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Talking Stocks With Dan Davidowitz and Damon Ficklin of Polen Capital

John Rotonti | April 03, 2018 | Interview , Commentary

This is The Motley Fool's second interview with master quality-growth-at-a-reasonable-price (QGARP) investors Dan Davidowitz and Damon Ficklin from Polen Capital. You can find our first interview here. Polen's processes, people, and culture have contributed to its long-term market-crushing performance, all of which you can read about below. In this interview, we also discuss several holdings in the Polen Focus Growth strategy, including ***Accenture*** *(NYSE: ACN),* ***Adobe*** *(NASDAQ: ADBE),* ***Facebook*** *(NASDAQ: FB),* ***Mastercard*** *(NYSE: MA),* ***Starbucks*** *(NASDAQ: SBUX), and more.*

John Rotonti: Adobe is your largest holding in the Focus Growth strategy. What's your investing thesis and how does it fit within your five guardrails? Also, Adobe's returns on invested capital and returns on equity have been trending up over the last several years -- what is driving this improvement, and do you think Adobe can maintain high returns going forward?

Dan and Damon: Yes, Adobe is currently our largest position at just under 10% of the portfolio. We've owned it twice in our history, most recently since early 2015. Regarding our guardrails, Adobe exceeds all of them handily. It has (1) a cash-rich balance sheet with $4 billion in net cash, (2) annual free cash flow of about $3 billion or roughly a 35% free cash flow margin, (3) a return on equity of over 30% and increasing, (4) operating margins improving rapidly from the mid-20s when we bought it to over 40% today and (5) revenue growth north of 20% annually. We believe the improvements in returns have been driven by a few factors, including the transition to a subscription business model, accelerating revenue growth as the world increasingly needs digital content creation and measurement tools, and leverage on the company's fixed cost base. We see a very bright future for Adobe as their digital media business has very little direct competition and long-term secular growth. The digital marketing business has more competition, but again there are strong secular tailwinds here that should allow for strong revenue growth for years to come. Adobe is the only company that has content creation and marketing measurement tools under the same roof, which is also a competitive advantage.

JR: Facebook has been having a difficult time recently. It is being scrutinized because of (1) news that Russia used Facebook to meddle in the 2016 U.S. presidential election, (2) the proliferation of fake news and violent content, and (3) prominent investors warning that social media is addictive and questioning its utility to society. Facebook is now under renewed scrutiny because it was reported that Cambridge Analytica collected data on 50 million Facebook users without consent. Following the Cambridge incident, Facebook is being investigated by the FTC. What are your views of Facebook's business going forward, its prospects for growth, and its current valuation? At $154, shares are trading at less than 18 times 2019 GAAP EPS estimates (and only 16 times ex-cash). Also, are you satisfied with Facebook's management response to the Cambridge Analytica scandal so far?

D&D: You are correct that Facebook has been under intense scrutiny lately for the reasons you mention, as well as others, like incorrectly calculating engagement metrics for their advertising customers. It is clear that Facebook's platform has been used by rogue governments, hate-speech peddlers, and others for nefarious activity. The company said as much a few quarters ago and committed to huge increases in operating and capital investments to secure the platform. It has also begun to tweak the news feed to have more relevant posts from friends and family prioritized over passive content such as videos. We trimmed our position nearly in half in early January, as we felt that Facebook's revenue growth and margins could be impacted over the next couple of years from these changes. That being said, we also felt that these are necessary investments to position Facebook for a very bright future. The more recent news on Cambridge Analytica is an unequivocal negative for the company. We do feel the company should be doing a lot more to protect their users. Facebook's users are the ones who create the content that makes the platform valuable in the first place, and they must trust the platform or else it opens up the door for a new competitor, so we understand the negative reaction to the stock after this news was made public. We believe Facebook has already made significant changes and today this kind of activity can't happen using Facebook's member data. That being said, we believe Facebook should overdeliver on user protections even if it means sacrificing short-term profits. The company is lucky in that there really is no significant competition today that could wrestle away its users, so it has the luxury of time to fix the problem. It is a little too early to assess any impact on the business, but very preliminary data indicates that user behavior hasn't meaningfully changed recently. The valuation today assumes an extremely negative scenario that we don't expect will occur.

