Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

# FANG IN A VALUE PORTFOLIO?

## A VALUE INVESTOR'S FRAMEWORK FOR BUYING GROWTH COMPANIES

The current market environment is challenging—investors are faced with tepid economic growth, considerable geopolitical risk, Federal Reserve tightening and elevated equity valuations. Value investors, in particular, are struggling to find opportunities that have the right balance of return potential and margin of safety. This challenge is compounded by the impressive performance of growth stocks.

Since we are late in the cycle, it is important that value investors consider high quality companies with growth prospects that are protected by barriers to entry – what we refer to as franchise value opportunities. Traditional multiples-based valuation methods can be overly simplistic and conceal opportunities in which high growth companies trade with an appropriate margin of safety. Growth and value should not be viewed as mutually exclusive. Rather, investors should depart from this line of thinking and consider growth as a component of value. This will help investors broaden their investable universe and improve their odds of generating attractive returns. This line of thinking can also show that a high-growth, leading on-demand customer relationship management company can be an attractive value stock.

## HOW TO FRAME FRANCHISE VALUE OPPORTUNITIES

*"The most valuable contribution that security analysts could make to the art of investing would be the determination of the investment and speculative components in the current price of any given common stock."*[1]

*~ Benjamin Graham*

Franchise value opportunities are companies that trade at a price that is higher than the present value of cash flows from existing assets while generating returns that exceed the cost of capital. In other words, a franchise value company is one whose share price indicates that the market is willing to pay for the present value of cash flows from management's future investments in new assets over and above the existing asset base.

When investing in franchise value opportunities, it is critical to isolate how much future value creation is priced into the current share price and to pay as little as possible for that future growth. It is also important to distinguish between two types of companies—low-asset growers (LAG) and high-asset growers (HAG). LAG businesses grow their asset base in the low- to mid- single digits while HAG businesses grow in the double digits. These groups are similar to the "cash cows" and "stars," coined in the growth-share matrix work of Bruce Henderson at Boston Consulting Group.[2] They are also referred to as mature businesses and compounders.

Some value investors have evolved from buying businesses at- or below- book value to buying LAG businesses trading in the franchise value territory as return on capital for the average American business has improved. This has increased the opportunity set for these investors. However, ruling out HAG businesses can still reduce an investor's opportunity set late in a market cycle. Management skill and technological progress continue to drive improvement in labor-to-output efficiency and reduction in asset-intensity. High quality platform businesses have become a material part of the global economy. Because of these reasons, it is an opportune time for value investors to add a framework for considering HAG franchise value opportunities.

The most important qualitative indicator in a compelling HAG franchise value company is a clear, identifiable barrier to entry protecting the runway for future investment. Additionally, a company's track record of making accretive investments along with the degree to which interests are aligned with shareholders should be assessed. Ultimately, since HAG companies attract competition, the success or failure of future value creation and ensuing investor return will depend on the strength of the barrier.

When evaluating HAG franchise value companies from a quantitative standpoint, investors should look for consistently high market share, excess returns on capital, demonstrable pricing power, low financial leverage, and low capital intensity. This will ultimately lead to an ability to compound shareholder value across various stages of a market cycle.

## DOES THE LEADING ON-DEMAND CUSTOMER RELATIONSHIP MANAGEMENT COMPANY HAVE A PLACE IN A VALUE PORTFOLIO?

If investors look at growth as a component of value, they can open themselves up to new opportunities, which may be capable of generating attractive returns. The following is a company example describing a 2016 investment in a leading on-demand customer relationship management company. This example demonstrates the above framework for investing in HAG franchise value businesses that is consistent with many core principles of value investing:

- Emphasizing the most reliable information in valuation
- Understanding how much future value creation is priced in
- Paying as little as possible for future value creation
- Prioritizing margin of safety

*Barrier Analysis:* The company's barrier to entry sources are customer captivity and economies of scale. Products are embedded in revenue-generating activities for their enterprise customers, leading to consistently high customer retention. With high relative market share in several business areas, the company is able to outspend rivals on product development, which helps the company's technology stay ahead of competitors. The barrier is evident in no-growth return on capital in the low-30% range, high relative market share, and pricing power.

*Negative Narrative:* Concern about a slowdown in the firm's organic growth rate came when the business' flagship sales force automation franchise, which had been growing in the higher double digits for almost two decades, dropped to 10%. Sentiment turned on the company, and the share price suffered a pullback.

*Valuation:* Due to these growth concerns, the share price had retreated to a level that was only slightly above the present value of cash flows from existing assets. The market was including very little future value creation in the price of the stock. When we initiated our position, domestic sales contributed 70% and there were large addressable foreign markets offering growth opportunities consistent with their competitive advantages. In our view, this entry price presented an attractive balance of upside potential and margin of safety for a company with strong barriers to entry in place to protect excess return on capital and a high probability of accretive growth.

Our process is keenly focused on identifying investment opportunities with strong barriers to entry and attractive valuations. Companies that are well managed and that generate excess returns on capital deserve further analysis. While many growth stocks may not possess these attributes, we do find select high asset growers with significant barriers to entry that protect the runway for future investment.  These franchise value opportunities fit nicely within our value-oriented framework.

[1] *"Securities in an Insecure World" A Lecture by Benjamin Graham, Delivered at Town Hall, St. Francis Hotel. November 15, 1963*
[2] *BCG Classics Revisited: The Growth Share Matrix*



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