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Through the Quality Looking Glass

Identifying “quality” businesses is a primary filter for defining Mar Vista’s investible universe of durable growth franchises. However, traditional quantitative measures of “quality,” such as returns on equity, earnings stability or balance sheet leverage, may mask the beauty of many attractive businesses. In fact, some truly exceptional businesses can appear as low quality, low returning businesses if the analyst takes the accounting numbers at face value and fails to dig deeper into economic reality. In our opinion, focusing on these traditional metrics overlooks the true drivers of quality: improving returns on capital, expanding free cash flow generation and growing per share intrinsic value.

Rather than rely on quantitative screens, our investment team uses *qualitative* filters to identify a durable growth franchise:

- Does it possess multiple competitive advantages that can keep competition at bay?
- Does it generate copious amounts of free cash flow?
- Are there opportunities to reinvest the excess capital at attractive returns on capital?
- Does management view their primary role as deploying capital to maximize long-term per share intrinsic value?

Even a business that passes these filters with flying colors may not necessarily see a consistently higher progression in profitability. Near-term financial results can be skewed by capital allocation priorities, competitive strategies and non-economic accounting requirements, each of which may pressure the perceived profitability, stability and capital intensity of the company.

Capital allocation decisions have enormous influence on the quality, growth and value of a business. Over ten years, the CEO of a business that generates and reinvests 10% returns on equity will be responsible for more than 60% of all the capital ever deployed in the business. Understanding management’s strategy and its impact on financials is an important role of any analyst in interpreting economic reality. Below are a few examples of how smart capital allocation and accounting standards can skew financial results and mask true value creation:

- *“Cannibals” may have negative book value*

Serial acquirers of their own undervalued stock may end up returning more capital to shareholders than earnings accumulated in book value. Such companies, which include Mettler Toledo, TransDigm and Starbucks, report negative shareholder equity on their balance sheets. For almost two decades, Mettler Toledo has consistently repurchased their own stock while TransDigm has skillfully used share repurchases, special dividends and leverage to reduce shareholders’ invested capital. Starbucks has also been an aggressive acquirer of its own undervalued stock in recent years. Metrics using shareholder equity for these types of businesses are unlikely to screen “quality,” however a business that can reduce invested capital while still growing operating profit is truly exceptional.

- *Acquisition strategies often dampen current returns on capital*

Acquisitions often dampen near-term returns on capital for the acquiror, but as long as the incremental long-term returns exceed the cost of the capital deployed, shareholder value is expanded. Serial acquirers, like Roper and Danaher, may show inferior return on invested capital (“ROIC”) relative to mature, less capital-intensive businesses like Pepsi or Johnson & Johnson, but if Roper can deploy 20% more capital per year in acquisitions that will generate 15-20% returns over time, intrinsic value growth will likely compound strongly.

- *Reinvestments to expand the size and duration of competitive advantages can pressure near-term margins and returns*

Some management teams are willing to endure reduced near-term profitability to invest in attractive projects that will accelerate long-term growth or expand the economic moat of their business. Amazon exemplifies a company which screens poorly on conventional valuation and quality metrics that do not encompass its long-term earnings power. Amazon’s management team allocates capital to maximize free cash flow per share, prioritizing the present

value of future cash flows over the optimization of GAAP accounting. The company's ability to expend enormous sums of capital over multiple decades has produced insurmountable competitive advantages in e-commerce, logistics, cloud computing, and advertising. Evaluating Amazon's investment quality on existing financial metrics fails to consider the inherent operating leverage in its flywheel. Amazon is poised for an extended period of excess economic returns with profit growth outpacing investment spend. As the company's profits and free cash flows accelerate, a significant improvement in its margin profile is likely, making GAAP financial metrics far less challenging than they may first appear.

- *Non-economic accounting requirements can increase earnings volatility*

While earnings stability can be a hallmark of a stalwart business, some outstanding businesses have hugely volatile earnings due to accounting standards. Berkshire Hathaway, arguably one of the highest-quality businesses in the last half century, reports wildly fluctuating quarterly earnings as their \$350 billion equity portfolio is marked-to-market through the P&L every quarter. Earnings have ranged from a massive \$50 billion loss in 1Q 2020 to a \$36 billion gain in 2Q 2023, but Berkshire's underlying economics and earnings power march steadily on. Trying to apply those traditional quality metrics to Berkshire would not uncover the steadiness and power of the compounding model. Other businesses with high non-cash expenses, like American Tower and Amazon, can also have widely varying quarterly earnings.

