Value Investor INSIGHT
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Long Run

Polen Capital's Todd Morris and Daniel Fields describe how they've translated a successful U.S. strategy overseas, why Europe tends to be fertile ground for the types of companies that interest them, what they took away from a challenging 2022, and why they see unrecognized prospective value today in Siemens Healthineers, Bunzl, Sage Group and Icon Plc.

Polen Capital
Todd Morris, Daniel Fields

Even for top-shelf "compounder" investors like Polen Capital, 2022 was an eye-opener on the risks of investing in high-quality companies. "You started to hear investors talk about how the macro environment didn't matter," says Todd Morris, lead manager of Polen's International Growth strategy. "2022 was a reminder that it does, and can significantly impact valuations of even the best companies."

Having navigated through the cycle well – the $2 billion (assets) International Growth strategy since its 2017 launch has earned a net annualized 8.0%, vs. 6.3% for the MSCI ACWI (ex USA) index – Morris and co-PM Daniel Fields are finding fairly priced compounders today in such areas as distribution, accounting software and outsourced drug trials.

You launched Polen's international strategy seven years ago to replicate the successful strategy employed in the U.S. Have there been any tweaks of note necessary over that time?

Daniel Fields: Honestly, no. It's the exact same philosophy and process of our Focus Growth strategy in the U.S. We invest in 25 to 35 of the highest-quality companies we can find that we can ideally own for a very long time. In narrowing down the universe we have strict parameters we call guardrails: better-than-average organic revenue growth, sustained returns on equity above 20%, balance sheets typically with net cash, stable or growing profit margins, and abundant free cash flow that tends to track with EBITDA. Those five guardrails exclude 90% of the universe. Of our 26 holdings today, 11 have been in the portfolio since inception and the total number of individual companies we've actually owned is less than 45.

There are some nuances when investing outside of the U.S., usually having to do with the political, legal and regulatory environments or the foreign-currency dynamics. With these we're mostly assessing how high the risk is that more macro factors could negate even our best bottom-up work. If that risk is too high, we just won't invest there.

Describe the typical company that interests you, with an example or two you've owned for a long time.

Todd Morris: We obviously want to own companies with what we believe are sustainable competitive advantages. They typically have asset-light business models and have excellent relationships with customers that translate into high levels of repeat business. They're often large companies with broad global franchises and a unique ability to invest in technology and product innovation that separates them from their competition and allows them to deliver more and more value over time to customers.

Accenture [ACN] fits this model well. The business is asset light, with high returns on capital and with an excellent value proposition in delivering IT consulting and implementation services to customers. That engenders high customer loyalty – once Accenture has delivered for you with some aspect of your IT implementation, you're not inclined to look elsewhere and you are inclined to call on them for more work across your enterprise. All of this makes for an enduring growth model that produces a significant amount of cash flow that can continue to be reinvested in the business.

DF: I would reiterate what Todd mentioned about enduring growth. One thing I'd argue that differentiates us from many of our competitors is our focus not just on the magnitude of growth, but also on the stability of that growth. Every business has some cyclicality, but we gravitate to companies like Accenture that can grow the top line at 6% or 7% or 8% consistently. We think that's a better recipe for long-term compounding.

Aon [AON], the insurance broker, would be another good example. Businesses need insurance – increasingly so in many areas – and Aon provides a valuable service in matching specific company needs with the available options and in seeking out the best deals possible. It benefits from multiple scale advantages. It can serve clients on a global basis. Customers come back every year to renew their policies, such that roughly 80% of total revenue is recurring. Given the underlying business and the strength of its competitive position, we believe long-term EPS growth here will be in the mid-teens.

Is the mid-teens a typical expectation for annual earnings growth for your companies today?

DF: The weighted average EPS growth estimate for the international portfolio is currently around 17%, which is more or less where it's been since inception. What is somewhat different today is the gap between our estimated earnings growth and the expectation for our benchmark, the MSCI All Country World Index ex-USA, where the average growth expectation is only 4%. That delta between the expected growth in our portfolio vs. the benchmark is much higher today than it is in our U.S. portfolio.

Polen has traditionally been more valuation-sensitive than many other growth investors. What tends to be going on for something you want to own to be attractively priced?

