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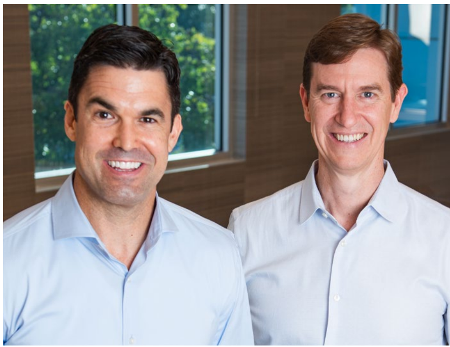
Value Investor INSIGHT

The Leading Authority on Value Investing

Taking the High Road

Polen Capital's Damon Ficklin and Jeff Mueller explain what "guardrails" they rely on in assessing new ideas, what's different about the current market downdraft, what advice they'd give to their 12-months-ago selves, how their strategy goes against human nature, and why they expect L'Oréal, Microsoft, Icon and Visa to be long-term investment winners.

INVESTOR INSIGHT



Polen Capital
Jeff Mueller (*l*), Damon Ficklin (*r*)

Investment Focus: Seek advantaged companies whose stocks trade at prices where they believe shareholder returns will match the growth in underlying earnings.

They are unabashed growth investors, but Damon Ficklin and Jeff Mueller of Polen Capital are also quick to highlight the "don't lose mentality" of the $4.8 billion (assets) Global Growth strategy they co-manage. "Our premise is that investing only in the best companies with long-term staying power improves our chances to deliver outsized returns and minimize risk," says Ficklin.

Since its inception at the beginning of 2015, Polen's Global Growth strategy has earned a net annualized 10.2%, vs. 7.1% for the MSCI All Country World Index. In today's increasingly risk-off market, Mueller and Ficklin are finding the best opportunities in already-owned names, in such areas as payments processing, beauty products, software and clinical-trial outsourcing.

In looking at the best companies in the world you check them against "guardrails" that might figuratively keep them as investments from running off the road. Please describe that.

Damon Ficklin: We believe shareholder returns are driven over time by company earnings growth. So at the highest level we're whittling down the roughly 3,000 businesses in the world with at least $10 billion or so in market cap to companies we think are truly competitively advantaged. As a result of their positions in their industries, they can grow faster than the market, which over the long term drives excess return.

Jeff Mueller: The guardrails are the first step in our process and have been in place since David Polen started Polen Capital in 1989. The overarching goal is to construct a portfolio of roughly 25 of the best businesses globally that in aggregate can compound underlying earnings per share at around 15%. As long as we don't overpay, over time stock appreciation will match the earnings growth of each individual business, which when rolled up to the portfolio level will do the same.

There are five guardrails: strong returns on equity, strong profit margins, abundant free cash flow, real organic revenue growth and strong balance sheets. Any one of those in isolation is a high hurdle, and we think in combination they're particularly potent.

We look for sustained returns on equity of at least 20% – about twice the corporate average through cycles – and for stable to improving profit margins. These two measures can signal competitive advantage. If there isn't something special about your market position, competition will compete your returns and profitability down over time.

The business model matters, so it's important the company produces free cash flow far in excess of what the business needs. That excess capital is then available for making value-creating investments and/or returning cash to shareholders.

The industry context and tailwinds also matter, so we want businesses exhibiting what we believe is sustainable organic revenue growth. We don't invest in companies where 100% of the growth comes from M&A.

We also believe in exceptionally strong balance sheets. There aren't hard and fast rules, but most of our companies have more cash than debt and could pay down their debt in total with free cash flow within two to three years.

These guardrails take the 3,000-business universe down to roughly 350 candidates. From there as we continue our process we're very focused on vetting the sustainability and predictability of the prospective earnings growth. We're sensitive to anything faddish and to total addressable markets. This is an old example, but a company like Crocs at one time might have passed our guardrail test, but for it to generate a long-term mid-teens return for our clients, some too-high percentage of people in the world needed to own at least one pair of Crocs. These businesses may be great investments for a time, but it's hard to be sure how durable their competitive advantages are given the narrow range of products.

We're also looking for consistent and persistent earnings growth through cycles. We concentrate the portfolio heavily in technology, consumer and health care, where we feel we find the highest-quality earnings and more sustainable growth. Historically we haven't invested in the materials and energy sectors because of their cyclicality, or in banks or REITs because they don't pass our debt screens. Companies in those areas tend not to fit a strategy set up to compound client returns at high levels while taking lower risk.

How does valuation come into play?

