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Structural advantages of supercompounders in emerging markets

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Executive summary

Quality is a rare commodity in emerging markets, with nearly 80%* of emerging market companies failing to earn a return on invested capital that exceeds their cost of capital. In such an environment, investors might be wise to focus their portfolios on only the select few able to generate high and compounding returns over long periods of time.

On a macro level, persistent trends continue to support the promise of emerging markets (EM). Faster growth rates, more competition, improving governance, increasingly sound economic policies, and rising consumer purchasing power represent ripe conditions for long-term growth.

The allure is strong, but risks remain. Higher volatility, rising and ebbing capital flows, and overly assertive governmental intervention are persistently present. Emerging market equity allocations, which have hovered near the fringes of investment policies for decades, reflect these risks.

But these risks can be effectively managed in the context of a well-constructed portfolio. Investors with strategic allocations to the EM asset class have many options, each with their own risks and opportunities.

As investors consider the best-suited options for their permanent allocation to emerging markets, we posit that there is a clear way forward; one that allows investors to maintain their long-term, core positions while allowing one of the magical power laws of investing to occur: compounding.

The search for supercompounders, a scarce but powerful source of returns

A select number of companies in emerging markets are able to generate high and compounding returns over long periods of time. These “supercompounders,” named for their ability to maintain their sources of excess returns and compound value over time, offer rich targets for high investment returns.

Uncovering and owning supercompounders can be an important source of confidence for high-conviction investors, enabling them to invest long-term while allowing the power of compounding returns to work in their favor. This is especially important in emerging markets where higher volatility, macro events and capital flow cycles often conspire to weaken an investor’s resolve and time horizon.

> *“Uncovering and owning supercompounders can be an important source of confidence for high-conviction investors.*

**Source: Jupiter, as at 25.10.2021.*

This brief will discuss the investment qualifications for supercompounder status, why they are rare and how owning relatively few of them may generate significant excess returns while reducing risk.

> *Of more than 30,000 companies across the EM universe, a small fraction exhibits all the conditions to qualify as a true "supercompounder."*

What *is* a Supercompounder?

We define supercompounders as high-quality companies with sustainable competitive advantages that generate excess returns for long periods of time.

Supercompounders enjoy advantaged positions relative to competitors, with preferred brand status, pricing power, and relatively low capital intensity among other factors. High-quality businesses with rising free cash flow and competitive advantages, and an ability to grow for a long time, are hallmark traits that define these companies. Of more than 30,000 companies across the EM universe, a small fraction exhibit all our conditions to qualify as a true "supercompounder." Their relative rarity makes them hard to find, unless you know what you're looking for.

Defining traits

#1: QUALITY
#2: FINANCIAL STRENGTH AND FLEXIBILITY
#3: SUSTAINABLE COMPETITIVE ADVANTAGES
#4: TIME CREATES DISTANCE
#5: STRUCTURALLY ADVANTAGED INDUSTRY
#6: COMPOUNDING (AKA GROWTH THROUGH REINVESTMENT)
#7: SUSTAINABLE BUSINESS PRACTICES

#1: QUALITY

Companies that earn high returns over and above their cost of capital create economic profit. Over time, the stock market rewards companies that consistently create economic profit with increases in market value.

It's simple in theory, but difficult in practice. Our research has found that approximately 20% of EM companies earn an average return higher than their cost of capital. The remaining ~80% are at risk of actively destroying shareholder value.

By contrast, supercompounder candidates typically possess high, stable, and sustainable returns on invested capital (ROIC) and return on equity (ROE), attractive free cash flow yields, and growing earnings—all indications of a quality company.

A recent HOLT analysis illustrates the important role quality plays in investment returns. Of 1000 emerging market companies in the study, the top 20% of firms rated on quality characteristics generated an annualized outperformance versus the EM universe by a meaningful 202 basis points over a ten-year period. Conversely, the lowest 20% of companies ranked by quality underperformed by 276 basis points annualized over the same period.

