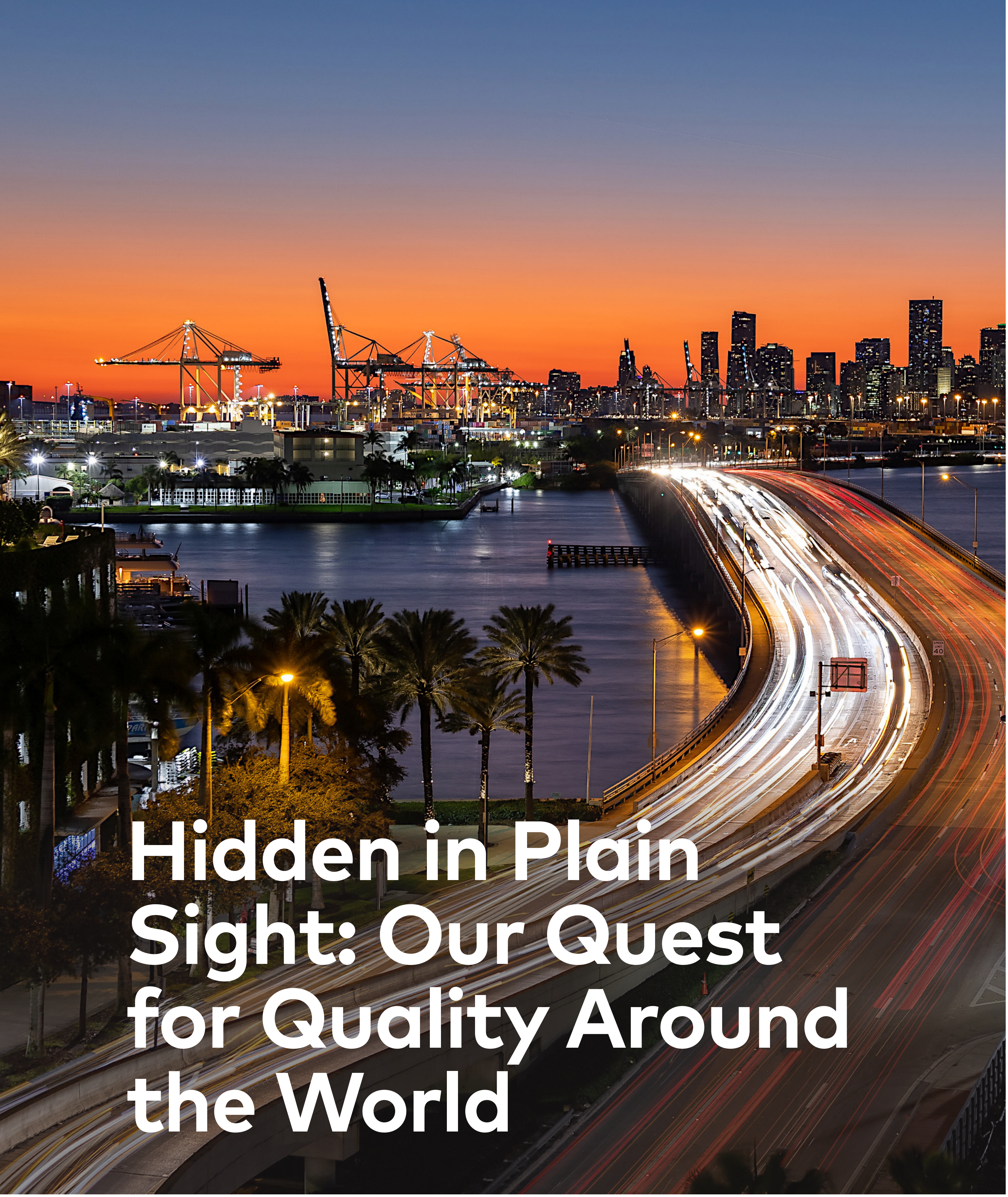
Hidden in Plain Sight: Our Quest for Quality Around the World



polen capital

There are plenty of outstanding businesses outside the United States that we think are simply too good to ignore.

Recently, we highlighted the attractive opportunity we see in international equities.[1] On the back of more than a decade of underperformance relative to the U.S., we believe international now has some notable winds at its back, including cheap absolute and relative valuations and moderating dollar strength.

Regardless of present tailwinds, we believe that investors who either have or are considering an international allocation should take a discerning approach. In a universe where many publicly traded companies offer low returns on capital, low growth, high leverage, and negative free cash flow, we believe it's crucial to narrow in on truly exceptional businesses with characteristics supportive of long-term compounding. In some cases, these businesses operate in specialized segments of the global economy where a U.S.-based equivalent company either doesn't exist or, in our opinion, is significantly inferior.