JM: Ben Graham used to talk about trying to find 50-cent dollars, but we're generally happy if we can find a dollar that is trading for about a dollar. But we expect that to be around $2 in five years, and $4 five years after that. As long as we feel we're buying at a reasonable valuation that is fair for the growth potential we see, we're not trying to micromanage on the price we pay.

DF: It might be helpful to talk about valuation in the context of selling as well. For example, we exited our position in beauty-products company Estée Lauder [EL] about a year ago, almost exclusively due to valuation. When we originally bought the stock, it traded at a low-30s forward multiple, which we thought was reasonable given the positive evolution of the business in recent years.

But as the stock did very well, the forward multiple moved into the mid-40s. At that point we were expecting 13-14% annual earnings growth, but thought a 30x multiple would be more reasonable. Having to build in a haircut on valuation meant that – despite how much we loved the business – we weren't confident we could realize the return on the stock we wanted. When that's the case, we should be looking for ways to put our capital to better use.

JM: One distinction I'd make in our approach to that of some investors targeting growing companies is that we very much focus on clear fundamental evidence of sustainable growth happening today rather than growth that's mostly on the come. One reason we gravitate toward larger companies is that it's hard to find those with the evidenced quality and dominance we're looking for on a global scale at a market cap of less than $10 billion.

Focusing on the quality of company that you do has traditionally protected your portfolio on the downside. Why hasn't that worked as well as usual so far in this year's downdraft?

DF: We've done as well as we have in most historical market periods characterized by pressure or challenge not because we've been tactically positioned for that moment, but because we own businesses that tend to weather pressure or challenge relatively well. What's been different so far in the recent environment has been the presence of meaningful inflation for the first time in more than 30 years. The necessary response from monetary authorities has been to increase interest rates, and long-duration assets – where a lot of the value comes from future growth – bear the brunt of that.

In addition, despite our best efforts to be disciplined and mindful about valuation, multiples in our portfolio were somewhat elevated coming into this year. That quickly has reversed and we'd say today that valuations look very reasonable. The companies in our Global Growth portfolio trade at an average of about 21x forward earnings, which is at the bottom of the range since we launched.

We feel very good on a go-forward basis about what we own, but that hasn't protected us from the correction we've seen in long-duration assets. We can't really control how the market is going to rate these assets at any given time – it could certainly go lower from here – but what we can control is that we're invested in outstanding businesses that are doing a great job for their customers, their partners, their employees and their shareholders. We're confident that will continue to serve us well.

Getting Ahead

They came to investing through different paths – Damon Ficklin early on was a "Warren Buffett junkie," while Jeff Mueller first got interested from reading *The Intelligent Investor* while serving as a Marine in Iraq. They eventually both earned MBAs – Ficklin from the University of Chicago and Mueller from Columbia – and have spent most of their careers at Polen Capital.

Founded in 1979, Polen grew quickly in the 2010s, from roughly $1 billion in assets to nearly $65 billion today. Mueller and Ficklin are quick to credit the firm's culture at least partly for that success. Each employee receives $5,000 per year to spend on any self-improvement effort. Even pre-pandemic, employees could decide when, where and how they worked best. To highlight the beneficiaries of their labors, the firm often hosts at its offices the firefighters, police officers and teachers whose retirement funds it manages.

Ficklin also highlights Polen's emphasis in employee interaction on "radical candor." As he explains: "Think of communication along two dimensions, the extent to which you challenge someone directly and the care with which you do so. If you're being very direct but don't really care for others, then you're kind of just being a jerk. If you care but aren't direct, or you're direct and don't care, you're less likely to get the improvement you want. The only combination that gives everyone the best chance of improving is to be very direct and also to care a lot. Most people are lousy at giving or receiving tough feedback, but that inhibits everyone – from leadership on down, it should go both ways – from getting better. We think we all have to be good at that to keep growing as people, as a firm and as a business."

As the market has corrected – the S&P 500 as of this moment is down more than 23% this year – where have you been particularly active?

DF: In general, we don't think the recent market drawdown has been all that discerning, so that even solidly performing and steady businesses are seeing meaningful share-price pressure. In terms of the actual impact on their businesses, we don't believe most of the companies in our portfolio are particularly exposed to risk from either higher inflation or higher interest rates.

With respect to second-order effects like a slowdown in economic growth, we own secular-growth companies that may see some impact from overall weakness, but we're not too concerned on that front either. Many of them can actually get stronger – buying competitors or stepping on the gas with investment while others are retrenching. These are some of our high-level thesis points – day-to-day we're focused on whether company results are confirming all that or not.

Given that we own what we consider the best businesses already, and that they're down as much as other great companies we don't yet own, we're focusing incrementally more of our attention on our existing portfolio companies than on new ideas. Comparing to what we own is a high benchmark.