JR: What is your investment thesis on Accenture, and what will drive at least 10% EPS growth over the next several years?

D&D: Accenture has been in our portfolio for more than 10 years now and has compounded earnings at a low-teens rate over that time. We expect about that rate of growth to continue. The company is one of the largest IT consulting companies in the world but only has roughly 4% market share in a $1 trillion market for IT services. The company's bread and butter is large transformation projects on a global basis for the world's largest companies. If you are a Fortune 1000 company, there is a very high likelihood that Accenture lives inside your company every day. They invest well ahead of technology trends to be able to assist companies in streamlining operations and enhancing revenue growth. Today, most large companies are moving workloads to the cloud, positioning services for mobile customers and harnessing the power of AI and data analytics. Accenture's consultants are experts on these areas and have been for many years, and they become independent and trusted resources for their clients. Probably the most telling statistic on the company's competitive advantage is that 70% of its revenue is sole-sourced. This means there is no RFP [request for proposal] or bidding process to win these projects; they go straight to Accenture. The global IT services industry grows at a GDP-like rate or slightly faster. Accenture has been taking market share because of its investments ahead of technology trends and its trusted advisor status, with access to the highest levels of management within its client base. We expect mid- to high-single-digit revenue growth from Accenture over the next five years, with double-digit earnings-per-share growth and a nearly 2% dividend leading to mid-teens investment returns.

JR: In the past two years, Align's [(NASDAQ: ALGN)] **share price has gone supersonic, jumping from about $72 on March 30, 2016, to about $245 today. Has the growth in the company's intrinsic value kept up (pretty much) with the growth in the company's share price? And are shares still reasonably valued, trading at about 42 times 2019 consensus EPS of $5.73?**

D&D: Align's valuation has grown faster than the company's earnings growth, so there is an argument that it has gotten ahead of intrinsic value. But it is important to remember that the company is investing very heavily in its business right now, which is keeping operating margins at 25%, which is well below where we think they will be over time. It is investing in product innovation, closer-to-the-customer manufacturing, and salespeople. These investments all make sense if you subscribe to the idea that Invisalign is a far superior product to brackets and wires being cemented on people's teeth. Imagine if both Invisalign and braces just showed up as new innovations today to treat malocclusions or crooked teeth. Which one would you choose if they both cost the same but only one can fix the smile in half the time, with better oral hygiene and superior aesthetics? Well, that is indeed the case with Invisalign. The only thing keeping brackets and wires in the market, in our view, is that the orthodontists want it that way, either because they make more money or because it allows them to show their inner artisan. That's like a retailer deciding to price products higher than Amazon because it's better for them but not the customer. We think eventually the patients will understand the value of invisible aligners over braces more tangibly as Align goes deeper into direct-to-consumer advertising. So optically the P/E does look high, and it is, but we still believe that Align will be multiples of its current size at maturity and invisible aligners will continue to expand the entire market for malocclusion treatments. We have trimmed our position in Align as we do expect some multiple compression over time but still maintain a roughly 4.5% weighting in our portfolio as our future annualized expected return on Align is still in the double digits.

JR: O'Reilly's (NASDAQ: ORLY) **stock price fell to a low of about $170 in the past year but has recently recovered to about $240. I think there are fears that Amazon** (NASDAQ: AMZN) **could disrupt its business and that electric/autonomous vehicles have fewer parts and will therefore require less maintenance. Another possible risk is that ride-sharing could lead to fewer cars on the road. I think the market thinks there may be more headwinds than tailwinds in O'Reilly's future. Do you think that's the case? How serious of a competitive threat are these risks, and have they changed your long-term investment thesis?**