Here, we offer four examples to illustrate the unique, secular growth opportunities we identify outside the U.S. Their market capitalizations range from $50B to $500B, but it would be a mistake to assume large cap is the exclusive domain of high-quality growth companies. Many small- and SMID-cap companies with dominant market share positions in a given niche or geography have the potential to become the leaders of tomorrow. In some instances, these companies have achieved scale and are broadening their horizons globally. In other cases, they follow a playbook already tested and proven in the U.S., allowing them to achieve scale efficiently.

Across the spectrum of sizes and regions, the common thread we seek is high-quality, unique businesses with a track record of sustainably compounded growth, which in turn can drive robust stock performance.

1 Polen Capital, Opportunity Beyond Borders, April 2023.

ASML: Setting the Standard for Semiconductors

The photo in Figure 1 is an extreme ultraviolet (EUV) lithography machine manufactured by ASML.[2] It weighs 180 tons, requires 20 trucks and three Boeing 747s to ship fully disassembled, and sells for $200 million. With this machine, semiconductor chip companies such as Taiwan Semiconductor can print extremely advanced designs onto wafers that allow chips to be manufactured at leading nodes, now as small as three nanometers. Professor Chris Miller, author of Chip War,[3] has described ASML's machines as "among the most complicated devices ever made."[4]

ASML has spent €6bn over 17 years[5] to develop EUV technology, and according to our research, it is the only company in the world that can do it at this level of sophistication. ASML is headquartered in the Netherlands, making it one of the few globally dominant technology firms based outside the U.S. (O-US).

It's unique businesses like ASML that, in our opinion, offer long-term-oriented managers the opportunity to generate idiosyncratic returns in international markets. This dynamic extends to other industries as well.