FIGURE 1: **Factor analysis** | Annualized growth rate (%)

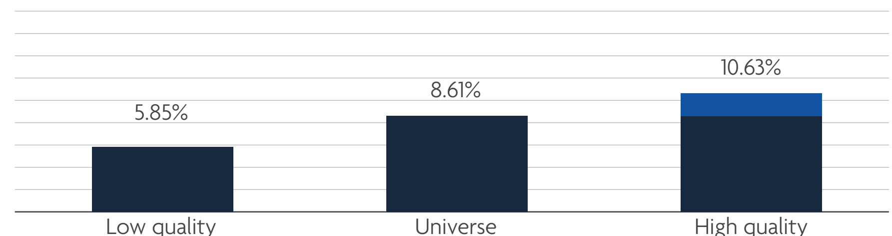

Figure 1: Universe is equities from MSCI Emerging Market countries in the Credit Suisse HOLT database on an equal weighted basis. High quality is defined as top quintile of (Cash flow return on investment) CFROI, CFROI Range and CFROI 5 year Median. Period: 31.12.03 – 31.05.21. Rebalancing Frequency: Monthly. Sample includes all active companies at the relevant point in time. Only companies that have published earnings estimates are recorded in the database. Total returns are calculated gross.

Source: Credit Suisse HOLT, as at May 31, 2021.

#2: FINANCIAL STRENGTH AND FLEXIBILITY

Generating a ROIC in excess of the cost of capital is an especially challenging feat in emerging markets, where the cost of capital is generally higher than in developed markets. Significant levels of free cash flow is the key to clearing that hurdle, driven by recurring revenue streams, high margins, and cost advantages.

Higher cash flow enhances a management team's flexibility to respond to opportunities and threats. They may choose to reinvest excess cash in the business to fund growth (our preference), press their competitive advantages, or pay cash to shareholders in the form of dividends. Excess cash can also be used internally to finance growth, driving economic profit even faster and at lower risk than relying on external financing.

Defensively, companies in stronger financial positions can reduce pricing and margins to address competitive threats or reduce balance sheet risk by lowering debt. They are also well-positioned to weather economic downturns. New acquisitions, too, must meet the high hurdle of accretive value. All opportunities, whether organic expansions into new lines of business, the acquisition of another company, etc. must meet the criteria for higher returns on invested capital.

#3: SUSTAINABLE COMPETITIVE ADVANTAGES

Businesses that consistently earn high returns on invested capital typically do so because they possess some form of competitive advantage. If they did not then new entrants would easily flow into the industry, attracted by the high returns on offer and enabled by low barriers to entry. Broadly speaking the sources of these competitive advantages can be found in four areas:

- The Network Effect
- Efficient Scale or Cost Advantage
- Switching Costs
- Intangible assets such as brands, patents, institutional knowledge or technological advantages

Innovative and nimble companies are well-equipped to fend off competitive pressures and preserve their economic opportunity over longer periods of time. In short, their advantages are difficult to replicate or beat. In the age of disruption, management teams who defend their positions while simultaneously playing offense by adapting to change are in a better position to maintain and grow their relative advantages.

Consider Hong Kong-listed Techtronic, the world's leading manufacturer of cordless power tools operating under the Milwaukee and Ryobi brands. Techtronic typically spends 3%-4% of sales per annum in research and development and recruits top engineering and software graduates to maintain its innovation edge in creating new product lines. In our view, the company's competitive edge rests on the compatibility of its battery technology with current and past tool models – they all use one battery standard. Old tools can be kept going with new batteries and new tools can be purchased without a battery if the user has an existing stock. This embeds a switching cost as once a contractor has a group of tools in the Milwaukee platform, it's difficult to switch to a different brand. Techtronic estimates that for a competitor to replicate their tool "fleet base" would take seven years from a standing start.

#4: TIME CREATES DISTANCE

The competitive advantage period (CAP)—the length of time a company can hold its advantaged position—is perhaps the most important factor that separates

Holding examples are for illustrative purposes only and are not a recommendation to buy or sell.

a supercompounder from the rest. It allows compounding of the company's many advantages to take effect and can result in significant economic profit.

Inevitably, even the strongest of companies are at risk of fading competitive positions. However, those that can "fight the fade" (the downward trend toward average) through constant innovation and development lengthen the opportunity to generate excess cashflows afforded by their advantaged positions. Accurately assessing that window can provide a distinct investment edge.

In our experience, supercompounders are far more likely to spring from structurally advantaged industries.

For example, Brazil's leading car rental company Localiza has continued to stay ahead of the competition by opening new markets in evolving trends for mobility. From traditional fleet and car rental, the company has created specific products for drivers operating in the fast-growing ride-hailing market (e.g., Uber) giving them the flexibility to rent rather than incurring the added expense of owning a vehicle. The company has also created products to address the growing rent-not-own trend in car ownership.