Adobe [ADBE] has been a giant winner for you over time, but its shares got slammed two weeks ago when it announced a $20-billion deal to buy a small competitor called Figma. How are you processing that so far?

JM: We've owned Adobe as a firm since 2015 and it passes all of the guardrails by a wide margin. ROE is off the charts. Operating margins have gone from under 20% to 45% and can go higher. Its software tools are the de facto standards for various applications around digital content creation and it also has a highly advantaged digital-marketing business. It produces abundant free cash flow, has high secular organic growth potential and – prior to the announced deal – had $1 billion in net cash.

We're still researching and thinking through the deal, the timing, the price and the rationale. The offer is expensive, and probably reveals that management believes Figma's collaboration platform is a key way design development will evolve in the future, and that they think it's easier to buy than build. That does imply some potential competitive weakness in this area that we, and the market, may not have fully appreciated.

We respect [Adobe Chairman and CEO] Shantanu Narayen's vision and ability to execute, and are inclined to believe he's looking three to five years ahead, as he should, and thinks this is an important strategic move. We wouldn't be surprised in the current antitrust environment if the deal came under some scrutiny. But while there are still questions to be answered and management has some work to do, we at this point believe Adobe still has strong competitive advantages in a big, growing market and that it's likely to remain a good long-term investment from here, with or without Figma.

ON LESSONS:

I would have warned myself of 12 months ago to be very careful in assessing big beneficiaries of the pandemic.

In the past six months you've moved on from two ideas – PayPal [PYPL] and Netflix [NFLX] – that have decidedly fallen out of the market's favor. Can you explain your thinking in each case?

DF: PayPal we first purchased in May of 2020, and the company performed very well as the pandemic seemed to really improve its ability to acquire new customers and to get them to repetitively engage. At the beginning of 2021 management put out long-term guidance calling for very strong ongoing user growth.

Into the third and fourth quarter of last year there were early signs that growth wasn't coming through quite as expected. Then in the first quarter of 2022 management basically walked away from the long-term business plan they laid out less than a year before. The message changed to "Don't worry about user growth, grabbing a lot of users doesn't mean you'll be able to monetize them well." Our conclusion was that they either saw problems bubbling up and weren't particularly direct in letting us know that, or they didn't have a great handle on the underlying metrics and dynamics of the business. Neither of those was a good thing, and we lost confidence in management and its ability to execute.

We still consider the payments space attractive, and PayPal generally serves the more attractive, growthier online and mobile parts of the market. Long term that's a good backdrop – if they can improve execution, the stock certainly could again be interesting to us.

Netflix we didn't come to until later, establishing a small position in the first quarter of this year. One factor here was that they provided new information shortly after we purchased it that really changed our frame of reference. When we took a small initial position in the company they described having 222 million paid subscribers against a total global broadband market – a proxy for the addressable market – that, ex-China, was around 900 million homes. Then when they reported first-quarter earnings, they disclosed they had more than 100 million non-paying users on top of the 222 million paid. So right away they were already more penetrated than we originally thought. They also now said the smart-TV market was likely to be half the size of the broadband market.

So we went from thinking that the untapped global market was from 222 million to 900 million, when it was really more like 322 million to 450 million. When we re-underwrote the investment case factoring that in, this was no longer one of our best ideas.

Another complication here, as it was in the case of PayPal, was how difficult it has been to pinpoint the extent to which companies like these actually benefited from the pandemic, and how much of that

benefit would go away when the pandemic eased. That has proven to be difficult to handicap and we haven't always gotten it right. If I could have given advice to myself 12 months ago, I would have said to be very careful in assessing any company that disproportionately benefited from the pandemic.

Turning to a recent buy, describe why you're high on the long-term prospects for L'Oréal [OR].

JM: We have followed the global cosmetics business for years, as a number of companies like L'Oréal, Estée Lauder, LG H&H [Seoul: 051900] and Shiseido [Tokyo: 4911] began passing our guardrail hurdles in a pretty strong manner.

The beauty "category," if you will, goes back at least to 10,000 B.C., where there's evidence from ancient Egypt that bodily decoration and what today would be considered beauty-related routines were an integral part of hygiene and health. It's deeply ingrained in us to attract mates and procreate – probably as durable a trend as you'll find.

With the advent of movies and television, what's considered beautiful started to morph from being more regionally and culturally specific to being more universal. This accelerated the ability of large, well-capitalized beauty companies to build global brands that promoted beauty ideals that were shared on a global scale. L'Oréal, which was founded in 1909, was at the forefront of that and is today the global beauty-market leader, with a roughly 14% share. It has a very healthy mix between higher-end and more mass-market brands and is well diversified geographically, with roughly equal shares of the business coming from Europe, Asia and North America.