ASML EUV Lithography Machine

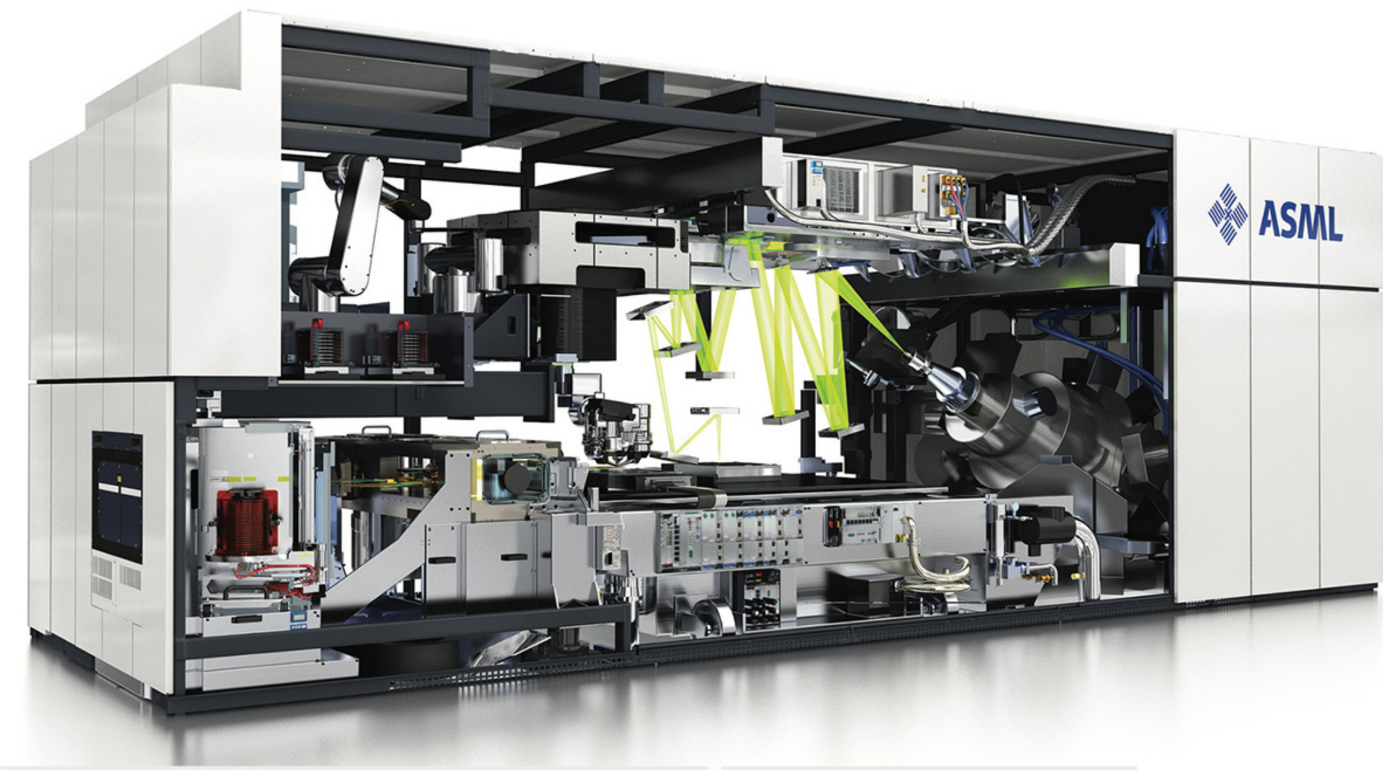


Figure 1

2 ASML is a holding in Polen Capital's International Growth strategy as of March 31, 2023.

3 Chip War: The Fight for the World's Most Critical Technology. We highly recommend this book for those looking to learn more about the evolution of the semiconductor industry.

4 Source: https://www.cnbc.com/2022/03/23/inside-asml-the-company-advanced-chipmakers-use-for-euv-lithography.html

5 Source: Company filings.

LVMH: A Timeless Luxury Leader

One of the finest examples, we think, is luxury goods, where the most iconic brands tend to be based in Western Europe. The region's history of artisan craftsmanship dates back hundreds of years. Among an elite group of companies, LVMH stands out in our eyes.[6] Perhaps best known for its signature handbags, LVMH's most visible brand, Louis Vuitton, was founded in Paris in 1854 as a manufacturer and designer of trunks. The rectangular design (Figure 2) permitted the trunks to be stacked more easily, which was particularly useful for steamship travel. It was an innovation at the time, as most trunks had rounded tops to allow for water run-off.[7]

Louis Vuitton Trunk

Figure 2

The modern incarnation of LVMH was founded and grown through the stewardship of current chairman and CEO Bernard Arnault. If one were compiling a list of the greatest CEOs of all time, we think Arnault's name should be on it. He is the ultimate long-term thinker, cultivating brands for decades. He appears to have recognized long ago that every aspect of a luxury business—from its designs to its craftsmanship to its marketing strategy—must be meticulously nurtured to create a truly timeless brand.

Since Arnault assumed control of LVMH at the beginning of 1989, LVMH stock has generated a 15% annualized total return.[8] We find this particularly impressive given the company sells products that consumers don't really need. The ability of luxury goods companies to "manufacture" demand is perhaps their most compelling value proposition. From our vantage point, the highest quality of these businesses are found only in Western Europe.

Turning now to other regions, we can see other compelling examples of unique businesses.

6 LVMH is a holding in Polen Capital's Global Growth and International Growth strategies as of March 31, 2023.

7 For those curious, the rectangular design did create the potential for water to pool on the top of the trunk. Vuitton solved this problem by creating a lacquer that when applied to the canvas trunk-top made it weatherproof and gave a "leather" look to it. Eventually, this lacquer approach was applied to the company's handbags as well. Today, the "leather" look of LVMH's handbags is actually created by a lacquered canvas with a leather trim.

8 Source: Company filings as of March 31, 2023.

Mercado Libre: An E-Commerce Powerhouse

When discussing the world's best e-commerce and fintech platforms, Argentina-based Mercado Libre's (MELI)[9] name may not come up, but we think it should. While its business model follows in the footsteps of predecessor companies such as Amazon and Alibaba, we view MELI as very much its own creation and an enterprise finely tuned to the Latin American market in which it operates. The company's e-commerce platform continues to thrive and remains the market share leader across its most important markets of Brazil, Argentina, and Mexico. It has succeeded despite competing in a challenging region of the world and sustaining multiple moat attacks from would-be competitors, including Amazon and, more recently, Singapore-based Shopee.

Mercado Libre Delivery

Figure 3

In our opinion, MELI's resilience can be attributed to a management team that thinks in years rather than calendar quarters and has been willing to make the necessary (and sometimes expensive) investments in areas such as installment payments,[10] fulfillment and logistics (Figure 3), consumer credit, off-platform payments, loyalty programs, and advertising.

With these long-term-minded investments, MELI has created a highly unique online business with the proverbial three legs to the stool – e-commerce, fulfillment, and payments/credit – which reinforce each other and strengthen the company's competitive advantages, in our view.

