TD Greystone Asset Management

Finding Great Investments

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Introduction

How can you tell if a company will be likely to profitably grow over time? In our view, return on invested capital ("ROIC") is a good indicator for sustainable growth. We incorporate it into our disciplined bottom-up investment process, which seeks companies that are exhibiting business momentum (i.e. improving their earnings generating capacity over the long term).

In this article, we explore ROIC and how we use it to identify investment opportunities.

ROIC Defined

Rising share prices and good accounting results don't necessarily indicate that a company is fundamentally healthy in the sense of being able to sustain its current performance and to build a profitable business into the future. **Evaluating a company on how it improves its earnings-generating capacity can provide a more robust indication of a company's sustainable growth potential.** It is important to cut through the noise, as the market periodically misprices companies displaying intelligent capital allocation for short-term reasons, creating an opportunity for disciplined investors focused on the longer term.

We define ROIC to be a company's net operating profit after tax divided by its operating assets. We prefer ROIC to other measures such as Return on Assets ("ROA"), which can be skewed by excess cash on a company's balance sheet, and Return on Equity ("ROE"), which can be unreliable when comparing two companies with different capital structures.

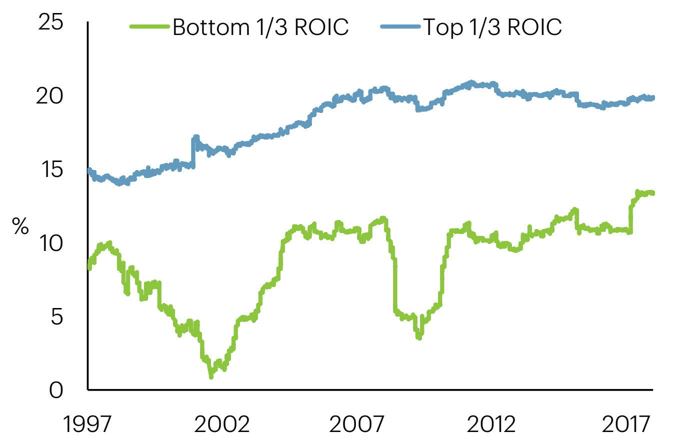
One drawback of ROIC is that it does not typically work well for companies in the financial sector due to operating leverage. Therefore, other measures of profitability should also be used in conjunction with ROIC when examining financial stocks.

However, the market generally rewards companies that can consistently increase returns on invested capital.

How ROIC is Related to Companies' Strengths

Historically, there is a trend for stocks with higher ROIC to have higher and less volatile operating margins versus stocks with lower ROIC (the operating margin compares a company's operating income to sales) (see Figure 1). A stock with a higher operating margin usually has considerable competitive advantages, which translate into a sizeable spread between revenue and operating expenses. Typically, changes in operating margins – positive or negative - are tied directly to management decisions.

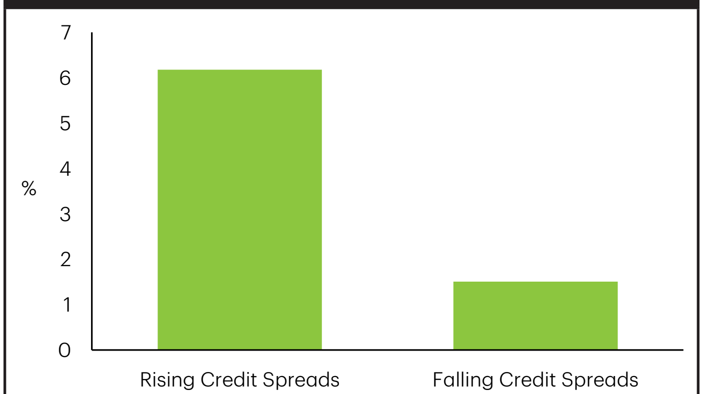
Figure 1: Average EBIT Operation Margin



This analysis segmented the MSCI World into three groups based on ROIC, re-selecting firms each month based on then-current profitability. Average EBIT margin was then calculated for all firms within the top 33% and bottom 33% groups. Time period reviewed December 31, 1997-2018. Source: FactSet, TD Greystone Asset Management.