DF: If you follow a business long enough, something comes up that scares the market. Almost every company we own or want to own will at some point drop 20%, 30% or 40% and it's incumbent upon us to distinguish short-term dislocations from longer-term structural impairment. I'd say 9 times out of 10 we conclude it's a short-term disruption. If we own the stock already we're likely to buy more, and if we don't we try to figure out if it's better than something we already own.

Our strategy allows us somewhat to pay up when the growth and quality of the business warrant it, but it's most likely the case that we believe the valuation at purchase is at least sustainable and we'll benefit as shareholders from the profit growth the business delivers. The portfolio overall has traded in a range of about 17x forward earnings, where it was at the end of 2022, and 21x forward earnings, where it is now. One benefit to our owning only 20 to 30 stocks and turning over 20-25% of the portfolio per year is that we can say "no" a lot whenever the valuation takes us further out on the risk spectrum than we'd like to be.

ON CHINA:

We haven't gone so far as to say it's uninvestable, but there are issues tied to risk that have kept us on the sidelines.

TM: To give a recent example of the market getting scared, we have for years owned Medtronic [MDT], which we think is well positioned as the largest global medical technology company. Going into last year we thought the business had weathered the storm of the prior Covid-impacted years and a case could be made for a reacceleration of growth in both revenue and margins. Then the stock got caught up in the negative narrative around GLP-1 losers and the shares sold off aggressively. We didn't think the business would be at all impaired by GLP-1 adoption, so when the market priced the stock at 13x earnings – its lowest valuation in a decade for a business we believe can still grow EPS at 10%-plus annually – we added to our position in November.

DF: I mentioned Aon earlier. While the rest of the market was going up and up, its stock in December fell sharply after it announced it was acquiring for $13.4 billion a leading middle-market insurance broker called NFP. Though the acquired company complements Aon's current business, the deal is expected to be dilutive to earnings in the near term and that prompted a selloff in the shares. While we continue to assess the merits of the NFP deal, it for now has not changed our long-term view of the company's ability to durably compound earnings, so the shares to us are more attractively priced than they were six or seven weeks ago.

Your portfolio is much heavier in European companies than your benchmark. Is that typical?

TM: We've always been overweight in Europe, which is largely due to the guardrails we've defined around business quality and growth. We also see less risk there from the macro environment than we see elsewhere. Our universe of available companies is just much higher in Europe.

While three years ago you had more than 20% of your portfolio in China-domiciled companies, the number today is zero. Has China become uninvestable for you?

TM: We haven't gone so far as to say that, but there are a number of issues tied to risk that have kept us on the sidelines in China at least for the time being. There are signs of a balance-sheet recession starting to take hold. There's been little progress in repairing relations with the U.S. The biggest non-starter, however, is overreach on the part of the government in going after individual companies and industries. There have been too many examples of companies from one day to the next going from thriving to desperate due to government fiat. That's not a risk we're prepared to take.

With the exception of Lasertec [Tokyo: 6920], a position you added in last year's second quarter, you own no other Japan-based positions. Why is that?

TM: We cover a handful of companies in Japan, but it's not a market overloaded with enduring growth businesses. Lasertec is an interesting exception. It is the dominant global provider of what are called actinic photomask inspection machines, which are often the best way for leading-edge semiconductor manufacturers to inspect the photomasks – which can be thought of like photo negatives – that are used to imprint the smallest features onto the surface of wafers. We'd followed the company for a few years, and when the semiconductor cycle turned down in the latter half of 2022 we stepped up our research on it and took a position in April of last year.

This touches somewhat on how we think about selling, but this is a case where the market in the fourth quarter of last year flipped fairly quickly from pessimism to optimism about the semiconductor cycle. Lastertec's stock was up 70% in the fourth quarter. Our perception now is that 2024 may not be as great as the market expects for the industry, so while we still have a position and we still believe the company can compound EPS by at least 25% annually, the valuation got to a point where we decided to reduce our exposure fairly materially.

You've also reduced your exposure over the past year in long-time favorites LVMH [Paris: MC] and Kering [Paris: KER]. What changed there?

DF: The Covid period was a remarkably good time for luxury-goods companies, which grew at unsustainable rates and because of the operating leverage in the business were able to deliver record margins and profitability. In April of last year China was reopening and luxury-goods stocks traded up even higher, at a time when it was not hard for us to imagine a slowing global economy impacting discretionary spending on luxury goods to a much greater degree than appeared to be priced into the stocks. We weren't assuming anything terrible, but we concluded we should be cutting back our exposure to that risk. So far that's proven to be the right thing to do. We still love the companies and the business models – we'll be paying careful attention over the next year or two to see how the growth and margin story plays out.

