the art of boring™

EP44 | Playing the plan: Mawer's global small cap portfolio

Andrew Johnson:	00:41	Well, hello everyone and welcome to the podcast! Joining me today is John Wilson, who's an equity analyst on our global small cap portfolio, and that's exactly what we're going to talk about today. You've been on the podcast a few times before, so welcome back, John.
John Wilson:	00:52	Thanks Andrew.
Andrew Johnson:	00:53	So I wanted to start with what's happening out there in the world, but I did also want to just step back a bit because there has been a theme emerging in our discussions with clients, as investors, (which includes our clients and us as the team that they've entrusted their capital to manage for them). We find ourselves in this...kind of constant state of noise all around us. We've got headlines coming at us, market moves, geopolitics, central banks. The list goes on. So, I was curious—as an analyst, what do you do to help separate yourself from the noise and formulate your own opinions and try to make informed decisions?
John Wilson:	01:29	I think one of the things that differentiates us from some of the other investors that I speak with, is that a lot of the other investors focus on trying to find the equity that will outperform over the next three months or six months. And my experience has been that not only is that a very difficult game to play, the other thing is that there's a lot of eyeballs on it. So, even if it wasn't difficult it would largely be [arbitraged] out. One of the things that we find is helpful and that has high signal value, is focusing on things that matter over a long time horizon. The average company in our portfolio has been there for multiple years—some as long as 10 or 15 years. One of the things that we think helps with that performance over that time is having a strong management team and investing in companies that have a moat, or sustainable competitive advantage. That doesn't mean that those companies will perform over the short-term—over the next six months or three months—but we think over the long-term that there'll be some signal there.

Andrew Johnson:	**02:32**	Out of all that noise, there are different trends and themes that emerge, and there are a couple of themes that we've been talking about for some time now, whether that's been in discussions here at Mawer, or in speaking with our clients. The first one that I want to explore with you is the slowing of growth around the world. What exactly are we seeing out there that tells us this is happening, and really, is there anything that we can do about it?
John Wilson:	**02:55**	Yeah, so that's one of the themes we've seen—especially in the last quarterly earnings season that we've gone through. We've seen companies come out and either show slower growth, or guide that, "growth is going to slow." There's been a number of profit warnings as well. One of the things that we talk about here at Mawer, is "not fixing your ship in a hurricane." That's not the time to go out and try to readjust your portfolio. It's beforehand. Over the last number of years, we've been talking about this, and right now our portfolio has a good mix of defensive companies that we think will be able to weather the hurricane.
Andrew Johnson:	**03:33**	All right. Well, let's delve into that. What comes to mind for you when you look at the portfolio right now that would fit that category?
John Wilson:	**03:39**	One business model that we've initiated on in the last 12 months, [is] we've purchased two companies involved in the retail of eyewear. If you think about LensCrafters, or Hakim Optical is the other one that comes to mind here in Canada—these companies do the same thing over in Europe. We own one company called Fielmann, which does this largely in Germany, and another one called GrandVision, which is based out of Netherlands, but operates optical retail chains in a number of different countries. We find that these businesses tend to be fairly defensive in nature.
Andrew Johnson:	**04:15**	Okay. So what exactly do we like about this type of business or maybe even these particular companies?
John Wilson:	**04:21**	That defensive piece...maybe I'll go a bit more into it. If you think about purchasing eyeglasses, we consider it a constant, basic need. You're going to continue to need these glasses, and the replacement cycle doesn't actually change that much through a cycle. If you look at these companies' performance during the last down cycle in 2008 and 2009, earnings either continue to grow or only saw slight declines. There's a constant basic need that helps provide defensiveness with these businesses.