For many consumer packaged goods companies the advent of the Internet has been a challenge, as buying up shelf space and spending big on TV advertising are not the competitive needle-movers they once were. But beauty-market leaders like L'Oréal and Estée Lauder have actually improved their market positions and profitability in this new world, capitalizing on the more direct and interactive lines of communication and closer relationships with customers that the Internet affords. The biggest and oldest brands have accelerated revenue growth. They're expanding market share. Profit margins are increasing. Even in the Internet's more decentralized environment, money talks. L'Oréal spends about 30% of its revenue every year on advertising and promotion, more than €10 billion per year, which is tough to compete with and signals the extent to which it continuously reinvests in the business.

While it's probably easier now for new beauty products to launch, few companies are better than L'Oréal in building and cultivating brands. Almost all of their 36 brands were acquired, and they'd argue the vetting process today for acquisitions is easier when they can more easily gauge customer engagement and affinity with new brands using social media. That takes some of the guesswork out of identifying up-and-coming brands to buy and plug into their global marketing and distribution footprint.

Give a quick guardrail update.

INVESTMENT SNAPSHOT

L'Oréal
(Paris: OR)

Business: Global manufacture, marketing and sale of beauty products; four operating divisions are Consumer Products, Luxe, Professional Products and Active Cosmetics.

Share Information
(@9/29/22, Exchange Rate: $1 = €1.02):

Price	**€323.35**
52-Week Range	€300.45 – €433.65
Dividend Yield	1.5%
Market Cap	€173.55 billion

Financials (TTM):

Revenue	€35.46 billion
Operating Profit Margin	19.5%
Net Profit Margin	15.4%

Valuation Metrics
(@9/29/22):

	OR	S&P 500
P/E (TTM)	32.3	18.1
Forward P/E (Est.)	27.1	16.4

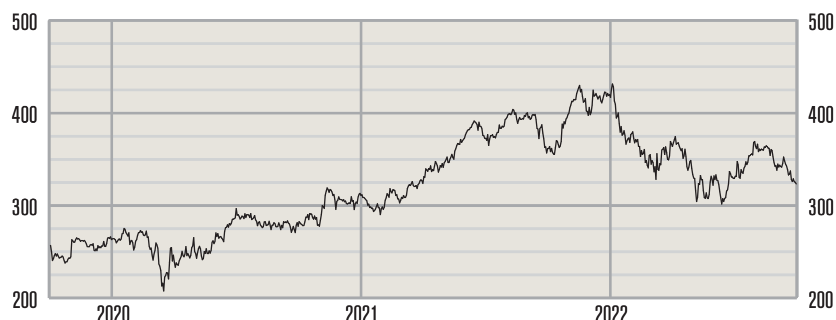
Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
Nestlé	20.1%
BlackRock	1.7%
Vanguard Group	1.6%
Norges Bank Inv Mgmt	1.0%
Amundi Asset Mgmt	0.6%

Short Interest (as of 9/15/22):

Shares Short/Float	n/a

OR PRICE HISTORY



THE BOTTOM LINE

The market doesn't appear to fully recognize the extent to which beauty-market leaders like L'Oréal have capitalized on the direct and interactive relationships with customers that the Internet affords, says Jeff Mueller. From today's valuation, he believes shareholder returns will match the 10-15% annual EPS growth he expects over the next several years.

Sources: Company reports, other publicly available information

JM: Returns on invested capital are around 30%. Operating margins, now about 19%, are stable to improving. The balance sheet is rock solid and the business is highly free-cash-flow generative. There's consistent organic revenue growth, driven by things like rising disposable incomes, aging populations, increased consumption of skincare products, and more spending by males.

With the shares down more than 20% this year, at today's price of around €323 how do you see potential growth here translating into shareholder return?

JM: This is not at the high end of our portfolio in terms of growth potential, but we believe earnings are likely to grow at a fairly consistent 10-15% annual rate over the next several years. We consider the valuation pretty normal – the 27x forward earnings multiple is a bit below the trailing 10-year average – so we think the earnings growth should translate into shareholder return.

Given the current economic and market environments, there's also a defensive aspect to this we appreciate. The industry has been recession-resistant, growing right through the 2008-2009 financial crisis, for example. We also like that L'Oréal has a large mass-market business, which has historically served as a net to capture people trading down in the event of an economic slowdown.

Even mighty Microsoft [MSFT] hasn't been immune to the market's recent travails. Describe how it fits your profile of a great business.