You made the case a few years ago [*VII*, August 31, 2020] for Europe-based medical-equipment maker Siemens Healthineers [Frankfurt: SHL], whose business had been hit by the pandemic but you thought had attractive compounding potential. We see you still own it – how has the investment played out so far?

DF: The pandemic impacted the company's business in a variety of ways – negatively as hospitals pulled back on upgrading their equipment and positively as the company sold home diagnostic tests for Covid – which we think has masked somewhat the underlying strength of the business. We expect annual revenue growth to accelerate from 5% or so historically to 6-8%, driven by an expanded product offering creating cross-selling opportunities that will deepen and broaden customer relationships. There's also significant room to increase margins, resulting in what we think is mid-teens annual earnings growth. At today's share price [of €52.30, up 37% from August 2020], we think the valuation today at less than 24x forward earnings is fair, if not a little cheap.

Describe your broader investment case for business-to-business distribution company Bunzl [London: BNZL].

TM: We're fans of distribution business at scale, which can often be quiet compounders. Bunzl was founded in the 1850s and is based in the U.K., with operations in 32 countries around the world. Its specialty is in the distribution of goods generally not for sale to end customers, so it's things like cleaning supplies, cash register tapes, coffee cups and pizza boxes. Their biggest markets are the U.K. and North America and they're expanding particularly in continental Europe and Latin America.

As to the value proposition, the products it delivers are essential to the customers' operations, but even on a consolidated basis make up less than 1% of their total expense burden. Having a supplier who can deliver dozens of products you need when and where you need them saves time and money, and outsourcing here is typically a no-brainer decision. Speaking to the stickiness of the offering, Bunzl has had a distribution relationship with Walmart for more than 30 years. If anybody in the world can source and move goods cheaply, it's Walmart. The fact that it uses the company is a good validation of the value proposition.

How do you see all that translating into enduring growth?

TM: The company has driven consistent double-digit earnings growth over the past few decades on the back of GDP-plus organic growth and a very effectively run mergers and acquisitions program. Since 2004 it has spent almost £5 billion on nearly 200 acquisitions, and the program contributes about two-thirds of the revenue growth the business generates on an ongoing basis. They have a classic advantaged-acquirer business model, where scale allows them synergies – and the ability to pay for those synergies – that others don't have. Even prior to rates going up, private-equity buyers competing for deals couldn't offer what Bunzl could to target companies.

The M&A opportunity is still vast. This type of distribution is extremely fragmented, and outside of grocery in the U.S., Bunzl isn't that penetrated in any one market. They often use acquisitions to establish a beachhead in a market, from which they consistently add new categories of customers, to whom they can distribute an increasingly broad array of products. They maintain relationships with over 1,000 target companies, often local mom-and-pop operations with a local warehouse or two, and make clear that whenever you're ready to retire, call us. They have plenty of balance sheet capacity to continue to make opportunistic acquisitions.

All this translates into high-single-digit annual revenue growth, which we see translating into long-term EPS growth of at least 10%. There's some operating leverage, and the company also benefits from an increasing mix of own-branded products – now just over 25% of sales – on which it earns higher margins. There's a 2% dividend yield as well.

How much are you paying for that growth and yield at today's share price of £32.20?

INVESTMENT SNAPSHOT

Bunzl
(London: BNZL)

Business: Global distributor of primarily not-for-resale supplies to a broad range of companies in the food, hospitality, industrial, construction and healthcare sectors.

Share Information
(@1/30/24, Exchange Rate: $1 = £0.79):

Price	**£32.18**
52-Week Range	£26.80 – £32.68
Dividend Yield	2.0%
Market Cap	£10.80 billion

Financials (TTM):

Revenue	£12.30 billion
Operating Profit Margin	6.3%
Net Profit Margin	4.0%

Valuation Metrics
(@1/30/24):