	04:51	The companies are [also] competing against independent, small retail chains. This is one thing that, after carrying out the research, I recognize as I walk around [here in] Toronto or in Calgary—how many small retail chains of eyeglasses or eyewear there are out there. And the reason why we like this, is because by being larger, these chains are able to have a lower cost. They're able to pool their purchasing power, and thus are able to obtain their inventory at lower prices and [...] either offer these glasses at lower prices, or they're able to reinvest that cost savings in[to] better serving the customer.
	05:32	The last piece—and you'll see this as a common theme across many of the investments in our portfolio—is that there's an engaged owner. That means that there's a large shareholder that's either engaged in the operations through actually managing it, or is on the board. And we find that that's a characteristic that can be quite helpful in the long-term.
Andrew Johnson:	05:53	So what's the big deal with that? Why is it important to have an engaged owner?
John Wilson:	05:57	The main thing you see is they are aligned: they have an economic interest; they're large shareholders; and they're capable. When they see that hurricane on the horizon, they're going to make sure they're going to do all they can, to try to avoid it as much as they can, and also make sure that once they're in it, that the ship actually makes it to the other side.
		It's a form of risk management. The other benefit of an engaged owner is not just on the risk management side, but also from an opportunity standpoint.
	06:26	One of the companies that comes to mind is Kainos, which is run by Brendan Mooney, who also owns 12% of the company. He's done a tremendous job growing that company over time. And every time I talk to Brendan, he's entered into a new adjacent business that helps create options for the shareholders. And he's done a tremendous job at executing it in those new businesses, so it can also be beneficial from an opportunity standpoint.
Andrew Johnson:	06:51	Okay, so that's all well and good. Let's go back to the eyeglass retailers, because unless you've been living in a cave for the last decade, you can now buy glasses online.

John Wilson:	**07:01**	That's right [laughs]. That's a threat that we continue to monitor. Now, what our research has shown is that if you think about eyeglasses on average, you're purchasing them every three to four years. It's quite important that you not only have the prescription correct, but the other thing that we found out in our research is that you'll find that the pupils need to actually be aligned with the focal point of the lens. And that will actually vary eye to eye. Your left eye will actually have a slight adjustment compared to your right eye, and that requires that you visit an optometrist to get that perfectly right.
	07:35	If you think about an investment that you're going to be wearing for the next three to four years, and where, if you get it wrong, it could cause you to have headaches or difficulty reading or seeing things....it's important that you get that prescription right. And that's the reason why today, online penetration of eyeglass wear is less than 5%. Even if you look at Warby Parker—which is a U.S. company that originally started as an online only retailer of eyeglasses—they've actually backtracked now and started opening physical stores, as they've realized that this is an important channel for them.
Andrew Johnson:	**08:10**	Okay. So tilting the portfolio toward more defensive business models is obviously one way that we can help, but what are some other ways that you're thinking and maybe talking about as a team to help position for this slowing growth?
John Wilson:	**08:23**	The one thing that becomes more important as growth slows, is you want companies that have what we call a "cookie-cutter runway." That's the idea of doing the same thing again and again and again in a very standard form. And what we found, is that the market tends to treat all growth the same—as though all growth has an equal probability of occurring. But I don't think that's the case. And I'll give a simplified example. If you think about three characteristics—you have the customer, the product, and geography—a cookie-cutter growth avenue would keep two of those fixed, and vary the third.
	08:59	An example would be: you're selling the exact same product to the exact same customer type, but—and here's the part that varies—geographically, you're moving one town over. If you think about that from a probability standpoint, just flexing that one variable slightly, that puts the odds in your favour that that growth actually materializes.

		On the other end of the spectrum, if you look at non-cookie cutter growth… that's selling a brand new product that you never sold before, into a brand new geography that you've never been, to a customer group that you never ever sold before. You can start to understand why that sort of growth—[the probability that it's] successful—is much lower. When we're looking for companies, we're looking for them to have that cookie-cutter growth avenue ahead of them.
Andrew Johnson:	**09:42**	That makes a lot of sense to me. In a world of slower growth, the market should be rewarding companies that execute and grow in the face of that. You talked about a few examples earlier. What do we have in the portfolio that fits this category?
John Wilson:	**09:55**	One that comes to mind is Bravida. This is a company that installs and maintains HVAC, electrical, and plumbing systems for commercial customers. That company is by far the largest provider in the Nordics of those services. So that allows them to have a cost advantage on their procurement. Now, that being said, despite being the largest company in the entire market, they still only have 15% market share in that region. So, the way the "cookie-cutter" formula [works] for them, is they sell to the same customer (they sell to commercial customers); they sell the same service; and they'll just move one town over, either through acquisition or expanding organically into that region. It's a very cookie-cutter approach and a very long runway ahead of it.
Andrew Johnson:	**10:44**	Okay, great. That's some really good insight into that. I think another trend that we've talked a lot about around here, is this theme of increasing leverage or debt with the companies that we're looking at—especially over the past several years. First, why is that a concern, and why is it happening?
John Wilson:	**11:00**	In terms of why it's a concern—anytime you increase the amount of leverage on your balance sheet, on the one hand (in good times), that can be quite beneficial to the equity holders because they have to put up less capital for every dollar of incremental growth. Now, where that can be quite painful is if you stretch it too far, because that increases the odds that you have a solvency issue, in which case the equity holders can be wiped out or can see a large impairment of their capital. So that's the downside. It can be beneficial, but it needs to be within reason.
Andrew Johnson:	**11:35**	So that's "why is it important," but why do you think this is happening at this moment, or this point in time over the last couple of years?

