

## Intermede's Investment Approach



Barry Dargan

Portfolio Manager & CEO

### Executive Summary

- Intermede's investment process is designed to **identify best-in-class companies on a global basis** and then ensure that the shares of these companies are **bought at discounts to intrinsic value**.
- **The investment team employ a rigorous process** to identify companies with a sustainable competitive advantage (a requirement for ownership); confirm that its financial model displays the facets of a best-in-class company; that its management team has strategic vision and are good allocators of capital and that the share price is at a discount to the team's derived intrinsic value of the company.
- **The decision as to whether a company is worthy of ownership is separated from the decision as to whether the company's shares are cheap enough to be bought.** Shares of a best-in-class company that are too expensive to be bought at the time are put on the watchlist and a future entry point is awaited when the market gives the opportunity.
- The investment team recognise that although **the basic fundamental research process framework doesn't change, the opportunity set does**. The ever-evolving global landscape means that new opportunities evolve and threats can emerge even to companies previously impervious to competition. **We aim to continuously improve what we do.**
- **Intermede has a strict definition of what makes a company eligible for inclusion in the portfolio in terms of minimum growth and return criteria.** In order to fully understand the opportunity set, we screen for these minimum growth and return criteria. The screen output shows that the companies that meet the requisite criteria are a small subset of the total universe, consistently approximating 8% of the overall global equity universe. **Intermede therefore owns top decile growth and return companies in its portfolio.**
- Intermede has a **focus on cash flow as a preferred measure of value creation by a company**, as it is largely immune to accounting considerations. The ability to deliver significant cash generation is a key attribute of the companies that Intermede owns, together with little need for the reinvestment of cash in order to grow. One of the valuation hurdles we typically apply is a prospective free cash flow yield which is approximately equal to that of the S&P 500. **Intermede therefore aims to own top decile growth and return companies for a valuation (on a free cash flow basis) no greater than the market average.**
- Our results since inception are consistent with those achieved by Barry Dargan in previous portfolio management roles, namely **annualised outperformance of 5.7% (net of fees) over MSCI ACWI (USD) Index since the strategy's inception on 1st October 2014** (as of 31.12.2020). Our portfolio has also declined less than the benchmark in down months and gone up more than the benchmark in up months on average over the period since inception.
- Intermede has been set-up in a way that **aligns the investment team's interests with those of its clients**, through majority insider ownership. The firm is optimally configured to minimise external distractions so the investment team can focus on company research, with appropriate team size and portfolio concentration.

*At Intermede we believe that high quality, high return companies with good management and strong market positions in attractive industries will outperform if their shares are bought at the right price.*

*Put simply, we invest in companies with demonstrated long term sustainable competitive advantage, that we expect to continue to deliver higher growth and returns than the industry in which they operate and whose stock prices do not fully reflect their long term potential.*

*Our mission is to construct a concentrated portfolio of the best available names within that opportunity set.*

### Evolution of philosophy and firm history

Intermede is the realisation of the founding team's vision to apply their investment approach in an unencumbered form, including appropriate level of portfolio concentration, optimal team size, and minimized distraction from internal bureaucracy and politics.

The two central tenets of Intermede's investment approach are grounded in lessons learned during the team's experience as investors, which spans over 30 years.

First, we employ detailed bottom up analysis to identify a small set of quality growth businesses in possession of defensible competitive advantages to hold for the long term. This emphasis emerged from a pattern observed throughout the team's years in analyst and portfolio management roles in Tokyo, Boston and London. Namely, the consistent long-term outperformance of businesses with strong franchises, even in otherwise tough market conditions, such as those experienced in Japan in the early 1990s post-bubble period. For example in Japan, during the period 1989 to 2012 (22 years) in which the Nikkei 225 fell 74%, only 19 of its constituents gave a positive absolute return, all of which were businesses with the requisite strong franchise we seek.

Secondly, we apply a strict valuation discipline, reflecting our experience of several bubble periods, including pre-1987 market conditions

which preceded the crash of that year, the late 1980s bubble in Japan, covering technology names in Asia in the late 1990s, and the global commodity and real estate bubble in 2006/7. Each of these bubbles was navigated safely, but provided enhanced awareness of the importance of valuation discipline (the absence of which may be the single most dangerous pitfall for a growth oriented investment strategy).

