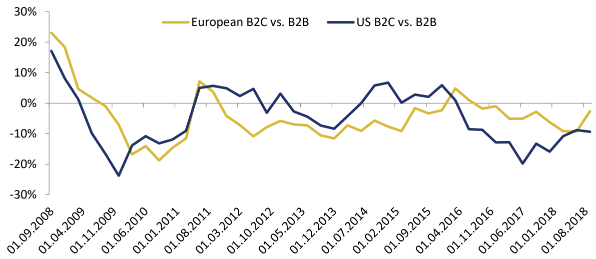
The resulting pattern both in USA and in Europe is similar: higher valuation is exhibited by the companies with more focused business models, i.e. having 1 or 2 segments, while the lowest PE levels can be found within the group of more diversified companies (Fig.1.). The exception, though, is a group of companies with over 6 segments, but is not representative due to low number of companies. Intuitively, one would also agree with the results: the competitive advantage is diluted when so many segments are being operated, as management team is unlikely to manage all the segments equally well (otherwise, it should be a very strong decentralized management model, which is a rare phenomenon).

… but not for B2C players

We have also considered the aspect of customer groups that are primarily targeted by the company, as this as well may be the root of significant differences in specifics of business models' and, as a result, require additional time and effort to understand the business.

Having classified MSCI Europe and MSCI USA constituents into B2B and B2C segments (excluded companies targeting both segments), we have put them in the context of valuation.

Fig. 2: PE differential of European and US B2C vs. B2B Companies



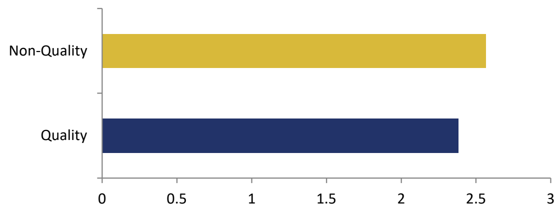
Source: Hérens Quality Asset Management, Reuters

The results in US and Europe show that, on average, B2B companies have higher valuation, implying that more value companies can be found within the consumer segments, which is somewhat contradicting to our initial hypothesis.

Business models of Quality Companies

Naturally, we were particularly interested in how the landscape of Quality companies looks in terms of business complexity. As a result of segment structure analysis, we discovered that Quality companies, on average, are a bit less fragmented in their operational focus as compared to the Non-Quality peers (Fig.3.).

Fig. 3: Average nr. of segments operated by Quality/Non-Quality Companies, 2018



Source: Hérens Quality Asset Management, Reuters

In terms of the business model specialization and target customer group, we also spotted certain differences. In Europe, more than half of Quality companies have B2C type of business model. In US, however, B2B and B2C business models are evenly spread within Quality universe.

In our investment decision process, business complexity is an important factor to consider, especially because our approach requires in-depth understanding of an investment target, so that we possess ability to proactively assess every risk and opportunity the company might face in the future. It often means that we are forced to avoid holdings popping out on our investment radar that are either overly diversified or are lacking aforementioned 'hedgehog concept'. However, by no means we purposefully disregard highly specialized B2B businesses; there, the documentation quality, the quality of investor relations and overall corporate culture can serve as a powerful argument in favour of the investment decision.

References

Collins, J. C. (2001). Good to great: Why some companies make the leap ... and others don't. New York, NY: HarperBusiness.

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