John Wilson:	**11:41**	I think part of it is we're more likely at the end of a cycle than at the start. People have had their hand on [a stove that hasn't been turned on] for a number of years now. So, they get braver and braver with that. I think that's part of it; it's human behaviour. I think the other part is interest rates just being so low. It's quite attractive to borrow at low rates. There's an excess supply of debt financing, so it's cheap and it's readily available so people tend to use it.
Andrew Johnson:	**12:08**	Okay, so similar to the growth theme: what can we do about that as investors? Especially when we're thinking about our portfolios.
John Wilson:	**12:15**	Our motto is, "Be boring. Make money.TM", so we try to be very boring with this sort of stuff. You look at the portfolio—we have a natural bias towards holding companies that have a net cash balance sheet. Within global small cap, 45% of the fund is invested in companies that have net cash on the balance sheet. So, that means they don't have net debt, but rather they have excess cash that's sitting around on their balance sheet, which can be quite helpful actually.
Andrew Johnson:	**12:42**	Okay. So net cash sounds like a really positive thing to me. Maybe let's explore that a little bit more. What are the advantages of having that cash, and are there any disadvantages or opportunity costs?
John Wilson:	**12:53**	Yeah, so where it's helpful is if you run into a situation where there's a downturn in the economy, or a downturn in demand. The cash on your balance sheet first of all acts as a shock absorber. You're going to be able to weather that crisis much more easily than someone that has a lot of debt on their balance sheet. The first one is that cash acts as a shock absorber. The other factor is that it can allow you really attractive investment rates—and I mean that in two ways. The first way is when markets sell off, if you have a net cash balance sheet, you'll be able to purchase your competitors or similar businesses at very attractive valuations. That can lead to high wealth creation for shareholders, so that's one.
	13:41	And the other factor is, even organically, if you're a company with net cash and your competitor has a lot of debt on their balance sheet, the competitor's not incented to invest extra in marketing or in R&D. They may even cut back those things, which they know long-term are beneficial to their moat. But in the short-term, they're focused primarily on just surviving. So by having a net cash balance sheet, you're able to continue to investing in these things that grow your moat and maybe even take share from some of these competitors in a downturn.

	14:11	The offset would be [is] you can be seen as a bit conservative by some shareholders. You're the only guy walking away from the punchbowl just as the party's getting started. That's one thing that we find is that management teams tend to get this pressure from some shareholders. You can understand if you're only holding the shares for six months or nine months, you're not really incented to worry too much about the balance sheet. You're more interested in them doing the next big deal. We try to engage with our management team on that because we think it's the people that want the management team to increase the leverage that write the emails and that are the squeaky wheels to the management team, pressuring them to increase their debt.
	14:57	Just a few weeks ago, I sent an email to one of the management teams in our portfolio encouraging them to continue to pay down debt as they had been. Because I think that for every email he receives from an investor like us saying, "keep producing debt, that's great," he's probably receiving three, four, five from other shareholders saying, "no, it's time to use more debt." We're trying to equalize that ratio a bit.
Andrew Johnson:	15:21	Well, that's good to hear too because I think that's one of the ways that we can kind of do the right thing for the portfolio, do the right thing for our clients, is to engage with the management teams that we've been able to establish relationships with through these long-term holdings.
John Wilson:	15:33	Absolutely.
Andrew Johnson:	15:34	One other pattern that I think has emerged, at least anecdotally for me, whether it's looking at our portfolios from a quarterly basis, looking at some of the transactions that have happened or even just generally looking at the headlines out there in the market, is that I've seen more and more mergers and acquisitions or takeovers of other companies. Is that a story that I'm making up? Or is there some more fact to that?
John Wilson:	15:56	No, I think you're absolutely right. As credit becomes more freely available and cheap, it's easier for private equity investors and even strategic buyers to use debt to purchase these companies.

In the last 12 months, we've had four of our companies in the portfolio receive takeover offers, three of which have gone through and have been acquired. I think you're absolutely seeing that in the market. I like to think of it as partly due to the increase in leverage. I wonder whether it's also a reflection of our investment horizon [and] style; where private equity investors are [also] longer term holders, obviously, so they tend to hold companies for five or seven years, so it naturally would follow that when we're looking at companies to hold for that long-term time horizon of 10 years, they would be interested in similar assets as that. I think that might also have something to do with that.