Companies with high ROIC and sustainable competitive advantages can materially extend the time that they can generate supernormal profits in excess of their cost of capital. The CAP is shaped and determined by a range of factors, each critically important, and requiring intensive research to identify.

#5: STRUCTURALLY ADVANTAGED INDUSTRY

In our experience, supercompounders are far more likely to spring from structurally advantaged industries, as they facilitate higher returns on capital. When considering industry structure, we ask the following questions:

- What is the level of competition within the industry? How many players? Concentrated with fierce competition or dispersed with no established leaders? Markets with irrational and aggressive competition are not a good place to be.
- How is the profit pool distributed across the industry? Ripe for 'winner takes most' or no clear winners?
- Is the market opportunity expanding or contracting?
- What are the barriers to entry? For example, TSM, the leading chip manufacturer in the world, spent $3.7bn in R&D and $18bn on CapEx in 2020. This investment is necessary to maintain its market-leading position. The sheer economic power of the company, which allows it to reinvest tens of billions of dollars each year, fortifies TSMC's position while discouraging competition. This is why there are only three players capable of cutting-edge logic chip production in the world.
- What is the balance of power between buyers and suppliers? Are buyers price-takers and suppliers price-makers? In this case, it's better to be on the side of suppliers.
- How much capital investment is required to compete? Beyond the TSMC example, consider what it costs to run an airline. Huge, variable costs are required before an airline can sell a ticket. Each airplane costs about $50 million and they need to be replaced every few years so the airline can benefit from constant technological advances in fuel economy. And they need to do this because the cost of fuel keeps rising—about 30% of variable costs are fuel-related over which they have no control. High capital intensity makes it difficult to grow enterprise value.

In the search for the rare supercompounder, it is often just as important to decide what should NOT be owned and identify where research effort would likely be wasted. Even the best run businesses will struggle to escape the gravity-well of poor industry dynamics.

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FIGURE 2: **Some examples of industries/rationale**
[NB this is not exhaustive.]

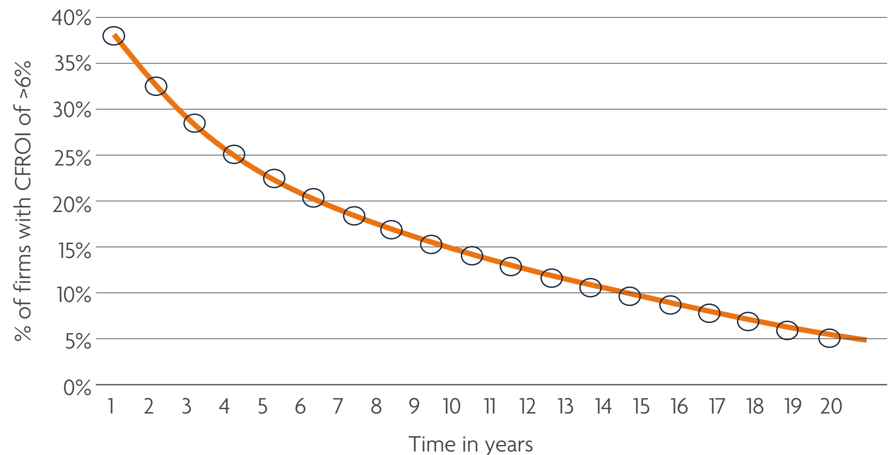
INDUSTRY	ADVANTAGES/DISADVANTAGES
SOUGHT	
Technology Hardware and Software	Network effects, intellectual property and innovation, low capital intensity in software and platform businesses
Financials/ Banks	In selected EMs, high concentration of players (eg: Bank of Georgia duopoly, doesn't exist in DMs); also, underbanked population is a significant long-term growth opportunity
Consumer Staples and Discretionary	Primary competitive advantage is often brand and in EM distribution capability. Subject to fade without constant reinvestment
Industrials	Often benefit from technological strengths, scale; Customers incur high switching costs
IT Consulting	Efficient scale & pricing; serving all industries toward digitalisation
Consumer-facing materials	Example: paint companies – Brand, distribution networks in large, dispersed geographies; pricing power to pass on rising raw material costs
AVOIDED	
Energy	Energy producers are price-takers, not price-makers. Returns on capital fluctuate widely with the underlying cost of the commodity. Can't predict or project
Utilities	Monopolies possess the widest of moats. However, returns on capital are dictated by government, limiting economic opportunity
Real-estate	Low returns, high leverage employed
Cyclical businesses	Subject to outside forces; difficult to predict
Telecoms	High capital-intensity; revenues compressed by competition and constant upgrade cycle
Biotechnology	Difficult to maintain a knowledge edge as an investor. Moonshot payoff profile vs steady compounders in other sectors