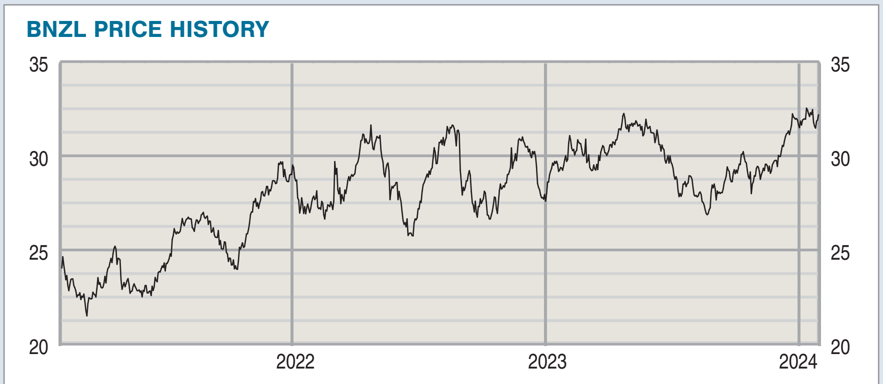
	BNZL	S&P 500
P/E (TTM)	22.1	22.6
Forward P/E (Est.)	17.5	22.0

Largest Institutional Owners
(@9/30/23 or latest filing):

Company	% Owned
BlackRock	7.5%
Mawer Inv Mgmt	5.5%
Capital Research & Mgmt	5.0%
Schroder Inv Mgmt	4.6%
Vanguard Group	4.6%

Short Interest (as of 1/15/24):

Shares Short/Float	n/a



THE BOTTOM LINE

While the market appears concerned over potential price deflation and rising labor costs, neither should impact the longer-term trajectory of the company's business, says Todd Morris. He considers the current valuation of the stock "totally reasonable" and expects to benefit as a shareholder from at least 10% annual EPS growth and a 2% dividend yield.

Sources: Capital IQ, company reports, other publicly available information

TM: The stock currently trades at less than 18x forward earnings, which we consider totally reasonable for a company with this level of consistent growth. With serial-acquirer business models the sell-side is typically unable to give much credit for the continuation of an M&A program, but we think that credit is justified in this case. Even with that reticence, we've often seen the stock historically trade at over 20x earnings.

There are some concerns on the part of investors around entering a more deflationary short-term environment, which wouldn't be a positive for distribution businesses, and also maybe around higher-than-normal wage increases for less-skilled labor. That combination could squeeze Bunzl's margins in the short term, but we don't see either issue impacting the long-term trajectory of the business. If wage increases persist, we would argue that might drive more companies to outsource this type of distribution that aren't doing so currently.

Turning to another U.K.-based business, describe why you're high on the prospects for business-software provider Sage Group [London: SGE].

DF: The company operates in two main categories. The legacy business is in accounting software systems for small businesses in the U.K. and Europe. Intuit [INTU] is the name people know in that business in the U.S., while Sage is the dominant brand in the U.K. and Europe. Through its Sage Intacct division, it's also growing rapidly in business accounting systems for mid-size companies in the U.S. with several hundred to several thousand employees. They are now #2 in that category in the U.S., behind Oracle's NetSuite.

The products are now delivered in the cloud and paid for by subscription, with more than 95% of revenues generated on a recurring basis. As the company transitioned to a SaaS [software-as-a-service] model through the late 2010s and early 2020s, the market sort of ignored the company as it looked optically like growth was slowing and margins were coming down. We actually added to our position over that time and Sage is now our second-largest position. Margins are now beginning to move up, as we've seen with every successful cloud transition, and we also believe revenue growth is beginning to reaccelerate.

What's driving the incremental growth in revenues and margins?

DF: In Europe the small-business category is still growing and Sage is taking share, while the company is also successfully bringing its mid-size-company offerings from the U.S. to Europe. In the U.S., Sage Intacct is growing 30% annually on its own, and the company sees a lot of potential to build out its small-business software offerings here as well.

Even more so with cloud-based applications, customer relationships are very sticky. That enhances cross-selling opportunities for Sage – which has added various new modules for things like payroll, customer relationship management and payments – and should also over time give it more pricing power. The company has also invested heavily in its sales efforts, so can increase sales volume without a commensurate increase in selling costs.

Overall, we see sustainable annual revenue growth in the 10%-plus range and believe operating margins can move from the low-20s up to closer to 30% over the next five years. If we're right, that would translate into high-teens earnings growth over that period.

Is the increasing application of artificial intelligence an issue, pro or con, here?

DF: We think it has the potential to be a positive. The company has been working for some time on productivity-enhancing applications of AI for its products, so we expect it to be a leader rather than follower in implementing those that make sense. Smaller businesses don't really have the ability to do this type of work on their own, so are going to be looking to third-party providers like Sage to do it for them. This isn't something we would bake into our numbers at this point, but it's certainly something to watch.

