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What Defines Quality?

Fund managers frequently say they like to buy *quality* companies and invest in *quality* management teams. But what rarely follows is an explanation of what *quality* actually means. What are the characteristics that we consider in management and why do we care about investing in such entities?

The idea of investing in quality companies has actually been a core part of many value investors' philosophies for decades. In the book, *The Intelligent Investor*, noted investor and author Benjamin Graham—considered the father of value investing—observes that the greatest losses occur not from buying quality at an excessively high price but by buying low-quality at a price that seems to be a good value. Modern portfolio theory teaches us that investors require additional return for higher risk investments, but empirical evidence on a stock level seems to differ somewhat from this assumption. We frequently witness stocks with similar multiples, but entirely different risk characteristics. Among investors in Asia, there still exists a pervading mentality that growth usurps all other metrics in importance, and those companies exhibiting growth in the near term deserve to trade at higher multiples. Alas, this mentality may work in the short term, but for long-term investors it can be fraught with issues. For example, during time periods such as the Asian Financial Crisis of the late 90s or the more recent Global Financial Crisis, quality stocks held up far better. Further, one must consider how sustainable this growth will be over the long term.

Part of the rationale for our focus on quality, is to gain this additional benefit of possible capital preservation during more volatile times; something that has often been underpriced by the market. This does not, however, mean that we ignore growth, but as investors focusing on some of the highest growth countries in the world, those opportunities are plentiful. We believe that the ultimate risk in investing is loss of capital and a focus on quality allows us to reduce the fundamental risk that can often lead to this.

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Facets to Quality

So what exactly do we mean by "quality"? In our March 2013 issue of Asia Insight "Kicking the Tires," we considered a number of challenges that face investors in Asia when it comes to corporate governance, an area of vital importance in analyzing quality. In that commentary we explored issues such as transparency and ownership structure. But there are many more facets to quality that are worth noting. These include:

- Management teams' incentives
- Track records
- Capital structure
- Return generation/profitability

At Matthews, we spend a lot of time meeting with senior management of listed companies, both within our offices and on the ground throughout Asia. There are a myriad of nuances to keep in mind when traveling across cultures. All too often we hear investors are unimpressed with the more balanced and conservative nature of certain management teams but enthusiastic toward those with ambitious growth plans and polished presentations. Indian management teams in particular tend to get much credit for their smooth ability to sway Western investors as witnessed by what seem like perennially higher valuation multiples. But these intangible facets to management evaluation really have little relevance to understanding the true value of a company and whether it is a quality firm with sustainable growth.

What matters more than charismatic management are their track records and incentivization structures. Whilst history is no doubt an imperfect guide to the future, evaluation of a management team's prior strategic decision-making can prove vital in understanding their mentality. Imperfection is part and parcel of management, mistakes will be made and finding an unblemished record is difficult and arguably should not be sought. However, we do look to understand previous decisions and whether lessons have been learnt from them. For example, one industrial company that we follow has a history of multiple acquisitions in its field. Financial history tells us that acquisitions can often be fraught with difficulty and rarely create value, but in this case, the management team has an impressive track record. Whilst not every acquisition has been instantly successful, the firm has learnt over the years how best to integrate new entities into its sales systems, set the right structures to keep

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key executives and eke out revenue and cost synergies. This management team may not possess the most impressive presentation skills, but its ability to create value speaks for itself through its prior actions and the positive impact on the firm's financial statements.

This goes hand in hand with having the right incentivization structure. Clearly, we need to see management aligned with ourselves as minority shareholders, and compensation is a key part of this. In places like the U.S., we have seen this taken to the extreme where CEO pay is at record highs of 354 times an average worker's salary. This may look like an unpalatable number to many, but it is less the quantum than the methodology that concerns us. A management team that creates shareholder wealth should be well compensated. What we are keen to evaluate is the timescale that this methodology is measured over and whether the measure of shareholder wealth is the right one. We, therefore, do not want to just see short-term earnings per share (EPS) growth targets for the C-Suite as those are easily abused. Smart operators find it straightforward to game or sandbag these often simplistic metrics in order to optimize their pay packages. We want to see relevant key performance indicators that cover items across not only the profit and loss statement, but also the balance sheet and cash flow statements. Further, we like to see these items measured over multiple years to align management with building a business and not focus on raising their share price. Finally, it is important that there is transparency into these metrics as well as into the payment structure (cash vs. stock) for stakeholders.

A strong management team with the right culture should also be reflected within the capital structure that it operates. There are many schools of thought on the importance of capital structure, with Modigliani and Miller's Theorem (M&M) on its "irrelevance" considered a cornerstone by many within corporate finance theory. In my mind, it is just that—theory. M&M claims that a company's value and risk profile is not impacted by the amount of debt that it takes on and, furthermore, that this has no impact on the fundamental profitability of the company, with leverage providing a sole benefit of boosting returns on equity. Whilst there may be theoretical truth in this, many market participants, such as ourselves, view our largest risk as permanent loss of capital. The issue with M&M's theory is that it falls into the trap of many economic models, ignoring practical realities such as information asymmetry, bankruptcy costs, or the need for companies to pay taxes, to name a few. In reality, the characteristics of industries and countries differ and evolve, as do the companies within them, and every situation necessitates evaluation of what an "appropriate" capital structure looks like. Inevitably, we have a preference for low levels of leverage within the companies in which we invest as we concern ourselves with their long-term sustainability, but some are better-placed than others to hold debt.[1] This was phrased well to me recently by the CEO of a regional industrial conglomerate, who commented that his firm "couldn't have financial leverage in those businesses that have operating leverage." The company does have leverage in entities that have more stable cash flows, but they fundamentally disagree with what can be a rather potent combination for potential financial collapse when more difficult economic times inevitably hit. This particular executive also said he was keen to ensure his business "is around in a few generations." This is a sentiment that we ourselves share as long-term investors. It is particularly true for those of us investing across Asia as we operate in more volatile markets, economies and political systems, often with less independent monetary policy decision-making.