D&D: Because O'Reilly is categorized as a retailer, it gets lumped in with the Amazon threat pretty easily, but we are not really worried about Amazon here. About half of the company's revenue is selling to professional mechanics on a near real-time basis that Amazon is unlikely to ever penetrate. Not only can O'Reilly meet aggressive delivery targets, but the pro mechanic is also insensitive to price because they just pass the cost on to the end customer. The mechanic wants to get the right part quickly so he can turn his bays over. O'Reilly's unmatched proximity to those customers is a big competitive advantage. The other half of the business is selling to do-it-yourselfers, who presumably could go online. But that thesis isn't exactly accurate. Again, Amazon would have to stock thousands of parts on hundreds of models of cars and decades of model years just to be in the market. Then it would have to get parts to customers quickly even if they don't have Amazon Prime. The average O'Reilly DIY customer has an average household income of $30k-$60k, which means they may not be able to afford Amazon Prime. The DIY customer only comes in to O'Reilly when something breaks on their car; they are not browsing for something interesting. We think of this as "health care for cars." As such, a customer can't wait days or weeks for a free-shipping order to come from Amazon so that they can go back to driving their cars. The Amazon risk just seems unlikely to us. If we did see a marked slowdown in the DIY business at O'Reilly, that would be an indicator that Amazon might be having an impact, but at the moment DIY is growing faster than the pro side. Yes, if electric and autonomous vehicles become large parts of the vehicle fleet, it would be a significant risk, but they currently represent well less than 1% of the cars on the road in the United States and will not be a meaningful percentage for many years based on the production rate of electric vehicles. We think the moderate slowdown that has impacted the aftermarket auto parts sector is for a more boring reason. When vehicles hit 7-10 years old is when they hit the "sweet spot" of needed repairs. Right now, that sweet spot mostly includes new cars sold during the financial crisis and recession of 2008-2009, which is a much smaller cohort than normal. As we move past that cohort in late 2018 and 2019, we expect to see growth rates resume to normal. As we see it, pretty straightforward. We had added to our O'Reilly position at $176/share on the weakness last year.

JR: Has the competitive threat to Visa (NYSE: V) and Mastercard increased with the rapid growth of PayPal (NASDAQ: PYPL) and Square (NYSE: SQ) and the fact that Apple Pay seems to be gaining traction?

D&D: There have been many payment companies that have been established and many large technology companies that have entered the payments space, but none have been able to work around or replicate what Visa and Mastercard do. All have now turned to partnering with Visa and Mastercard. It is extremely, extremely difficult to replicate the merchant acceptance, bank acceptance, cardholder acceptance, speed, security and rules structure that these companies have put in place over the last five decades. It is not to say that there can't be other competitors, just not likely in well-established markets like the United States and Western Europe. We do see China as being essentially off-limits to Visa and Mastercard outside of cross-border transactions, and there is some risk in other emerging markets, like India, that card-based payments may not end up being the default. But even in more mature markets, we believe the runway for growth for debit and credit is wide open.

JR: It seemed as if Visa and Mastercard were very similar businesses until Mastercard acquired VocaLink, a Fast ACH platform that diversified its revenue, increased its market opportunity, and possibly widened its moat by making it a one-stop shop with two sets of rails to process payments. Did Mastercard meaningfully differentiate itself from Visa with the VocaLink acquisition?

D&D: We also believe Mastercard's acquisition of Vocalink was a smart and relatively inexpensive call option on the potential to move business-to-business (B2B) transactions over a digital network. We like the deal but don't expect to see it move the needle anytime soon. Visa has taken a different strategy, which is to essentially try to do B2B transactions over its existing debit network. We will see what happens over the long term. It is difficult to monetize large B2B transactions because they are usually not very time-sensitive and there is little counterparty risk. But B2B volumes are tremendously large, trillions of dollars, so if the payment networks can even get a small number of basis points per transaction, it could be very meaningful.

JR: Does bitcoin or blockchain technology present a long-term risk to Visa and Mastercard?