JM: Nearly every company in every industry today is searching for ways to become more digital, do more with less, and connect with their employees in a hybrid environment. There is arguably no company better positioned than Microsoft to help companies around the world with all of those goals.

The business has three strong segments: Productivity and Business, where Office 365 and LinkedIn are; Intelligent Cloud, which includes server products and Azure cloud services; and More Personal Computing, which is Windows, Surface computers, gaming and a few other things. Intelligent Cloud is roughly 40% of the business with the rest evenly split between the other two segments. Profitability across the board is high – high-40s operating margins for Productivity, mid-40s for Intelligent Cloud, and roughly 35% for More Personal Computing.

What's particularly noteworthy about Microsoft is how much the company has evolved over the past 10 years. I'll highlight just a few of the biggest changes and how important they are to the company's positioning going forward.

Transitioning the Office 365 suite of products to subscriptions and making it available on mobile devices has materially expanded its total addressable market, and the company has been very smart about offering different product versions for different customers. They're great at giving you a good-enough solution to mostly accomplish your goals, but there's also usually an incremental upgrade that isn't much more expensive but superior to what you have right now. For example, they have an anti-malware product called

INVESTMENT SNAPSHOT

Microsoft
(Nasdaq: MSFT)

Business: Provider of software, hardware and services through three operating segments: Productivity and Business Services, Intelligent Cloud and More Personal Computing.

Share Information (@9/29/22):

Price	**237.50**
52-Week Range	234.41 – 349.67
Dividend Yield	1.1%
Market Cap	$1.77 trillion

Financials (TTM):

Revenue	$198.27 billion
Operating Profit Margin	42.0%
Net Profit Margin	36.7%

Valuation Metrics
(@9/29/22):

	MSFT	S&P 500
P/E (TTM)	24.6	18.1
Forward P/E (Est.)	19.9	16.4

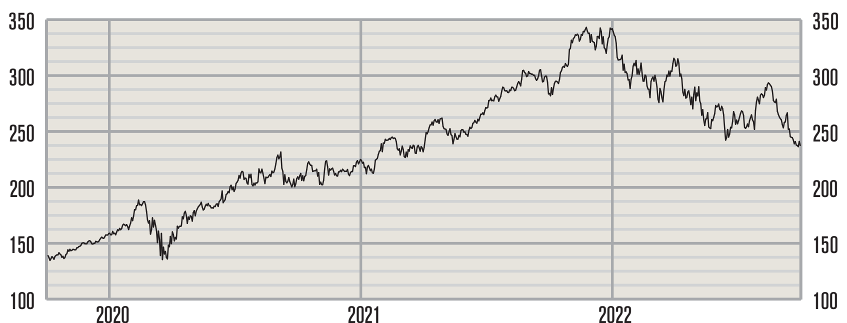
Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
Vanguard Group	8.4%
BlackRock	7.0%
State Street	3.9%
Capital Research & Mgmt	3.6%
T. Rowe Price	2.6%

Short Interest (as of 9/15/22):

Shares Short/Float	0.6%

MSFT PRICE HISTORY



THE BOTTOM LINE

There is arguably no company better positioned to enable customers to become more digital, do more with less, and connect with their employees in a hybrid environment, says Jeff Mueller. Given the pullback in the stock's valuation, he believes shareholder returns over the next five years can at least match his estimate of 15% annual growth in EPS.

Sources: Company reports, other publicly available information

Defender that's included in a premium version of Office 365. It's a perfectly fine security tool, but you might not have gone with it if that's all you were looking for. As part of an inexpensive upgrade, however, you're happy to have it. It's a small example, but multiplied over and over again speaks to the power of the company's installed base.

When Google created its Google Docs product in 2005, people thought it might be a real challenge to Office. It was cloud-native, free and enabled real-time collaboration with a theoretically unlimited number of users anywhere in the world. Now 17 years later, we estimate that Google Docs' dollar market share has topped out at around 10% and they haven't gotten much traction at all with large companies and enterprises. This was a frontal competitive attack by one of the most innovative and well-capitalized companies in the world and the impact on Office has been minimal. That shows how entrenched it is.

I'd also mention LinkedIn, which Microsoft acquired in 2016. It accounts for maybe 5% of the company's total sales, but it's a unique asset with run-rate annual revenue of over $10 billion, which has been compounding at around 30% per year. It has powerful network effects and has established itself without a close peer as the place for companies to access passive job seekers at scale. This is differentiated from active job seekers, who are typically unemployed, less desirable and found on other sites like Monster.com or Indeed. LinkedIn's value proposition is also highly desirable versus a more direct alternative like hiring a recruiter who has far less access to qualified candidates and charges 30-40% of the hiree's first-year cash compensation.