Maintaining an edge

Businesses that can fight the fade and consistently produce economic profit are very rare. Good businesses with lasting competitive advantages in structurally advantaged industries are well-positioned to compound ROIC/CFROI (Return on invested capital/Cash flow return on investment) at a high level over the long-term. To illustrate this reality, research firm CS Holt analysed the EM universe in an attempt to quantify just how rare these businesses are. The analysis placed a low threshold of starting CFROI of 6% or higher as the starting point and tallied the number of companies that maintained or grew CFROI from one to 20 years. As one would expect, nearly 40% of the companies maintained their cash flow levels one year out. Most importantly, however, the percentage of companies dwindled to approximately 15% eight years later and in year 20, less than 5% of firms sustained or grew CFROI. Persistency is an important trait and is closely tied into a company's valuation, a topic we will address in more detail below.

Less than 5% of firms can sustain a level of CFROI for more than 20 years.

FIGURE 3: **Rare breed: firms than can fight the fade over time**
Percentage of firms with starting CFROI of 6% or higher that maintain or improve CFROI over time. Note that less than 5% of firms can sustain a level of CFROI for more than 20 years.



Source: Credit Suisse HOLT, August 2017.

#6: COMPOUNDING (AKA GROWTH THROUGH REINVESTMENT)

For a supercompounder to truly work, it needs to be able to grow. As we've demonstrated, the company needs high returns on capital and a competitive advantage to protect those returns, but to truly grow economic profit and thus market valuation, the business needs to reinvest in growth projects at similar levels of ROIC.

Consider two businesses that earn a 20% ROIC, but one can grow and the other cannot. The mature, no-growth business should pay out all its excess cash flow to shareholders as dividends or buybacks. For the business that has growth opportunity, if it can reinvest all or most of its excess cash flows back in the business, in projects that will earn a similar 20% ROIC, it should do so in a heartbeat. The compounding effect of those investments will keep growing the value of the business. Thus, favored businesses are those that have ample room in front of them to reinvest.

"The light that burns twice as bright burns half as long" Dr Tyrell, Bladerunner

We can extend Dr Tyrell's metaphor of android life expectancy to the speed of growth: too fast and it won't last. Measured, sustainable and lower-risk growth by companies continuing to execute more of the thing they excel at is preferred. The long runways of available growth are one of the key structural advantages of emerging markets that we seek to take advantage of.

#7: SUSTAINABLE BUSINESS PRACTICES

If supercompounders are about the durability of the franchise and the longevity of the competitive advantage period (CAP) then surely it is critical to ensure that the very advantages we seek are built to last and built on a firm, fair and sustainable footing. A business that is run for the benefit of all stakeholders is more likely to thrive over the long term than one which seeks to gain a competitive advantage by cutting corners or makes decisions to the detriment of a stakeholder group – such behavior has a habit of coming back to bite. Thus, our aim is to integrate an assessment of the material non-financial risks (and opportunities) facing a business into all our work.

> "
> *The carbon footprint of the portfolio is measured and available.*

Very early in our research process we undertake a quantitative and qualitative ESG assessment of a candidate company. It saves a lot of heartbreak and wasted effort. If we find issues that are irreconcilable, we take an early pass and move on to the next idea.

The growing industry around sustainability data (MSCI, Sustainalytics, RepRisk, etc.) would like you to believe their scores and ratings matter most. We do not rely on them, however, and would caution against relying on them solely (such as building a passive product off them). This is particularly true in emerging markets, where the quality of ESG data and the resource allocation of the providers to them leave room for considerable improvement. True sustainability and governance issues are rarely as black and white as a simple rating suggests.

We believe it is critical to do our own active, qualitative assessment of the issues a business faces and engage with company management on an ongoing basis. Afterall, we are responsible for the choices we make in the portfolio. Positive opportunities come from playing a part in financing companies who are seeking to improve.