How are you looking at valuation with the stock at around £11.90?

DF: The market has started to recognize the potential here and the shares trade at more than 30x forward earnings. We wouldn't call that cheap, but we also don't believe it's at all a stretch for a company that can sustainably grow earnings at a high-teens annual rate. The valuation is still at a discount to other similar companies. Intuit trades at 39x forward earnings. Xero Ltd. [Sydney: XRO], which is the market leader with a comparable product mix in Australia, trades at closer to 90x earnings.

Explain why contract research organization Icon [ICLR] warrants being your largest current position.

TM: This is a stock we've owned since the inception of the International Growth strategy in 2017. The company provides outsourced services for the planning, enrollment and execution of clinical trials for biotech, pharmaceutical and medical-device companies around the world. The value proposition is key to understanding the investment case. Speed to market is critical for their customers, and Icon through its scale, network and expertise is able to execute the trial research part of that process for companies more effectively and efficiently than they could do on their own.

So one key growth driver is increased penetration for outsourcing. Roughly half of clinical-trial research today is still handled in-house by the big firms and half is outsourced to players like Icon. We expect outsourcing's share to continue to trend upward toward at least 70% over the next ten years. The company will also benefit from the consistent global increase in medical R&D spending, and it has been a share gainer for years. There are other big competitors – including IQVIA [IQV] and the PPD division of Thermo Fisher Scientific – but scale players that can provide the breadth of coverage Icon can and the capability it has to identify trial subjects and get them enrolled quickly are few and far between.

We think there are two primary issues weighing on the stock today. With the increase in interest rates, venture-capital funding to early-stage biotech companies

INVESTMENT SNAPSHOT

Sage Group
(London: SGE)

Business: Provider of accounting, payroll and enterprise resource planning software mostly to small and mid-size companies located in the United States, U.K. and Europe.

Share Information
(@1/30/24, Exchange Rate: $1 = £0.79):

Price	**£11.93**
52-Week Range	£7.25 – £12.08
Dividend Yield	1.6%
Market Cap	£12.11 billion

Financials (TTM):

Revenue	£2.18 billion
Operating Profit Margin	24.1%
Net Profit Margin	9.7%

Valuation Metrics
(@1/30/24):

	SGE	S&P 500
P/E (TTM)	58.4	22.6
Forward P/E (Est.)	33.1	22.0

Largest Institutional Owners
(@9/30/23 or latest filing):

Company	% Owned
BlackRock	9.3%
Fidelity Mgmt & Research	6.5%
Lindsell Train	5.0%
Vanguard Group	4.6%
Royal London Asset Mgmt	4.0%

Short Interest (as of 1/15/24):

Shares Short/Float	n/a

SGE PRICE HISTORY

THE BOTTOM LINE

After being "sort of ignored" by the market as it transitioned to a SaaS business model, the company is starting to increase margins and its revenue growth is poised to reaccelerate, says Daniel Fields. While not cheap, he considers the shares' current valuation on forward earnings reasonable for a company that can sustainably grow EPS at a high-teens rate.

Sources: Capital IQ, company reports, other publicly available information

INVESTMENT SNAPSHOT

Icon
(Nasdaq: ICLR)

Business: Provider of the outsourced management of regulatory-trial research primarily to pharmaceutical, biotechnology and medical-device companies located worldwide.

Share Information (@1/30/24):

Price	**262.50**
52-Week Range	181.92 – 288.49
Dividend Yield	0.0%
Market Cap	$21.61 billion

Financials (TTM):

Revenue	$8.02 billion
Operating Profit Margin	13.4%
Net Profit Margin	6.4%

Valuation Metrics
(@1/30/24):