Most people by now would have spoken about the many virtues of the Azure cloud-services business.

JM: We don't, but we could make the investment case for Microsoft more or less on Azure alone. Through network effects, trust and capital requirements, the cloud-services industry has fairly quickly consolidated with a winners-take-most dynamic. The three hyper-scalers – Azure, Amazon Web Services and Google Cloud – have entrenched themselves as the primary market leaders, without a real #4 other than maybe Oracle or Alibaba's AliCloud in China. The amount of capital required to compete with them is now in the tens of billions of dollars per year and we can't even price what it would cost to gain the trust of the largest governments and companies in the world who hold their most precious data in the top-three's datacenters.

ON VALUING GROWTH:

We focus much more on clear evidence of sustainable growth today than on growth that's mostly on the come.

People know cloud services is a great business for these companies, but many are understandably starting to ask, "How long does it last?" We've spent a lot of time on that and are confident the answer is "a very long time." One input to that is the sheer amount of data expansion going on today. In 2020 there were roughly 50 zettabytes of digital data in the world. That's up from 2.7 zettabytes in 2012 and IDC forecasts that it's going to 175 zettabytes in 2025. [The number of bytes in a zettabyte starts with a 1, followed by 21 zeros.] This is happening because of the continued expansion of the Internet and huge advancements in data types and data collection. For example, there are up to 50 billion sensors now connected to the Internet accumulating data that needs to be stored and analyzed. Numbers like that are growing exponentially with no sign of decelerating.

We also believe we're still in the early innings in terms of public and private cloud penetration. Well over half of today's data still resides in on-premise solutions. The three hyper-scalers currently account for roughly two-thirds of the world's cloud infrastructure, which we also believe will become more concentrated as those transitioning to the cloud in even greater percentages opt for the big three. To give a sense of the scale and pace, in the past 12 months the big three collectively generated over $140 billion in revenue, growing over 30% a year. Azure in that period grew even faster, at 46%, which was almost 50% above the rate of AWS. Given its growth profile, as the commercial cloud becomes a larger piece of Microsoft overall, it's likely to accelerate total revenue growth.

At a recent $237.50, the company's shares are off nearly 33% from their 52-week high. How are you looking at upside from today's level?

JM: We expect at least low-double-digit annual revenue growth, margin expansion from scale efficiencies, and the impact of share repurchases to result in at least 15% earnings-per-share growth over the next five years. Given the durability of high growth beyond that, we don't expect multiple compression from today's free-cash-flow multiple in the low-20s. This is a roughly 6% position for us, reflecting our conviction in the business, the company and its management.

From software to clinical trials, explain your investment case for Icon PLC [ICLR].

DF: This isn't a household name like some of the companies we've been talking about, but it's the largest pure-play Clinical Research Organization [CRO] in the world. Clinical trials are obviously a critical part of the drug-development process, and CROs provide such services on an outsourced basis to everything from big pharma companies to emerging biotechs. Roughly half of clinical-trial research today is handled in-house and half is outsourced to players like Icon.

Right around the time last summer when we added our Icon position, it was closing on a $12 billion deal to acquire a competing company called PRA Health

Sciences. The industry has been consolidating and we thought it was the right move at the right time to establish the company as a market leader. It's the biggest pure-play, with competitors of similar scale that are part of Lab Corp. of America, Thermo Fisher Scientific and IQVIA Holdings. Icon was historically stronger in big pharma, while PRA was strong in mid-size to small biotech. Now the mix is roughly 50/50 between those two.

There are multiple positive things happening. The underlying growth in clinical-trial spending isn't high, but it grows nicely and steadily as populations age and the rewards for successful clinical breakthroughs remain attractive. The share of trial work that is outsourced has also been steadily increasing over time. This is happening in a number of industries, where companies are concluding that if something isn't your core competency, someone with the competency and scale will likely do it better and cheaper than you can.

Scale advantages in the business are increasing. A majority of trials now have some element that is decentralized, with technology enabling tests to be run in multiple domestic locations and increasingly off-site in people's homes. More data can be tracked and collected in real time. The bigger players have the resources in place to facilitate all that, while others don't. Scale also means you have greater access to patients across a number of domains, whether oncology, heart disease or something like depression – a plus particularly for the large pharmaceutical companies. A big player is also likely to have geographic breadth that's critical for running simultaneous trials in multiple jurisdictions. Icon is a leader, but it probably still only has 10% market share – we think its scale will help it increase that number meaningfully over time.

How does Icon fare on the guardrail front?