- *Use of leverage doesn't mean lower quality or higher risk*

Some businesses, such as TransDigm and American Tower, can appropriately use low-cost debt for certain types of highly defensive and cash flow generative models. American Tower has more than 70% of domestic revenues contracted over the next three years. Even in deep recessions, cellular service carriers are likely to pay their tower lease on time and keep their wireless network operating. Similarly, TransDigm enjoys staple-like after-market demand proven over many economic cycles.

MVIP's Quality Metrics

With the short-comings of traditional quality metrics, we offer a few key metrics that we think are more indicative of MVIP's quality criteria. While whittling down a complex and nuanced framework into a few key quantitative metrics fails to give a complete picture, it should, on average and over time, provide a fair snapshot of our portfolio's quality.

We highlight these three metrics to assess quality:

- *Improvement in returns on capital over five years*

Ultimately, a business creates value when its return on capital exceeds the cost of capital deployed. While economic returns can vary widely, from an asset-light software company like Adobe with 90%+ ROIC or an industrial gas producer like Air Products with 10% ROIC, expanding long-term profits per dollar of invested capital is a sure sign of value creation. Our average improvement in ROIC for the portfolio is expected to expand from 21% to 32% over the next five years fueled by strong expected returns, particularly in our software/digital economy positions.

- *Free cash flow margins*

Defined as operating cash flow less capital expenditures divided by revenue, free cash flow margins provide a second marker of excess capital generated after adjustments for non-cash expenses, working capital requirements and capital investments. Generally, competitively advantaged businesses should show expanding operating margins via pricing power and unit growth, and more productive use of capital over time. Our portfolio averages 21% margins with a wide range depending on the sector and the various investment cycles.

- *Per share intrinsic value growth*

The ultimate arbiter of quality is a business' ability to generate durable shareholder wealth over extended periods of time. We previously highlighted the importance of competitive advantages, organic reinvestment opportunities and capital deployment strategies, all of which are the key drivers of per share intrinsic value growth. Our current portfolio average for per share intrinsic value growth is estimated at 13%, which we believe correlates with long-term expected equity returns and additional alpha-generation from discounted stock prices.

The chart below shows MVIP's Strategic Growth portfolio as of 9/30/23 with the traditional quality metrics, with adjustments to the averages to account for the outliers, and our own key metrics highlighted above.