In addition, high ROIC stocks typically perform best when credit spreads are rising from low levels, during the late cycle and recession phases of the business cycle, and struggle in the early phase of economic recovery (see Figure 2).

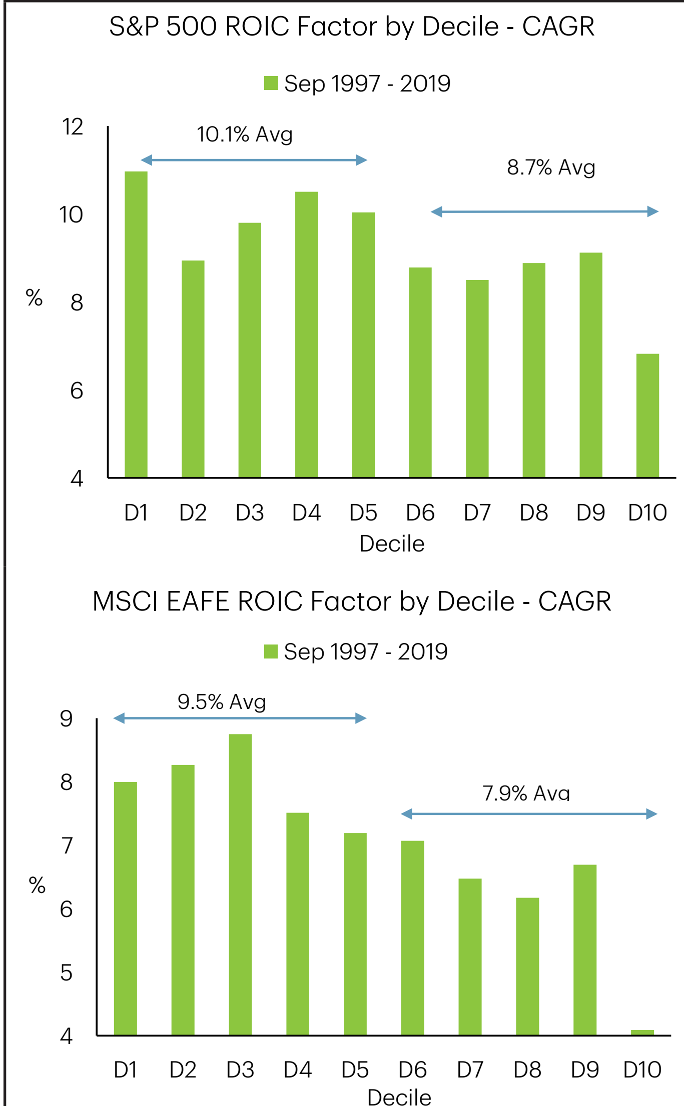
Figure 2: Average Excess Return High ROIC vs S&P 500



This analysis focuses on the behaviour of high ROIC firms relative to the S&P 500 during periods of rising or falling credit spreads. The high ROIC portfolio was re-selected monthly (owning the 10% most profitable firms within the index), and credit spreads were measured using the difference between U.S. AAA corporate yields less the 10 year government bond yield. The time period was September 1990-February 2019. The performance in each instance of rising/falling spreads was then averaged. Source: FactSet, TD Greystone Asset Management.

Generally, historical stock market performance is higher for stocks that are higher in ROIC. When breaking market performance for the S&P 500 and MSCI EAFE benchmarks into deciles by ROIC and examining the returns historically, firms in the top five deciles of ROIC generated stronger performance than firms in the bottom five deciles.