D&D: We do not believe blockchain represents a material risk to Visa and Mastercard because it doesn't do anything better, faster, or cheaper. Visa today can process up to 65,000 transactions per second. Blockchain can do 10. But even if speed wasn't the issue, a blockchain processor would still have to replicate cards' millions of points of acceptance and earn the trust of banks and spending customers, a non-trivial point. We think blockchain would be much more valuable in other areas. For example, it still takes one to three days to settle stock market trades today. Why not use blockchain technology to make it near real-time?

JR: Starbucks recently lowered its long-term guidance. It now expects revenue growth in the high single digits and EPS growth of at least 12%. Do you think it can achieve these long-term goals, and what excites you the most about the Starbucks story?

D&D: We do believe that Starbucks can achieve high-single-digit revenue growth and mid-teens EPS growth over the long term. Its previous guidance of 15%-20% EPS growth felt like a stretch at the high end and now seems more reasonable in the 12%-17% range. It is also worth remembering that Starbucks has an extremely loyal customer base and many years of growth ahead of it in the United States, Asia, and even in Europe, where there are better competitors. Some of the recent traffic weakness in the United States is likely related to the overall weak retail environment, but we also believe Starbucks has had some execution issues that have impacted traffic in the afternoons and more specifically with the customers that are not part of its rewards program. Management does seem to have a good understanding of how to reaccelerate traffic through a combination of product innovation and new loyalty initiatives. Like many companies, Starbucks has had its share of stumbles over the years, only to return to strong growth on the back of an advantaged business and highly loyal customer base.

JR: **In addition to O'Reilly and Starbucks, you own shares of a third retailer, Dollar General** (NYSE: DG). **Can you give us your quick investment thesis on Dollar General and explain why you think it will be able to thrive in the age of Amazon?**

D&D: Dollar General is essentially the convenience store in rural America. It operates small stores in very sparse populations selling everyday consumable items. You need a very large store base and extremely efficient infrastructure to operate profitably in these markets. In addition, customers tend to have very low annual incomes and need to be able to stretch a dollar. The small number of stock-keeping units of high-need products gives Dollar General excellent negotiating power with large consumer-products companies, and it can pass those savings through to its customers. We see high-single-digit revenue growth and low-double-digit EPS growth for the next five years. Amazon is strong in dense populations but has much more difficulty reaching rural, low-income areas in the United States, and a very low percentage of DG customers are Amazon Prime customers.

JR: Since inception on Jan. 1, 1989, through Dec. 31, 2017 (so creeping up on 30 years), the Polen Focus Growth Strategy has generated gross annualized returns of 14.5% (and annualized returns net of fees of 13.5%) compared with the Russell 1000 and the S&P 500, which have both returned about 10.5% annually. That's a remarkable degree of outperformance that you are providing your investors. What is the secret to your long-term investing success?

D&D: Well, there is no secret. We are very vocal that we only own the very best companies in the world and nothing less, and that by holding those companies for a long time, their earnings growth drives our returns. That's it. That nearly 30-year gross return of 14.5% annually is just a little bit lower than the long-term earnings growth of our portfolio, which is slightly above 15%. The key is to remain long-term focused and disciplined. We don't waiver from what we do because it has worked. Short-termism has been present in capital markets forever because most people would rather try to make $1 today than a little more than $1 tomorrow. That thought process is necessary for highly functioning capital markets, but we don't have to think that way. We think about our clients and how can we best preserve and grow their assets. We think our high hurdles, or guardrails, limit us to only the most competitively advantaged and financially superior companies, and then we do a lot of research to focus our investments on roughly the 20 best that we feel very confident in for the long term. No secrets, just a lot of research and the discipline to keep doing it our way.

JR: What have you found is the primary driver of your portfolio returns over time? Is it revenue growth? EPS growth? Or returns on incremental invested capital?

D&D: The primary driver of our returns has been earnings-per-share growth, but of course strong revenue growth is the primary way that has occurred for our companies. It is important that each company have a big competitive advantage in a large growth market. That allows the revenue to grow without competition and for margins to expand, leading to strong earnings growth.