			TRADITIONAL METRICS					KEY M/VP QUALITY METRICS				
			EPS Grow th		P/E		ROE	Net Debt/	Est. ROIC	Est. ROIC	FCF Margin	Est. IV
			2023	2024	2023	2024	2023	EBITDA	2023	2028	2023	5yr CAGR
Materials												
APD	Air Products and Chemicals, Inc.		11%	12%	24.7	22.2	18%	1.7	12%	16%	-8%	11%
LIN	Linde plc		14%	9%	27.8	25.5	31%	1.2	15%	18%	16%	12%
Industrials												
FTV	Fortive Corp.		8%	8%	19.3	17.8	12%	1.3	10%	13%	23%	11%
GXO	GXO Logistics Inc		-9%	21%	20.9	17.3	11%	5.1	30%	30%	3%	15%
HON	Honeywell International Inc.		5%	9%	20.6	18.9	35%	1.4	17%	15%	11%	8%
HEI	HEICO Corporation		14%	19%	54.5	45.9	13%	0.7	11%	15%	15%	13%
ROP	Roper Technologies, Inc.		17%	10%	29.9	27.2	10%	2.6	9%	16%	36%	14%
TDG	TransDigm Group Incorporated		40%	21%	32.9	27.1	-78%	5.1	12%	18%	18%	15%
VLTO	Veralto Corporation		16%	11%	23.1	21.6	35%	1.8	20%	25%	5%	13%
Discretionary												
AMZN	Amazon.com, Inc.		-1062%	35%	53.0	39.3	16%	0.9	13%	28%	6%	18%
NKE	NIKE, Inc. Class B		2%	17%	29.9	25.7	43%	0.5	26%	38%	11%	13%
SBUX	Starbucks Corporation		18%	15%	27.2	23.6	-46%	2.9	26%	40%	11%	13%
Communication Services												
DIS	Walt Disney Company		10%	26%	21.6	17.2	7%	2.4	5%	10%	8%	13%
GOOG	Alphabet Inc. Class C		26%	16%	22.6	19.5	27%		31%	42%	26%	13%
Staples												
PEP	PepsiCo, Inc.		11%	8%	22.1	20.5	55%	2.1	17%	24%	9%	10%
REITs												
AMT	American Tower Corporation		5%	21%	47.3	39.1	45%	5.1	9%	17%	40%	11%
Financials												
BRK.B	Berkshire Hathaway Inc. Class B		20%	6%	20.9	19.8	7%		12%	15%	6%	10%
MCO	Moody's Corporation		17%	12%	32.5	29.0	56%	2.0	21%	31%	30%	13%
MKL	Markel Group Inc.		-371%	18%	18.0	15.2	8%		12%	15%	17%	11%
V	Visa Inc. Class A		16%	13%	26.9	23.8	50%		30%	50%	54%	13%
Healthcare												
JNJ	Johnson & Johnson		-1%	7%	14.9	13.9	36%	0.2	20%	23%	27%	8%
DHR	Danaher Corporation		-13%	-5%	23.5	24.8	13%	1.3	11%	15%	31%	13%
MTD	Mettler-Toledo International Inc.		2%	6%	24.5	23.0	-804%	1.6	35%	40%	20%	13%
Technology												
AAPL	Apple Inc.		2%	7%	28.2	26.3	201%	0.4	74%	144%	27%	8%
ADBE	Adobe Incorporated		16%	13%	34.8	30.7	45%		41%	92%	42%	15%
APH	Amphenol Corporation Class A		-2%	9%	28.1	25.8	23%	0.9	18%	23%	18%	16%
CRM	Salesforce, Inc.		50%	19%	26.6	22.4	13%	0.1	13%	41%	23%	14%
INTU	Intuit Inc.		18%	14%	32.4	28.4	24%	0.5	19%	37%	33%	14%
MCHP	Microchip Technology Incorporated		7%	1%	12.3	12.2	51%	1.4	23%	26%	36%	18%
MSFT	Microsoft Corporation		10%	15%	33.4	29.0	34%		49%	48%	30%	17%
ORCL	Oracle Corporation		7%	11%	20.2	18.2	386%	2.9	25%	22%	29%	16%
SAP	SAP SE Sponsored ADR		24%	18%	25.2	21.4	14%		14%	21%	17%	14%
Averages			-34%	13%	27.5	24.1	12%	1.8	21%	32%	21%	13%
Adjusted Avgs*			12%	13%	27.5	24.1	27%	1.8				

* 2023 EPS excludes AMZN and MKL

2023 ROE excludes negative book value outliers (TDG, SBUX and MTD) and exceedingly high ROE (AAPL, ORCL)

Source: Traditional Quality Metrics – FactSet; Key MVIP Quality Metrics - Mar Vista estimates. Information has been gathered from sources considered to be reliable, however its accuracy cannot be guaranteed. Securities mentioned in this letter were held in the account of a Strategic Growth client that Mar Vista believes to be representative of the accounts that Mar Vista manages for this investment strategy as of September 30, 2023. Other Mar Vista clients managed with different investment objectives may hold different securities than those listed. The securities listed in this letter should not be considered a recommendation to purchase or sell any particular security. The reader should not assume that investments in the specific securities identified herein were or will be profitable. **Earnings per share growth** ("EPS Growth") illustrates the growth of earnings over time. **Price to earnings** ("P/E") is a way to value a company by comparing the price of the stock to its earnings. **Return on Equity** ("ROE") is a financial ratio that shows how well a company is managing the capital that shareholders have invested in it. **Net Debt EBITDA** (earnings before interest depreciation and amortization) ratio is a measurement of leverage calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. **Return on invested capital** ("ROIC") is the amount of money a company makes that is above the cost that it pays for its debt and equity capital. **Free cash flow** ("FCF") **margin** measures the amount of cash generated by a firm as a proportion of revenue. **Intrinsic value 5 year estimated growth** ("IV 5yr CAGR") is an estimate of the actual value of a company separate from how the market values it. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.