	ICLR	S&P 500
P/E (TTM)	42.2	22.6
Forward P/E (Est.)	18.2	22.0

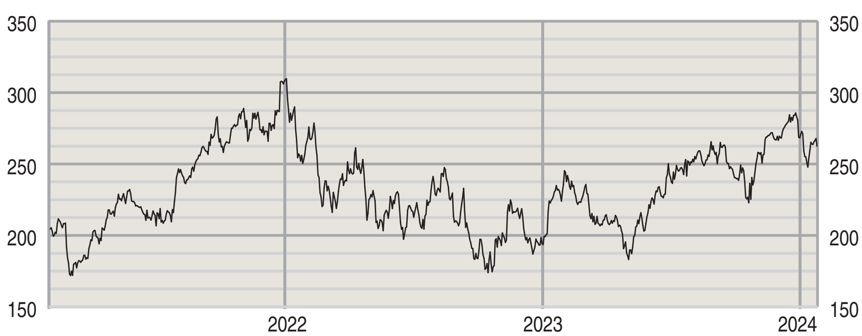
Largest Institutional Owners
(@9/30/23 or latest filing):

Company	% Owned
WCM Inv Mgmt	8.3%
Massachusetts Fin Serv	7.4%
Wellington Mgmt	4.1%
Fidelity Mgmt & Research	3.7%
Lazard Asset Management	3.7%

Short Interest (as of 1/15/24):

Shares Short/Float	2.0%

ICLR PRICE HISTORY



THE BOTTOM LINE

Despite concerns over a short-term slowdown in R&D spending at big and small drug companies alike, the company is well positioned to take share in a strong underlying growth market, says Todd Morris. He considers the stock at 18x forward earnings undervalued for a company he believes can generate long-term EPS growth in the mid-teens.

Sources: Capital IQ, company reports, other publicly available information

has declined materially, resulting in less spending on outsourced drug trials by such companies. While that may continue to be a short-term headwind, early-stage biotech makes up less than 15% of Icon's sales. We'd also argue that the worst of the VC funding cycle has passed and that spending by early-stage companies will recover over time.

Another issue is that some large pharma companies like Pfizer, Icon's largest customer, are going through difficult times of their own and that may impact their R&D spending. We look through that and believe Pfizer's and others' research and trial programs aren't at risk and will, if anything, just be postponed until they work through their internal issues. In that process, we think one result might be the shifting of even more work to efficient and effective outsourcers like Icon.

At today's price of around $262, how attractively priced do you consider the shares?

TM: We expect revenues to grow at a high-single-digit rate, which with continued regular operating leverage and the positive impacts of integrating the 2021 acquisition of PRA Health Sciences and of paying down the debt taken on to buy it, can translate into high-teens earnings growth in the near term and mid-teens growth beyond.

The stock today trades at 18x estimated forward earnings. If we're right about the level of profit growth, the potential shareholder return just from that is quite attractive. But if the company does grow at the rate we think it can, we would not be at all surprised to see the stock trading at a better than 20x multiple over the next few years.

Even with sensitivity to valuation, your strategy and others at Polen had a fairly rough 2022. Any important takeaways from that?

DF: The 13 years following the Great Financial Crisis were favorable to our style of investing. We do care a lot about valuation, but I would say we could have done a better job in recognizing the valuation risk in certain stocks where investors had gotten particularly euphoric, a euphoria that went away very quickly when the cost of capital went up. We haven't changed how we make decisions, but I would say our attention to that type of valuation risk has been heightened.

I'd come back to our emphasis on companies with more-stable growth prospects, some at quite a high level and some less so. Our 10,000-foot view is that there's elevated uncertainty around the current macroeconomic environment and there's a good chance that translates into elevated stock market volatility. At a time when consistent, enduring growth seems to be less well recognized by investors, we think that focus on consistency and stability should serve us relatively well in the environment we see ahead. VII

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Accenture, Aon, Medtronic, Lasertec, LVMH, Kering, Siemens Healthineers, Bunzl, Sage, and ICON Plc are holdings in Polen's International Growth Portfolio as of December 31, 2023. **Polen's International Growth net performance is 27.73% (1 year), 6.26% (5 year) and 8.02% (since inception, January 1, 2017).** Accenture, Aon, LVMH, Siemens Healthineers, and ICON Plc are holdings in Polen's Global Growth Portfolio as of December 31, 2023. Accenture is also a holding in Polen's Focus Growth Portfolio as of December 31, 2023.2023.

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The MSCI ACWI ex USA Index is a market capitalization weighted equity index that measures the performance of large and mid- cap segments across developed and emerging market countries (excluding the U.S). The index is maintained by Morgan Stanley Capital International.

EBITDA is Earnings Before Interest, Taxes, Depreciation, and Amortization. EPS is Earnings Per Share, **a Polen Capital estimate of projected long-term earnings growth rates. Earnings Growth is not a measure of future performance.**

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