### Why invest this way?

We believe that a focus on identifying individual winners on a bottom-up basis is a rational response to long term equity market arithmetic. Big winners drive overall returns to an extent that is generally underappreciated. For example, recent research by Hendrik Bessembinder<sup>1</sup> has shown that 4% of companies have accounted for 100% of US equity market wealth creation since 1926.

Seeking winners also makes intuitive sense given certain features of today's corporate landscape, across which we observe increasing winner-takes-all dynamics, evidenced by profitability and returns on capital at top firms staying higher for longer<sup>2</sup>, increased corporate concentration<sup>3</sup>, and the ability of cash rich incumbents to purchase upstart challengers.

Long term compounding growth and returns drives a growing store of value that becomes better recognised by the stock market over

<sup>1</sup> <http://csinvesting.org/wp-content/uploads/2017/05/Bessembinder-Do-Stocks-Outperform-Treasury-Bills.pdf>

<sup>2</sup> According to McKinsey, an American firm that was very profitable in 2003 (one with post-tax returns on capital of 15-25%, excl goodwill), has an 83% chance of still being very profitable in 2013. In the previous decade, the odds were about 50%

<sup>3</sup> The number of listed US corporations has fallen by approximately half in the last 20 years according to research by Credit Suisse

time, affording a higher multiple to be placed on the earnings. The strength of the competitive advantage enjoyed by the company is what allows the superior returns and it is this that we must first identify and confirm. The assisted valuation we place on it must then allow upside for the current share price. This combination shows the long-term drive out-performance of our portfolio.

### Intermede's investment process

The nature of our opportunity set is continuously changing. When outlining our investment approach, we therefore find it useful to draw a distinction between its sustainable and evolving features.

Our basic four step process remains the framework for identifying and ensuring that a company has the enduring ability to compound its earnings for the long term and that we are underpaying for the business when we buy it. This four step process framework is:

1. Identify sustainable competitive advantage.
2. Confirm superior business model (check that high and growing returns and cash flow emanating from the advantage identified in step 1 are evident in the financial performance of the company historically).
3. Evaluate management team to identify prudent capital allocators of good character and reputation.
4. Valuation assessment – identifying the boundary of intrinsic value, to ensure we buy substantially below that.

We will look in greater detail at each of these steps in the process in turn. Before this it should be noted that we recognise that although the basic process framework does not change, there are evolving features of our process which include an effort to strive for constant improvement in what we do, and a recognition that we face a shifting opportunity set, driven by technological change and the

emergence of disruptive innovators, which requires vigilance to ensure that we avoid becoming stuck in a static view of what provides a given business with a competitive advantage in its markets.

This accelerating rate of change is made clear by recent shifts in the composition of the upper end of large-cap equity indices. The increasingly dominant role of intangible assets in 21st century business has been reflected in the remarkable rise of big technology firms. In late 2006, only one out of the ten most valuable global companies was a tech firm. At the time of writing in late 2018, it was seven out of ten.

### 1. Identifying sustainable competitive advantage – the qualitative assessment

We need to be able to identify the 'moat' or defensible competitive advantage that will enable the business to repel competition and generate attractive returns on capital for a prolonged period. *Types of moat or competitive advantage we seek include:*

- a. Network effects: characterised by Metcalfe's law, which states that network effects are present if the addition of each incremental user adds value for every other user (Facebook, Google, Alibaba).
- b. Associated with network effects, *possession of user data* is increasingly powerful as an advantage. Prior to the rise of Facebook and Google, in a world where quality content was scarce, anyone could compete. Today, when attention is the scarce commodity, user data plus targeting ability plus ability to provide free, within platform access to other providers' content (and to accompany it with targeted advertising) provides a prohibitive advantage.
- c. Other *intangibles*: software, R&D, brands, manufacturing or process know-how, entertainment content & copyrights, patents.