Meanwhile, MELI's competitors are being forced to retrench for various reasons. Brazil-based Americanas, which we estimate is among the top five largest e-commerce vendors in that country, has recently been embroiled in an accounting scandal that has raised serious questions about the company's ability to operate as a going concern. Additionally, Shopee has rationalized some of its investment in the LatAm region, including exiting from Argentina entirely and reducing operations in Mexico, Chile, and Colombia. We view these recent market dynamics as evidence of the challenges that less advantaged or less experienced competitors face in LatAm and it is likely, in our view, that MELI could see its moat strengthen even more. Furthermore, the tech sector in LatAm appears significantly under-invested compared to other regions, which offers the prospect of dramatic value creation if one assumes LatAm can reach similar levels of tech penetration.[11] In such a scenario, we would expect a technology-centric company like MELI to be a significant beneficiary.

9 MELI is a holding in Polen Capital's International and Emerging Markets Growth portfolios as of March 31, 2023.

10 Providing installment payments is an important factor in acquiring e-commerce customers in LatAm, where income levels tend to be lower compared to more developed markets.

11 According to Atlantico's Digital Transformation Report 2022, Latin America's technology value creation "catch-up potential" exceeds $3T, with respect to the penetration levels seen in the United States.

CSL Collection Clinic

Figure 4

CSL: The Business of Blood

Lastly, Australia-based CSL[12] is a company that we think likely flies beneath most investors' radar unless perhaps you have donated plasma at one of their collection clinics (Figure 4). CSL's primary revenue source is the collection and fractionation of blood plasma, which is used to treat a litany of immune-deficiency disorders. Collecting and processing blood plasma is a difficult business, requiring the operation of plasma donation centers (at least 800 in the U.S. alone, according to our estimates) and fractionation facilities to safely separate the plasma from the blood itself.[13]

We estimate these facilities cost approximately $1B to manufacture. This is a long, expensive process with significant regulatory hurdles, as these companies are collecting, shipping, processing, and reselling human blood. Hence, gross margins for this part of CSL's business are generally in the 25% range, not too different from a typical supermarket chain.

On the flip side, the lower margin profile and hefty regulatory oversight deter competitors from entering the market. As a result, CSL operates in a stable global oligopoly with only two other scaled peers.

Importantly, the core blood plasma business allows CSL to create other blood plasma byproducts to sell in more specialized therapeutic markets, such as hemophilia. Compared to CSL's core blood plasma business, these specialized products tend to have very high margins because CSL allocates a large portion of the associated development expenses into its core business. As a result, our research indicates that many of the new treatments that CSL develops are often at nearly 100% incremental margins. CSL's core blood plasma business is also highly cash-generative, allowing it to expand into adjacent market areas such as flu vaccines and renal disease treatment, which are also higher-margin segments than its core business. Thus, total company gross margins for CSL are in the 50-55% range. The combination of high barriers to entry, stable oligopolistic industry structure, and high margin specialty markets makes CSL an attractive O-US franchise in our opinion.

12 CSL is a holding in Polen Capital's International and Global Growth portfolios as of March 31, 2023.

13 For those curious, in the U.S. blood donors are typically not compensated for donating blood; however, plasma donors are compensated. The main reason is that donated blood is typically transfused directly back into a patient. This presents the risk of blood-borne illnesses being transmitted and the FDA does not want to incentivize people with potentially contaminated blood to donate it. Plasma, on the other hand, is not directly transfused back into another person but rather is highly processed and then used for various pharmaceutical treatments. Thus, the risk of contamination with donated plasma is much lower compared to donated blood.

Key Takeaway

We hope these examples help demonstrate our belief that the U.S. does not have a monopoly on high-quality businesses. In some cases, these companies operate in specialized industries without a U.S. equivalent; in others, the companies are so globally dominant that they don't have a true peer with whom to compete. Investors that take an overly U.S.-centric view may miss out on some quality businesses the public markets offer, in our opinion. We believe that high-quality compounders, regardless of where they are found in the world, are attractive components of a well-diversified portfolio.

Going Beyond with Polen Capital

Polen Capital is a team of experienced investment industry professionals who share an unwavering commitment to our clients, investors, community and each other. We have been dedicated to serving investors by providing concentrated portfolios of what we believe are the highest-quality companies for more than three decades. At Polen Capital, we have built a culture of results, and in this, an inherent belief in going beyond what's expected for the people and communities we serve.

We adhere to a time-tested process of researching and analyzing companies around the globe—seeking only the best to build highly concentrated portfolios. Then, we invest for the long haul and with a business owner's mindset—giving these companies time to grow.

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