Andrew Johnson: 16:47 Yeah, and those takeovers are bittersweet because they can usually be a pretty good payday for our clients, but we'd probably rather hold on to those businesses for another 10 years or so, and generate more value for clients. It can also have an impact on the portfolio because it increases our weight in cash, at least temporarily, and that can have a structural change to the portfolio.

John Wilson: 17:07 Yes, absolutely.

Andrew Johnson: 17:08 All right, well let's round things out with a couple of examples of what's happening in the portfolio. One thing that has popped out to me has been XP Power, and this is because we've held this for...I think a little over five years, or maybe right around five years. But it hasn't been doing so hot lately. First of all, maybe share with our listeners what XP Power is and what's been going on with them.

John Wilson: 17:29 Sure. XP Power is a UK-based company that designs, builds, and assembles power converters using typically high-end devices. So, if you think about the power converter that would be used on a dialysis machine; medical equipment is a big end market for them. Semiconductors has increasingly become a larger market for them. The component itself is mission critical, so if you think about that dialysis machine example, where, if that fails, then that can be quite problematic for the patient. So, that's one component that we like about it. The other component is once these converters are designed into a product, they will stay in that product for the life of the product, which is typically seven years. So there's a bit of stickiness there that we like, so that's the other aspect.

18:16 One of the things that's happened over the last three years is that the company has benefited a tremendous amount from the growth in semiconductors.

		[When] we initiated on this company, the amount of revenue contributed from semiconductors would round to zero. It was almost nonexistent. And over that time period, it's grown to 25-30% of the company's revenue. As you can imagine, that's created a significant tailwind for the company. So, the company's growth has benefited from that, the stock price has benefited from that. But what's happened over the last nine months is semiconductors…that industry has started to slow. And [we] started to see negative growth within that part of the business. The rest of the business continues to grow, but that semiconductor business is starting to shrink. That's caused the stock to come down and sell off.
	19:08	As you mentioned, we've held this for a number of years now. And when we purchased it, we weren't purchasing it for semiconductor exposure or anything like that. We purchased it because of that mission-critical nature of the business; the stickiness of the business; and also the CEO, Duncan Penny [and] his ability to execute as an operator. He's done an excellent job moving the company into higher margin branded products and he plans to continue to do that. So, right now with the lower share price because of these concerns around semiconductors, we think the valuation's much more reasonable.
Andrew Johnson:	19:43	Okay. So going forward, it sounds to me like we still like this business, still like it as an investment. Is that an accurate assessment?
John Wilson:	19:49	Yeah, absolutely. I think with this one, the investment thesis is largely intact.
Andrew Johnson:	19:55	Great! Okay. Well, if we're going to talk about the sour, we got to have some sweet too. What's an example of a stock in a portfolio that has done well lately, whether it's been executing on our thesis, or maybe it's even surprised us to the upside?
John Wilson:	20:07	One that's done fairly well is 4imprint. This is a company that produces promotional material. An example would be if [we] go to a trade show [with] a booth; we would have "Mawer" written on the side of a pen, or Frisbee, or shirt or hat—anything like that.
Andrew Johnson:	20:29	—Or little chocolate M&Ms?

John Wilson:	**20:30**	Exactly, exactly. They do things like that. That's a fairly "boring" business. The reason why we like it is because the decision-maker is often someone in the marketing department, where their main concern is to make sure that the product is high quality; they want to have a wide selection so they can find the product that fits with their company's branding; and they want to make sure that it gets there on time, because oftentimes these products are ordered for a particular trade show or a particular event, and there's no point in getting branded pens or hats or shirts if it shows up after the trade show date.
	21:09	Actually, the "aha!" moment for me with this one came when I went and spoke to Sabrina in the marketing department and I asked her, "when you're deciding on which provider to go with, what matters to you?" And she said, "selection matters, quality matters, and making sure that it's there on time matters." And I had to follow up and ask, "what about price?" It didn't even come up in the conversation. That's just not top of mind. That's not something that really matters. The actual cost of these items are small, so that's not a huge component of the decision. So when you have a customer that's price insensitive, that can be make for a very good business model. The other factor—talking about cookie-cutter runways—this company has 4% market share. Despite that, they're number one or number two in the U.S., which gives them a scale advantage, so they still have a tremendous amount of growth that they continue to execute on.
Andrew Johnson:	**22:02**	John, I just want to thank you so much for being on the podcast today, and I'm really looking forward to sitting down and chatting with you again.
John Wilson:	**22:09**	Absolutely. Thanks, Andrew.