Similarly, governance structures and corporate culture and behavior, which may differ in developing markets to US or European norms, must be actively assessed. Ideally, we want to invest in a great business for a very long time, so we really do want to know who we are going into business with, understand their motivations and verify how they treat shareholders.

Practical Implications

1. It is expected that the businesses we own are signatories to, or endorse the principals of, the UN Global Compact, on issues such as environmental practice and pursuit of a positive stakeholder agenda.

2. Our process also excludes certain sectors where we deem ESG risks too high or where risks cannot be mitigated and thus are a serious threat to the duration of the company. These are: tobacco, fossil fuels, both for environmental and stranded asset risks, and defense/military spending.

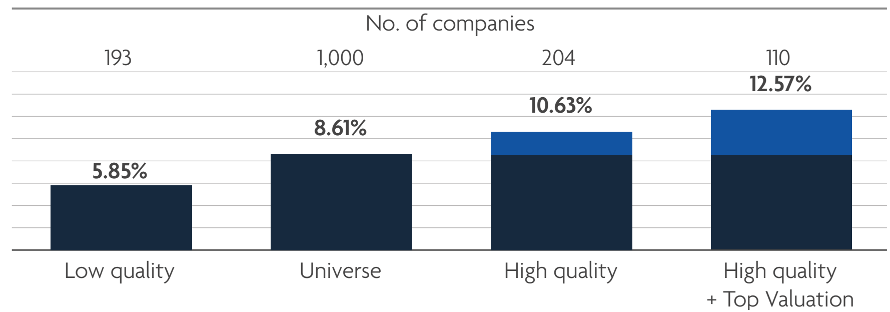
3. The carbon footprint of the portfolio and constituent holdings is measured and available. This will be baselined and we actively assess the progress of investee companies towards net zero targets through collaborative engagement on an ongoing basis.

Paying the (fair) price

The combination of all the above defining traits can be difficult to find in any one company. Rarer still are supercompounding companies trading at what we would consider an attractive valuation. Companies with reasonable valuations—not necessarily "cheap," but fair—offer two potentially powerful sources of long-term returns: a business that benefits from higher returns on capital growing in value with the added benefit of not paying too much for future earnings. Combining these two conditions offers obvious return advantages.

Figure 4: Universe is equities of Emerging Markets countries in the Credit Suisse HOLT database on an equal weighted basis. High quality is defined as top quintile of (Cash flow return on investment) CFROI, CFROI Range and CFROI 5 year Median. Value is defined as top half of sector-relative HOLT Percent-to-Best, HOLT Economic P/E, HOLT Price to Book Ratio and Dividend Yield. Period: 31.12.03 – 31.05.21. Rebalancing Frequency: Monthly. Sample includes all active companies at the relevant point in time. Only companies that have published earnings estimates are recorded in the database. Total returns are calculated gross.

FIGURE 4: **Factor analysis** | Annualized growth rate (%)



Source: Credit Suisse HOLT, as at May 31, 2021.

In the HOLT analysis mentioned above, buying quality companies at an attractive (fair) valuation would have added an additional 194 basis points, annualized. These companies, too, are rare. Of the 1000 companies followed in the study, only 11% met this hurdle.

Persistency – Winners keep winning

When attempting to assign an appropriate valuation to a company, it's helpful to recall that relatively few companies transition from being good to bad, and vice versa. Quality traits, whether a result of industry advantages, competitive positioning or other factors, tend to persist. As such, truly great businesses rarely go on sale. Buying these businesses at the right price takes patience. Inevitably, we have found, the market provides opportunities to take positions through occasional uncertainty and periods of volatility.

The table below shows just how little movement there is between quintiles on CFROI (cashflow return on investment), a measure of quality similar to ROIC. For example, 56% of companies that started in the 1st quartile (highest CFROI) maintained high CFROI four years later. Conversely, only 9% of companies that started in the 4th quartile (lowest CFROI) improved to the top quartile in the same time frame. This analysis, which tracked the CFROI performance of companies over a four-year period, comports with our experience: Good companies, with all of their advantaged traits, tend to stay good over longer periods of time. And very few poor companies, often in structurally disadvantaged industries, escape the gravity well of poor industry dynamics.

FIGURE 5: **Good companies stay good** | % of universe.