Figure 3: ROIC Performance

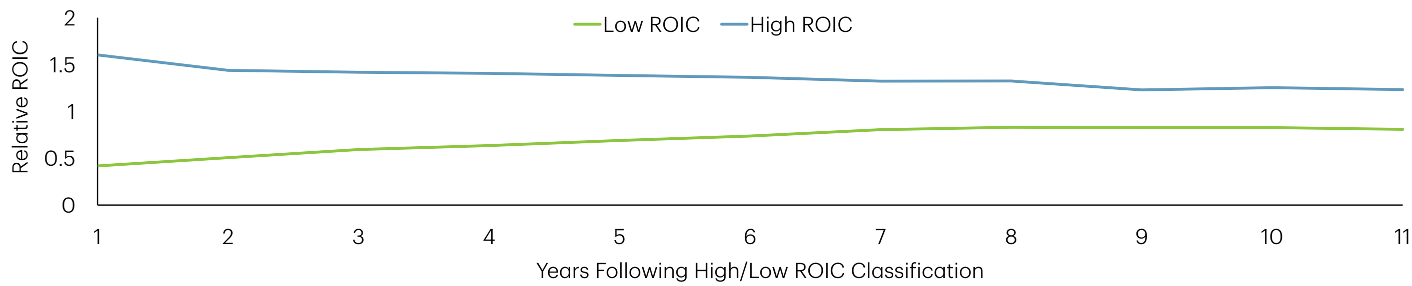


This analysis classifies stocks in the S&P 500 and MSCI EAFE into deciles (10 segments) based on ROIC, and examined the compound annual growth of each decile over the September 1997 - February 2019 time period.
Source: FactSet, TD Greystone Asset Management.

Finally, the ROIC character of a company is relatively stable over time. Although there is an overall general tendency of mean reversion in ROIC of stocks over time, **there is a strong tendency for stocks with higher ROIC to maintain their "profitability premium" for at least 5-10 years vis-à-vis low ROIC stocks.** A study by McKinsey & Company shows evidence of this on the S&P 500, finding that the best performing companies do not revert back to the aggregate median over 15 years, but in general are remarkably capable of sustaining a competitive advantage in their businesses or finding new business where they continue or rebuild such advantages.[1] Thus, ROIC is well-suited as a screening factor for a long-term investor.

[1] Tim Koller, Marck Goedhart, David Wessels, Valuation: Measuring and Managing the Value of Companies, 6th Edition, John Wiley & Sons, 2015 pp.104-105. Study was based on U.S. non-financial companies with revenues greater than $1 billion (inflation adjusted) from 1963 to 2013.

Figure 4: Relative to Base Year



For this analysis, two portfolios were formed each January, from 1990-2013, holding the 10% most profitable (high ROIC) and 10% least profitable (low ROIC) firms within the S&P 500. The average ROIC of each basket was then tracked for up to 10 years, to assess how profitability changed relative to the base year. This resulted in 23 ROIC mean-reversion charts (one for each year), which were then averaged to produce the chart above. The analysis ends in 2013 to ensure that at least six years of data was available for assessing mean-reversion.

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How TD Greystone Asset Management Uses ROIC

The preceding paragraphs explain why we think that stocks higher in ROIC exhibit resilient performance characteristics. We believe our disciplined investment process can identify companies that have a future competitive position that is better than today's stock price implies. Our focus is on companies that are exhibiting business momentum, which may derive from any growth driver that is improving the earnings generating capacity of the business over the long term. Some examples of growth drivers include sales momentum, market share gains, accretive M&As or divesting poor performing assets, EBIT or cash flow improvements, and increasing pricing power.

We look at ROIC in conjunction with historical earnings growth, earnings revisions, and valuation measures. Companies with higher ROICs generally have some fundamental competitive advantage, so we utilize such frameworks as Michael Porter's five forces model[2] to fully evaluate the strength of a company's competitive advantages. We evaluate the power of suppliers, the power of buyers, the degree of industry rivalry, the threat of substitutes and the threat of new entrants. Understanding the competitive positioning that creates the sustainable growth is vital, along with evaluating the quality of the management team and their ability to make capital decisions. Comparing ROICs across similar companies within an industry is particularly useful, as this takes account of the fact that some industries earn returns that are higher than others.