In addition to understanding management mentality around financial gearing, we also pay great attention to their attitude toward the allocation of capital. Compensation structures play a key role here as many options are available to companies in how to run and finance their business. This ranges across reinvestment in the business, dividends, share buybacks, balance sheet strengthening and acquisitions. Once more, there is a great degree of subjectivity on what the "right" balance is, but we spend significant time trying to understand the decisions of management. In prior writings we have noted particularly complicated financial shenanigans in parts of the region for which capital is extracted by owners by means other than the dividend. But this is only part of the story. In places like South Korea, the idea of discussing capital allocation with senior management can be tricky. In part, this may be due to a culture where slowing growth is deemed to be dangerous to management positions and unattractive to stakeholders. South Korea also continues to struggle with minority shareholder rights. Frequently, we see companies entering new business ventures with little prior expertise, or pursuing aggressive overseas expansion in order to grow the empire ever further. Although not always entirely without merit, this can frequently lead to poor use of shareholder funds.

1 This is a reflection of the process in our Asia Focus and Asian Growth and Income strategies and not a reflection of a firm-wide process.

“The greater economic growth across the Asian region creates exciting opportunities for companies to enhance profits, but growth at rates of return below a firm’s cost of capital creates no real value for minority shareholders.”

PERSISTENCY OF RETURN ON CAPITAL INVESTED IN ASIA

A sample* of the listed companies from the MSCI AC Asia ex Japan Index was reviewed for Returns on Invested Capital (ROICs). Quartile 1 companies show top ROICs over a three-year period. Nearly half, or 48%, of the companies that demonstrated Quartile 1 performance from 1999 to 2001 maintained this top quartile performance again from 2009 to 2011. This indicates that, to some extent, companies that saw a solid return on capital at the beginning of the decade were able to maintain this performance through several market cycles. In addition, the data reveals some correlation between ROIC and sales growth. Those companies that consistently delivered better returns also demonstrated higher sales growth.

% of Companies Ranked by Quartile		3-Yr Average Return on Invested Capital (2009–2011)				Average Sales Compound Annual Growth Rate (%, 1999–2011)
		Quartile 1	Quartile 2	Quartile 3	Quartile 4	
3-Yr Average Return on Invested Capital (1999–2001)	Quartile 1	48%	23%	16%	13%	14%
	Quartile 2	16%	32%	30%	22%	11%
	Quartile 3	18%	21%	35%	26%	11%
	Quartile 4	17%	26%	20%	37%	7%

*This sample is comprised of 363 companies in the Index for which data was available for both time periods. It is not possible to invest in an index. The rates and returns shown here do not represent or imply Fund performance. Past performance is no guarantee of future results.

Source: FactSet

Of course, having the right management team and capital structure in place is of limited use if a company is not in a position to generate high and sustainable returns. Many economists teach that corporate profit margins in most industries revert to the mean over time as new entrants are attracted to the ability to generate such profits. Again, this may be true in the textbooks, but what we witness in our research is that this is often incorrect. Time and again, we analyze businesses that are able to maintain persistently high returns on capital. Allocation of capital is an integral facet to being able to deliver competitive returns through economic cycles, but ultimately the largest driver is whether a company has a real competitive advantage. This can be derived in many ways, but we can broadly assign them to the following buckets: brand, scale, distribution, technology and intellectual capital.

But why do we care about high returns? Fundamentally, equity markets are driven by corporate profitability. The greater economic growth across the Asian region creates exciting opportunities for companies to enhance profits, but growth at rates of return below a firm’s cost of capital creates no real value for minority shareholders. For example, many Indian infrastructure companies have come to market with grand tales of future emphatic growth, but time and time again, there have been disappointments. Earnings per share may have grown in certain cases, but inevitably at slower rates than expected. Further, low returns on invested capital (ROICs) have often resulted in dilution to minority shareholders as primary offerings for “growth” capital is required on a frequent basis. Of course, the inverse to this is true for high ROIC generators as these have the ability to reinvest in the business as well as pay out dividends and undergo share buybacks as appropriate.

The growth path for much of the Asia Pacific region is an exciting one, but investors need to look at the best way of exploiting such opportunities in their portfolios. This is why we believe active management, and our bottom-up approach to investing, are critical. Whilst there is no additional honor or credit in generating returns from investing in “good” companies rather than “bad,” there does tend to be a mispricing exhibited in the region. Often, we find those companies that we view as long-term picks trading at similar or even lower valuations than the “more exciting,” higher growth companies that may not be able to consistently deliver sustainable growth or weather tougher economic times. We believe that investing in *quality* companies that exhibit such attributes as strong governance standards, the right incentivization structure for management, good track records, an appropriate capital structure and superior return generation, has the potential to yield impressive returns with a lower risk of permanent loss of capital.

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