DF: This is one where we're looking beyond some short-term impacts, mostly from the PRA acquisition. For example, the company has consistently earned 20%-plus ROE, but right after the acquisition it's fallen a bit short of that. Leverage today is over 3x net debt to EBITDA, a bit higher than we typically like. Margins fell somewhat in the immediate aftermath of the acquisition, as Icon was more profitable than PRA. In all these cases, however, we believe any shortfalls to the guardrails are temporary and the result of making what we consider a strategic and smart acquisition.

The stock hasn't held up as well in the latest turmoil as one might imagine given the company's business. How attractive is it at today's $184 price?

DF: It appears the market is concerned that declines in biotech funding from record levels in 2020 will be an issue. We're hard pressed to figure out anything else investors would be concerned about. We know this type of spending can go up and down somewhat, but Icon's mix of big pharma versus small biotech strikes us as an offset the market isn't fully contemplating. I'd also mention that despite the fact the stock is down 40% this year, up to this point there's been no real tangible evidence of a pullback from any part of their customer base.

INVESTMENT SNAPSHOT

Icon PLC
(Nasdaq: ICLR)

Business: Global provider of full-service outsourced clinical research services for pharmaceutical, biotechnology, medical-device and government-sponsored customers.

Share Information (@9/29/22):

Price	**184.02**
52-Week Range	179.75 – 313.00
Dividend Yield	0.0%
Market Cap	$15.00 billion

Financials (TTM):

Revenue	$7.59 billion
Operating Profit Margin	8.8%
Net Profit Margin	2.8%

Valuation Metrics
(@9/29/22):

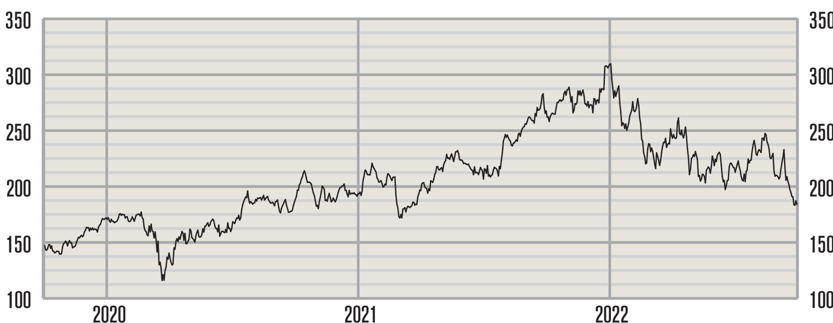
	ICLR	S&P 500
P/E (TTM)	73.1	18.1
Forward P/E (Est.)	14.0	16.4

Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
Massachusetts Fin Serv	9.8%
WCM Inv Mgmt	7.9%
Wellington Mgmt	5.1%
Boston Partners	3.6%
American Century Inv Mgmt	3.4%

Short Interest (as of 9/15/22):

Shares Short/Float	2.0%



THE BOTTOM LINE

The company is well positioned as a market leader in a secular-growth business to take market share and further capitalize on increasing scale advantages, says Damon Ficklin. He considers the stock's less than 15x forward multiple to be "more than reasonable" for a business he believes can generate mid- to high-teen earnings growth in coming years.

Sources: Company reports, other publicly available information

The shares today trade at less than 15x forward earnings. We think that's more than reasonable for a business positioned to deliver mid- to high-teens earnings per share growth in the coming years.

Visa [V] also seems to have lost some of its cachet with the market. Why do you think that's misguided?

DF: Visa needs no introduction – it and Mastercard [MA] are the two scale global payments-processing networks. To your point, there does seem to be a lot going on here, but we'd argue our story for the company is really the same as it has been for at least the past 10 years.

When it comes to consumer-to-merchant payments, it's hard to imagine anyone offering all constituents any more value than Visa and Mastercard do. Small transactions are processed across millions of end points. Functionality of the network is extremely high. You hear about the all-in expense a merchant might pay to enable a consumer to use a credit card, but the vast majority of those economics go to the intermediary bank rather than Visa, whose take is quite small. Replicating or improving on what they do seems almost impossible.

When you hear about the threat of cryptocurrencies or of things like "buy now, pay later," they seem to us similar to what people worried about years ago with Apple Pay, or with the Google browser storing your bank information so you could pay for things online without a credit card, or how PayPal would allow you to do the same thing. The reality has been that when any new fintech solution reaches a certain scale they have a big decision on whether to spend the time and money to connect all the same dots Visa and Mastercard have connected, or just decide to partner with them instead. That's what Apple, Google and PayPal did.