- d. *High switching costs*: tight integration into customer processes and/or lack of substitutes, can all act as form of lock-in that make it difficult for customers to leave. Ability to raise price consistently can be evidence of these advantages (for example Kerry Group produces hard-to-substitute food ingredients that are integrated into customers’ products).
- e. *Economies of scale*: often closely associated with cost advantage (“low cost provider”) and operating leverage. Here the ideal business can scale revenue and customer base far more rapidly than fixed costs (for example Online broker Charles Schwab is five times larger than its nearest competitor and can onboard new customers at almost zero incremental cost).
- f. *Brands*: the goodwill built-up over years of being in the consumers’ consciousness, providing instant recognition and a guarantee of quality, can remain a powerful way to set one’s product apart.

Beware narrowing moats! We must remain alert to potential erosion of moats – no advantage is ever

permanent. Rapid innovation and cheap and abundant capital make certain incumbent moats ever more vulnerable. One useful thought experiment to test for such vulnerability is to ask ‘*what aspects of this company’s competitive advantage could not be replicated within a year by a competitor with free access to capital?*’.

Billion-dollar brands that once won consumer mindshare by having the most robust advertising budget now face upstart brands with millions of cheaply obtained<sup>4</sup> and highly engaged social media followers, as well as commoditisation of trust through easily accessible online reviews (eg Amazon). Tech companies that built switching cost advantages using legacy systems now need to justify their typically-high prices against Software-as-a-Service (SaaS) alternatives. Industrial distributors that relied on scale-driven cost advantages and sticky relationships are finding their customers more willing to shop and price-compare. Some primary risk for each of the several types of moat we focus on include:

Moat Type	Potential Threat
Network effects	Weakening user engagement; disruptive new networks
Intangibles / brands	Decreasing hold of linear TV advertising on the popular consciousness. Mere heritage is no longer enough – brands must be relevant.
Switching costs	The emergence of ‘good enough’ alternatives at lower price points; a change in the basis of competition can render products / services redundant or obsolete, eliminating customer ‘lock-in’
Scale	Irrational/price-insensitive competitors; shifts in consumer preference
Cost advantages	Emerging technology or changing commodity input costs can erode moats grounded in cost advantage

<sup>4</sup> The humorous Dollar Shave Club promotional video was reportedly produced for \$4,500, and at time of writing has been viewed 25.2m times on YouTube. Dollar Shave Club was purchased by Unilever in 2016 for \$1B.

## 2. Superior business model assessment

A company with an identified sustainable competitive advantage is going to display superior financial performance to one that does not. A deep dive into the historical financial metrics of the company should show that the company has best-in-class margins (compared to peers), resulting high returns on capital and strong cash flow. It would be a surprise to find a situation in which a company evidently has a competitive advantage but fails to display the financial superiority we seek. This would merit further investigation to find the cause. It may be the case that a younger 'challenger' type of company has not yet entrenched its leadership sufficiently to demonstrate the sort of superior returns we expect to find. In this case, we may be prepared to look further ahead, so long as we are confident that these returns and cash flow will come in the near future (within our modelled forecast time frame).

We actively seek companies which require very little capital to grow their business, these capital light businesses will therefore generate significant free cash flow, as they can grow with minimum reinvestment. A low capital employed business model means more return for every dollar of capital invested.

## 3. Management: assessment – character, candour and competence

While we agree with Warren Buffett that good jockeys won't do well on bad horses (meaning that the question of primary importance is always the quality of the business and its long-term ability to achieve profitable growth), the judgement and integrity of the management teams with whom we entrust client capital matters a great deal. Perhaps the main reason this is the case is that firms we favour will typically generate abundant capital internally.

This then requires deployment in the form of reinvestment, buybacks, M&A, dividends or debt repayment, meaning that management's capital allocation ability is a key criterion we must assess when performing our diligence on a potential investment.

We therefore meet with all companies before investing, and favour management teams that display integrity, curiosity and rationality, and present (and adhere to) thoughtful and clearly expressed capital allocation policies. We are looking for managements that are committed to maximizing value for shareholders. We also value frugality, evidence of a clearly thought out long term strategic plan for the business. On occasions, we will follow highly esteemed managers into a new business, as was the case recently when Kaspar Rorsted's move to Adidas, after a successful decade at Henkel, provided a catalyst for positive change.