To illustrate our process, an example may be useful. Headquartered in Quanzhou, Anta Sports Products ("Anta") is China's largest domestic sportswear company and was first listed publicly in Hong Kong in 2007. The company is benefitting from macro tailwinds of mass urbanization and the rising salaries of the Chinese consumer, along with their shift to focusing on leisure and fitness. We discussed these macro factors in our recent paper on investing in China.

The company's core product is functional, value for money sporting goods – including footwear, apparel and accessories - for the Chinese domestic market. The company also has a kid's line, which will benefit from the end of the one-child policy. Anta's scale gives it an advantage over domestic peers, because with costs for advertising and research and development being fixed, the company can outspend its peers on brand building and improving its products. The company was the first among domestic peers to solve the problem of high inventories in its distribution channel, and Anta continues to improve on operating efficiency by shortening production lead times and by investing in a logistics centre.

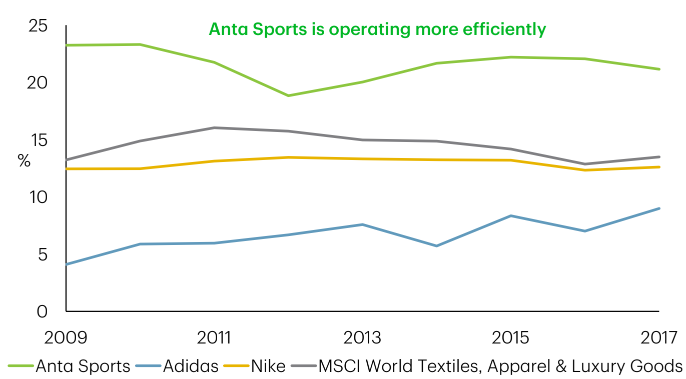
The company management team at Anta has an excellent track record, and has managed to expand market share with the "Single-Focus, Multi-Brand and Omni-Channel" strategy and further launching a globalization strategy in 2018. The company has successfully expanded its product mix, adding to its multi-brands with the licensing of the brand name FILA in 2009; in 2016 with Japan's Descente and Itochu; in 2017 with South Korea's Kolon Sport; and more recently with a 58% stake in a recent acquisition of Amer Sports, a Finish sporting good company with premium

[2] Michael E. Porter, Competitive Strategy Techniques for Analyzing Industries and Competitors, 1998, The Free Press.

brands including Salomon and Arc'teryx. The recent transaction with Amer Sports is expected to be accretive starting in 2019. Since 2009, Anta's market share in the Chinese Sports market has grown from 7.2% to 10.6%, and it is the leading Chinese domestic company and is number three in market share in China, behind global competitors Nike and Adidas.

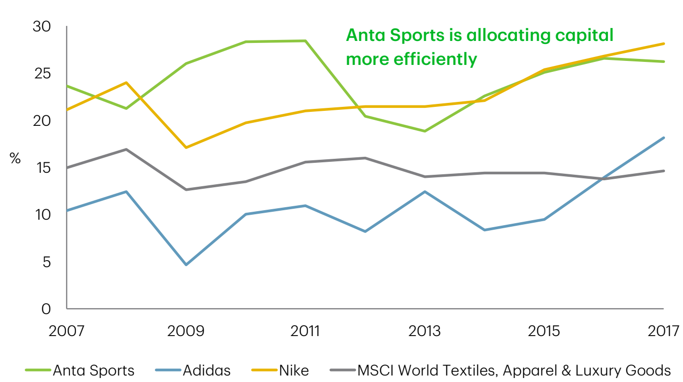
We believe that due to the management team's prudent strategies and effective product positioning, along with its multiple-brand strategy, Anta has effectively maintained a return on invested capital around 20%. Our quantitative screening for high impact growth characteristics initially picked up on this and other attractive growth factors, and our fundamental analysts thoroughly reviewed the earnings growth drivers and the competitiveness of the company in the industry before we made the initial purchase in 2015. Since the purchase, the company has been able to maintain double-digit revenue growth, and the stock has been a strong performer in our foreign equity strategies. In addition, Anta has significant free cash flow and has been able to increase the dividend payout ratio, so the stock is also in our foreign income and growth strategies.