JR: What does the typical day in the life of an analyst at Polen look like? What percent of their day is spent doing company research? How often do they travel to conferences, investor days, or company meetings?

D&D: A typical day for our investment team involves a lot of reading, not surprisingly. But it also includes a lot of team collaboration. For most of our more interesting ideas, more than one member of the team is likely working on it. Our team is highly trained and skilled on communication and collaboration. We spend a lot of time on it. Our jobs involve making predictions about unknowable things, and to be effective you need to have open and well-established lines of communication to minimize emotion getting in the way. We separate facts and data from opinions and narrative so that we can understand companies better and make better decisions. Our team members spend the vast majority of their time doing research in the office or wherever they feel most productive. We do spend a small amount of time meeting with companies and attending conferences. The team also spends about 10% of its time meeting with clients as well. This is not only important for the client to have access to our team, but it is important for the investment team to have face-to-face client interactions so that there is a personal connection. Maintaining a clear understanding of who we are managing money for and why we do what we do is most important to us.

JR: Does Polen provide the investing team with tools such as Bloomberg terminals, FactSet (NYSE: FDS) workstations, or S&P Global (NYSE: SPGI) Market Intelligence? What about CFROI analysis from HOLT at Credit Suisse?

D&D: Our team does use Factset and Bloomberg for accessing fundamental data. We don't use S&P's various offerings or HOLT.

JR: Polen has been recognized for its great workplace culture, and your investing performance is truly exceptional over a very long period of time. What makes your culture unique, and how do you create an investing environment where analysts can grow and thrive?

D&D: I could talk about this for days, but in short, we have developed a culture at Polen Capital that we think allows us to attract and retain the best talent in order to provide the best client experience. Purpose is in everything that we do for our clients and our community. We believe that if we do the right things for our clients, it will make our business successful and our employees successful. Our mission to "preserve and grow client assets to protect their present and enable their future," as well as our core values of (1) do the right thing, (2) do more than expected, and (3) respect the individual, set the tone. But we also want to be a firm that gives our people autonomy, opportunities for continuous improvement, and purpose. We operate a "Results Only Work Environment" where our senior leaders manage outcomes and results, not people. Our people are free to work from wherever they want and to do their work in the way that best works for them as long as they meet agreed-upon results. This conveys trust among all our employees and has been a big part of what our people love about Polen Capital. We also provide a training budget for all employees to use however they want to make themselves better. Some use it for directly applicable things like industry conferences, while others use it for things like public speaking classes or language classes. The goal here is to help each person achieve mastery in their functions over time. All of these things lead to a workplace that isn't just a place you come to do your job and go home. It hopefully connects each of our employees to the impact that they have on our clients and community in a more tangible way.

JR: Is attracting top investing talent difficult because of competition from other mutual funds, hedge funds, private equity, venture capital, and possibly even Silicon Valley? Or has Polen's brand, performance, and culture made it relatively easy to onboard high-quality, passionate investors?

D&D: Finding the right talent is always difficult and we spend a tremendous amount of time as a firm on it. Our culture and performance have certainly helped in recruiting. One of the other things that has helped is that we are very willing to hire people with little direct experience if we think they possess the right skills to be successful at Polen Capital. We can usually teach people how to do what we do but we can't change who they are. We want people who want to work hard and who want to succeed as our clients succeed. They also need to be team players and to be lifelong learners.

JR: Do you rank your analysts based on how their stock picks perform?

D&D: We don't. It would be hard to compensate analysts based on the stocks they recommend because our returns often accumulate over a long holding period, so when would you reward that? Also, most of our ideas are collaborative with multiple team members contributing. We think it is better to reward the process of research and the intelligence researchers bring to the team's collective knowledge, so bonuses are partly impacted by the quality of the research done and knowledge brought to the team through their research notes, team meetings, etc. The analysts are also compensated on their contributions to the firm's culture and client interactions. So each investment team member has their bonus impacted by research, firm culture, and client impact.

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