## 4. Valuation: what we're willing to pay

Valuation is an intriguing challenge for high growth, high return businesses, because the substantial majority of what makes up our estimate of intrinsic value typically resides in the future. A central aspect of the investment case for businesses we own at Intermede is that defensible competitive advantage will allow the firm to earn supernormal profits for a period longer than the current market valuation reflects. We believe it is often the case that the market overvalues the short-term and undervalues the long term. We therefore undertake detailed qualitative assessment of the prospects of each business we cover, writing an in-depth research report, accompanied by a full DCF model. We are also careful to construct DCFs in a manner that is congruent with our investment approach, with an explicit forecast period, followed by a 'fade rate' period, followed by the application of a terminal growth rate.

We also employ basic multiple analysis, examining price to earnings, price to cash flow and EV/EBITDA multiples among other metrics. Free cash flow yield is also a key area of focus, as our strong preference is for portfolio companies to be achieving cash generative growth, rather than mere expansion of accounting profits. It should be noted that the highly free cash generative nature of the investments in our portfolio means that although our portfolio is slightly more expensive than the index we have to beat (MSCI ACWI) on measures such as P/E, EV/EBITDA and P/CF, it is roughly the same as the index on P/FCF, despite the fact that the growth and returns generated by our portfolio are significantly higher than the index.

For the right businesses, we are happy paying a seemingly elevated near-term multiple of earnings, if we are confident that the long-term prospects of the business will 'amortise' this premium. This willingness to 'pay up' for the right business, where long-term growth is being under valued, may be one source of competitive advantage, as many traditional 'value' investors will avoid optically expensive situations where growth businesses are in fact trading far below intrinsic value. That said, we look for a hurdle of a 4% FCF yield on an unlevered prospective basis as one of our valuation guides. We have found that we can find even rapidly growing companies which meet this valuation criteria.

At the end of the day, we recognise that an idea that is smart at one price is stupid at another.

### Addressing the global equity universe: how we identify a set of potentially investible high growth, high return businesses

*Wide reading:* our analysts are sector specialists, and extensive reading of company filings, annual reports / 10Ks, industry journals and

high quality third party research allows us to continually expand our knowledge of potentially investible businesses. We have also found that deep knowledge of a sector often helps foster awareness of emerging trends that can throw up adjacent investment opportunities.

#### *Management meetings / industry conferences:*

It is essential that we meet, and assess the character and judgement of, the individuals that will be responsible for allocating our clients' capital, and for reinvesting the subsequent returns earned on it.

*Screening:* For us, the ideal business is one where we can say with a high degree of certainty that in several years' time, it will be generating substantially more free cash than it is now, while being overseen by a management team that will allocate that capital prudently. Therefore, a sensible starting point is to review the universe of available investments and determine which businesses have achieved this historically.

One tool we employ in our research is therefore a long-term screen that has basic hurdles in terms of long term revenue and earnings growth, and return on equity (and a market cap floor of \$1b to exclude illiquid names). The growth and return hurdles we screen for are the minimum growth and return criteria that we expect any names that we own would deliver annually on average. Namely growth of 5% in revenues, 10% in EPS, RoE of 15% and rising RoE over the most recent 10 year period. This helps us to focus on the elite top decile growth and return names available (on average only 8% of companies have delivered on these metrics) and interestingly, the screen output itself has outperformed the MSCI ACWI over the past 20 years.

### ESG matters

The nature of the type of companies we own means that our portfolio screens well from an ESG point of view. We own innovative com-

panies that are growing their markets, companies with questionable practices or selling harmful products will not have the sustainable advantage we look for. Additionally, we look for business models that are capital light which means most heavy industrial businesses (the most polluting and environmentally questionable) do not meet our criteria for investment. Our focus on excellent management also leads to strong governance credentials in the businesses we wish to own.