The biggest risk to the existing networks is account-to-account payments – somehow connect bank-to-bank without using the platform. An example would be something like a PayPal wallet funded by a bank account. There are new real-time platforms in some countries that can be used to circumvent Visa or Mastercard. I don't want to overly downplay any of this, but we generally see these things taking away some incremental opportunity rather than derailing the companies' core consumer-to-merchant payments business. It's just really hard to do that any better.

I should also mention that the company is making considerable effort to look at other forms of payment processing beyond just consumer to merchant. Things like peer to peer and merchant to consumer. Some of these markets are very big and while Visa won't be as dominant in them, we think it could have success that would make a difference.

Are the traditional underlying industry tailwinds for Visa still intact?

DF: Yes. Personal consumer expenditures globally grow at a mid-single-digit rate. On top of that the company benefits from the continued share gain for credit and debit cards over payment by cash or check. The penetration of card payments today is just north of 50% globally and while no one thinks that goes to 100%, there's still a lot of growth potential from

INVESTMENT SNAPSHOT

Visa
(NYSE: V)

Business: Operates a global network connecting consumers, merchants and financial institutions to facilitate the authorization, clearing and settlement of payment transactions.

Share Information (@9/29/22):

Price	**180.06**
52-Week Range	174.83 – 236.96
Dividend Yield	0.8%
Market Cap	$372.51 billion

Financials (TTM):

Revenue	$28.08 billion
Operating Profit Margin	67.5%
Net Profit Margin	52.0%

Valuation Metrics
(@9/29/22):

	V	S&P 500
P/E (TTM)	28.1	18.1
Forward P/E (Est.)	21.4	16.4

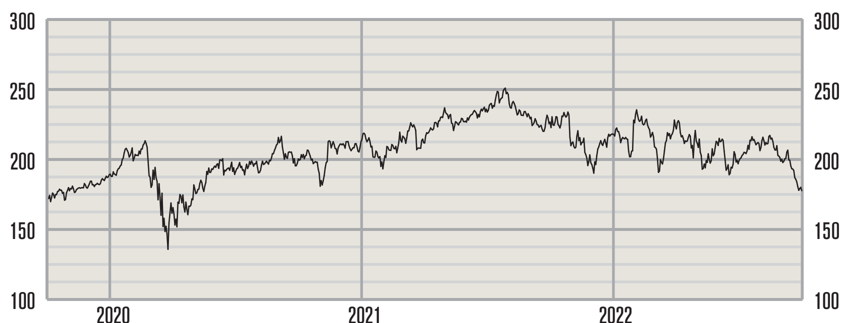
Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
Vanguard Group	7.0%
BlackRock	6.0%
State Street	3.4%
T. Rowe Price	2.5%
Fidelity Mgmt & Research	2.1%

Short Interest (as of 9/15/22):

Shares Short/Float	2.8%

V PRICE HISTORY



THE BOTTOM LINE

Despite concerns about competitive disruption, Damon Ficklin argues that "our story for the company is really the same as it has been for at least the past 10 years" – leading to his estimate for it to deliver mid-teens or better earnings per share growth for many years. Given that, he considers the current 21x forward earnings multiple "not at all aggressive."

Sources: Company reports, other publicly available information

it going to 65% to 70%. Given that the marginal cost of their processing one more transaction is almost literally zero, volume growth is highly profitable. That's why Visa has 60%-plus operating margins and they're still going up.

One actual headwind that we consider temporary is the slowdown in cross-border transactions as pandemic lockdowns stifled travel. As countries and geographies fully reopen that's already going away, but that has contributed we think to some of the negativity on the stock.

At today's price of $180, how inexpensive do you consider the shares?

DF: The stock trades today at about 21x consensus forward earnings estimates, on earnings that due to cross-border issues are still slightly depressed. Given that when we roll it all up we think the company still has many years of solid earnings per share growth in the mid-teens or better, that to our mind is not at all an aggressive valuation.

Your basic strategy is reminiscent of Akre Capital's Chuck Akre [*VII*, December 30, 2020], who in trouncing the market over a long period always made it sound so simple: Buy great companies, don't pay too much for them, and let them compound value. Why is that so much harder than it sounds?

JM: Yeah I know, that's all it takes, right? It sounds simple. In fact, it is simple, but not easy. You obviously have to be right about great companies staying great – which is not an easy task – but I think the hardest part is having the patience to let their underlying earnings compound and let the stocks follow the earnings growth over long periods of time. People want to hit it big right away and go after shiny objects that are ever-present in the industry. It's very difficult to execute our strategy day after day in a disciplined fashion without getting distracted by all that. A lot of what we do goes against human nature, which we hope means the opportunity for us will always be there. VII

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