STARTING CFROI QUARTILE	ENDING CFROI QUARTILE			
	Q4:	**Q3:**	**Q2:**	**Q1:**
Q4:	51	28	12	9
Q3:	20	39	28	13
Q2:	8	23	40	28
Q1:	6	11	27	56

Source: Credit Suisse HOLT, October 2013.

> *To make money in stocks you must have the vision to see them, the courage to buy them and the patience to hold them. Patience is the rarest of the three.*
>
> *Thomas Phelps in 100 to 1 in The Stock Market.*

Investing in the structurally advantaged: Concentrated, long-term investment in supercompounders

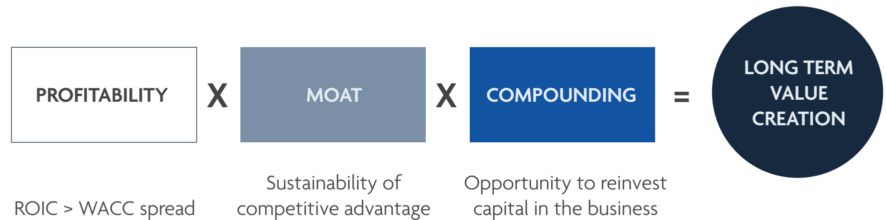
The Global Emerging Markets Focus team's process leads us to build a concentrated portfolio of about 30–40 supercompounder positions and aims to hold them for a long time to let the power of compounding do its work. Why a concentrated portfolio?

1. True supercompounders are rare, as demonstrated in this paper.

2. Placing meaningful capital behind high-conviction ideas, so that if we get things right this conviction will be reflected in returns.

3. A hard limit of 30–40 stocks forces us to make choices and think very carefully about what we own and how we use our research time.

4. Patience – investing with conviction requires us to be selective and considered in our choices, which is more likely to help with the hardest part of all: being patient. Supercompounding only works if you buy right and hold on.



About the authors

NICK PAYNE **Investment Manager**

Nick joined the company in June 2017 as head of global emerging markets. He previously worked at Nomura Asset Management from 2014. In 2015 he was appointed head of emerging and frontier equities at Nomura, as well as taking on lead management responsibilities on the Nomura Global Emerging Markets Equity Fund. Nick started his career as a graduate trainee at Kleinwort Benson in 1996, where he went on to become an analyst, then portfolio manager in the emerging markets team. In 1999 he joined Rexiter Capital Management as director, head of Latin America. He has over 20 years' experience in emerging markets equity management.

LIZ GIFFORD, CFA **Investment Manager**

Liz joined the company in June 2017 as a portfolio manager in the global emerging markets equity team. Liz started her career at Nomura Asset Management, where she spent five years in total, initially analysing consumer companies, before expanding coverage to include all emerging market regions and sectors. Liz has employed a bottom-up, fundamental approach to investing throughout her career. She became a CFA charterholder in September 2015. Liz graduated from Leeds University with a first-class degree in Spanish and Management.

SALMAN SIDDIQUI, ACA **Investment Manager**

Salman joined the company in June 2017 as a portfolio manager in the global emerging markets equity team. Prior to this he was at Nomura Asset Management from 2007, where he worked as an equity analyst until he was appointed as a portfolio manager in 2009. During his time at Nomura, he took on portfolio management responsibilities for a number of strategies including: the Nomura Arabian Fund, the Nomura Turkey Fund, the Nomura Africa Fund and the Nomura Frontier Fund. He has 20 years' experience, having started his career as a capital markets analyst at Citigroup in 2001. Salman has a degree in Philosophy, Politics & Economics from Oxford University.

LEIGHTON RILEY **Investment Director**

Leighton joined Jupiter in 2016 and was previously an Investment Director on the Value Equities team, having also held various roles at Jupiter including in Product Development and Risk. Leighton started his career in 2010 in the graduate programme at ANZ Bank in New Zealand, working in traded Market Risk. He has degrees in Chemistry and Finance.

Market and exchange rate movements can cause the value of an investment to fall as well as rise, and you may get back less than originally invested.

The views expressed are those of the authors at the time of writing, are not necessarily those of Jupiter as a whole and may be subject to change. This is particularly true during periods of rapidly changing market circumstances. Stock examples are for illustrative purposes only and are not a recommendation to buy or sell.

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