To identify companies which may pose an ESG risk, we retain Sustainalytics, a consultant that specialises in this area to screen our portfolio for outliers. If we identify companies which are not meeting our ESG criteria, we will identify the issue and then engage with management to see if it is being addressed. Ultimately our view is that a company with poor ESG credentials will not sustain its advantage in the market place as it will come under ever greater scrutiny.

### Patience

We are patient long term investors, as reflected in our typical three to four year holding period for names in the portfolio. When performing work on an idea, we separate the business analysis from the business valuation assessment. This means we do a lot of work on companies that we ultimately judge to be too expensive to own at the time of doing the work. However, we know at what price we would like to own the shares, using our price target discipline. We are then patient, waiting for the market to give us the opportunity to enter a name at a price that makes sense. This may come about as a result of a poor quarterly announcement, or the sector going out of fashion. We find that a great many of the stocks we own were bought at temporarily discounted prices when an opportunity arose. For example, we bought Alibaba during the 'China growth scare' of summer 2015, below its original IPO price.

At Intermede there is an absence of the pres-

sure, which is invariably present in most investment organisations, for analysts' stocks recommendation idea to be investable in the near term. Instead, the questions, 'Is this a good business?' and 'What is it worth?' are separated to an unusual degree as we perform our work. We believe this clear separation between business analysis and security valuation mitigates the potentially discouraging effect of optically higher near term valuations, thereby allowing us greater freedom to continually accumulate a library of potentially investible ideas.

### Our 'Edge': what are our advantages?

**Analytical:** In combination, a lengthy time horizon (12% turnover in 2019) and unusual levels of patience (which confers the ability to steadily build a library of research on attractive businesses, without pressure for ideas to be immediately actionable) creates an ideal environment for analysts. Experience across multiple market cycles has given us the confidence that if we work consistently to identify the best businesses, inevitable volatility in individual names (the market will always be overreacting on the downside/ upside somewhere) will consistently serve up compelling entry points into these favoured businesses, even in an environment of elevated overall equity valuations

As mentioned earlier, there are many instances where a company hits a speedbump and reports ugly numbers, eliciting a market overreaction, but with minimal-to-no damage to the long-term value of the underlying franchise. We think the extent of this volatility in individual names, even among the largest companies, is underappreciated (we note that, for example, in June 2016 the 52-week average percentage change in price for the 10 largest companies in the S&P500 was just under 50%. Intrinsic value simply does not move

this wildly). Therefore, steady work, allied with patience, and readiness to be greedy when others are fearful, should continue to allow us to add value in the long term.

**Behavioural:** When building our team, we sought the same set of qualities that we look for in company management teams. Namely, humility, intellectual curiosity, and deep understanding of the challenges and pitfalls of long term capital allocation. We feel that we have been successful in creating a low ego team with strong rapport and mutual respect, the founders of which have now worked effectively together across many different market environments.

Having the right people configured in an optimal way with minimal external distractions helps take emotion out of the equation by fostering a respectful culture of debate. This minimises the risk of stock specific discussions getting stuck in entrenched positions (we are always happy to change our minds when the evidence supports it), as well as helping mitigate the numerous behavioural biases that decision-making organisations can be subject to.

**Organisational:** Intermede has been organised to reflect our investment approach in an unencumbered form, including appropriate level of portfolio concentration, optimal team size,

and minimized distraction from internal bureaucracy and politics.

Intermede is therefore structured as a pure investment organisation, meaning that the Portfolio Manager and investment team have limited day to day involvement in business management and marketing, instead being free to spend the substantial majority of their time working to identify high quality growth businesses that would be suitable for Intermede client portfolios at the right price. Intermede's sharply defined and commonly understood investment discipline fosters shared purpose and direction across the team as we pursue these businesses together.

**Alignment of interests with clients':** The firm is majority owned by the investment team, to whom the success of the firm is of paramount importance. We understand that this is only possible if clients enjoy a good outcome to their investments with us.

### What are our results?

The consistent long-term outperformance of MSCI ACWI achieved by the portfolio manager's approach across multiple market cycles and firms has been continued at Intermede, with returns of +5.7% net of fees (annualised) in excess of the MSCI ACWI (USD) Index delivered since the strategy's inception to time of writing (31st December 2020).

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