# Investment Focus: HOLT – An introduction to BlueAlpha's black box

BLUEALPHA
INVESTMENT MANAGEMENT

"BlueAlpha is a Quality investor with a Growth tilt - investing in high quality businesses with the ability to grow", this soundbite is easy to agree with and most investors would say they target businesses with similar attributes, but what actually is the thinking around our process? In this first of a three-part series, we take a closer look inside BlueAlpha's black box.

The concepts of quality, growth, value, and risk are inseparable from one another, so the order in which we choose to focus on them is going to have an influence on the conclusions we reach. In general, we will ask three questions in our process:

- Quality – Can the business earn a return ahead of its cost of capital?
- Growth – Can the business grow ahead of its cost of capital?
- Valuation – what is a fair price to pay?

## Quality

Below we show some select data from two hypothetical companies. A quick glance will show that these businesses are almost identical. The two firms earn the same nominal amount of 100 – and here we will use NOPAT* as a measure of earnings - Company A achieves this return off an asset base of 500, while Company B employs 1000 worth of assets to generate the same return.

| Year 1 | Company A | Company B |
|---|---|---|
| Earnings (NOPAT) | 100 | 100 |
| Operating Expenses | 500 | 1000 |
| ROIC | 20.0% | 10.0% |
| WACC | 12.5% | 12.5% |
| Economic Profit | 38 | -25 |
| EV to IC | 1.6 | 0.8 |

As mentioned, our first step is to measure operational quality, and here we will use ROIC*. Company A earns a higher ROIC than B, demonstrating a higher level of operational efficiency. This return can't only be looked at in isolation though, it has to cover cost of capital for the business (WACC*) and both of the businesses have a cost of capital of 12.5%.

Company A earns a return more than this hurdle rate, while Company B does not. This difference to the respective hurdle rates, when multiplied by the asset base translates into the value that the firm has created over the last year, also called Economic Profit.

At this point we can observe how these firms are valued by the market. One way we can look at it is the ratio of a firm's total value (Enterprise value) vs the value of its assets. Company A's value is at a premium to its asset base, while Company B is at a discount. With this information in mind, let's walk forward one year and see how the two businesses have fared.

| Year 2 | Company A | Company B |
|---|---|---|
| Growth | 10.0% | 10.0% |
| Earnings (NOPAT) | 110 | 110 |
| Operating Assets | 550 | 1100 |
| ROIC | 20.0% | 10.0% |
| Economic Profit | 41 | -28 |
| EV to IC | 4.0 | |
| Justifiable PE | 20 | ? |

## Growth

Both companies have grown their assets and earnings by 10%, and both are achieving the same ROIC levels they were last year. Again, we are looking at the operational quality, as well as the value created and see that Company A's Economic profit has improved from last year, while Company B was already destroying value, has destroyed even more value this financial year.

This brings us to an important point that our process leans on. Not all growth is the same. Company A was creating value, and by growing was able to further improve that level, but Company B, by not beating its cost of capital, its growth only further worsened its financial condition.

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## Valuation

Now the last step, valuation. With only the information we have on hand we can get to a justified PE ratio for Company A of 20, for company B however this isn't possible.  B's is continuing to add capital to value destructive operations. Even keeping the mechanics of our example aside, how could we holistically derive a price for an operation that burns through capital?

It is only because of assessing the business' quality first, are we lead to choose Company A over B. If we started by first examining which of the two are relatively cheaper, we might have made the case for Company B - was it is trading at discount to assets and growing at the same rate as Company A after all.

This difference between the two approaches' conclusions should be a word of caution for investors – where you start will determine how you end.

*NOPAT: Net Operating Profit After Tax

*ROIC: Return on Invested Capital (NOPAT / Asset Base)

*WACC: Weighted average cost of capital