Figure 5: EBIT Operating Margin



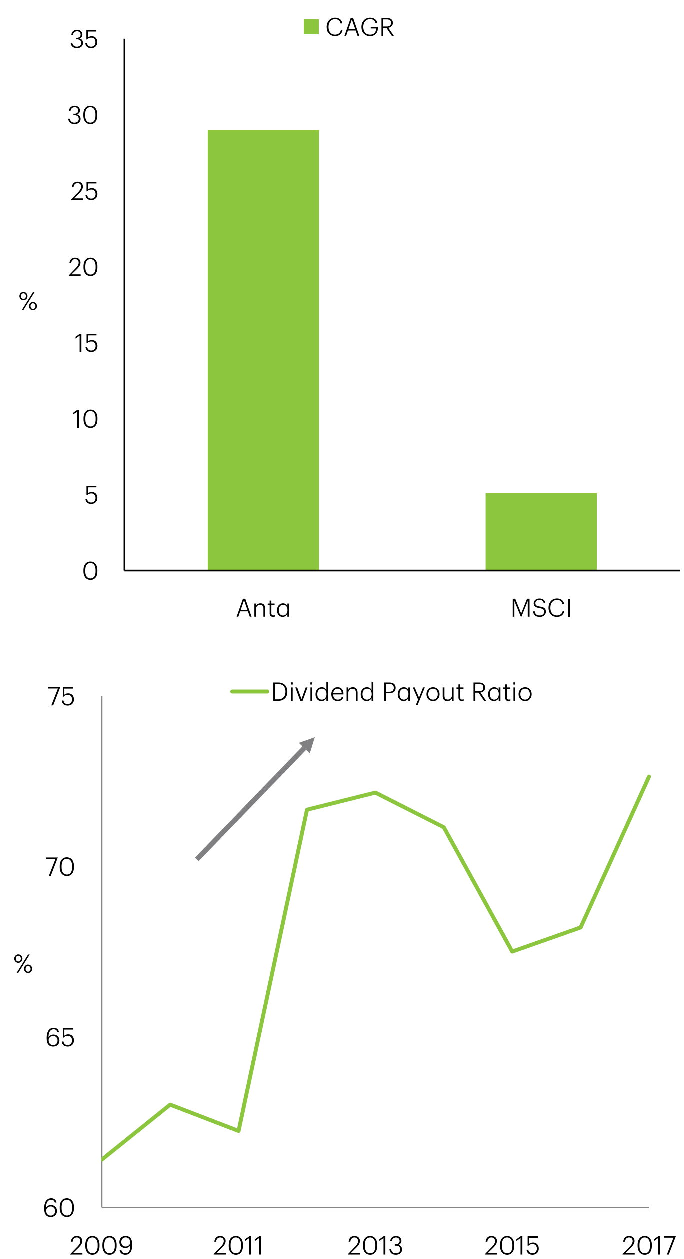
Source: FactSet.

Figure 6: Return on Invested Capital



Source: FactSet.

Figure 7: Anta Sports is Growing Faster than MSCI World



Source: FactSet.

In conclusion, we believe that ROIC is an important growth factor to consider, as it has sound economic rationale and is a good indicator for sustainable growth. We incorporate it along with other factors into our disciplined bottom-up investment process, which seeks companies that are exhibiting business momentum, improving their earnings-generating capacity over the long term. Companies with high ROIC typically have some notable competitive advantages, are able to sustain high ROIC for a period of time, and provide investors with sustainable financial returns.

Growth.

It’s what we do.

Broader offerings. More opportunities.

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