Growth investing:

it all starts with the top line

BY PIERRE LAMELIN

Fund management and tree selection

"Watching trees grow and selecting the right species with durable growth prospects": I would never have thought of describing the job of portfolio manager that way, but that is how a Comgest veteran put it to me when discussing growth investment in European equities. The image of trees growing did not actually correspond to the share prices, or at least not directly, but to the gradual increase in portfolio companies' earnings, as we firmly believe that superior share price returns are generated by outstanding companies able to sustain superior growth in earnings per share for an extended period of time under certain conditions: self-financed growth and sustained returns on invested capital.

Over the long term, earnings estimates matter more than the valuation multiple, as illustrated in the following example: for the sake of simplicity, we assume that the share price of a company equals its Earning Per Share (EPS) at a given time multiplied by its Price Earnings Ratio (PE). One may assume that over time, the market valuation PE for a growth stock may range from - say - 10x to 35x, or a ca.300% amplitude. This looks high but is nothing in comparison to the earnings amplitude of a growth company over more than 10 years. For instance, assuming EPS growth of 13% p.a. over 10 years gives a 1x to 4x EPS range. Compounding earnings growth over 25 years and it becomes 1x to 21x: a seven times larger amplitude than the valuation multiple! (Exhibit 1)

Share price	= P/E	x EPS
Amplitude over		
5 years	[10-35x]	[1-2x]
10 years	[10-35x]	[1-4x]
25 years	[10-35x]	[1-21x]
50 years	[10-35x]	[1-450x]

Note: EPS growing at a 13% CAGR

Exhibit 1: PE and EPS amplitude over time
Source: Comgest

Forecasting earnings and their sustainability is thus not only more interesting than betting on valuation multiples (it is all about analyzing businesses from the real economy), but it also makes much more sense from a total shareholder return standpoint over the long term. The intimate knowledge of a company and the relevant sector is generally required to build long-term earnings forecasts.

There are a variety of ways to grow earnings per share…

To grow, trees generally require air, light, water and nutrients coming from the soil. What about companies' earnings? The following table (Exhibit 2) summarizes the main sources of EPS growth in a classic P&L.

There are a variety of ways to achieve double-digit EPS growth. The table below (Exhibit 3) shows a series of "real" examples based on the latest available fiscal year data.

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(% Chg.)		
	(+) Organic growth	Mega-trends fuelling market growth. Market share gains through innovative products or services, new segments, geographies or stores. Pricing.
SALES		Usual breakdown: Volume, price, mix
	(+/-) Acquisitions / Disposals	Fragmented markets? New business? Generally less recurring
	(+/-) FX	
Operating margin	(+) Op. leverage	Lower costs, positive product/geo/business mix, synergies post acquisitions
	(-) Op. deleverage	Higher costs, negative business or regional mix
Finance	(+) Deleverage, lower cost of debt	Cash generation
(Associates / Tax / Mino)	(-) More debt, higher cost of debt	Financing of capex, WCR, acquisitions, dividend, buybacks
Share count	(+) Buyback & cancellation	
	(-) Issue of shares	Capital increase or share-based payment
EPS	> 10% ?	

Exhibit 2: Main contributors to EPS growth in a classic P&L
Source: Comgest

(% Chg.)		Jeronimo (FY12)	SAP (FY12)	Diageo (FY13)	Nestlé (FY12)	Sodexo (FY12)	ARM (FY12)
	(+) Organic growth	+12	+8	+5	+6	+6.5	+16
SALES	(+/-) Acq. / Disp.	+0	+2	+2	+2	+4	+0
	(+/-) FX	-2	+4	-1	+2	+3	+1
Operating margin		-5	-3	+4	+2	-1	+1
Finance, tax & other		+1	-4	+2	+0	-0	+1
Share count		+0	+0	-1	+0	+2	-1
EPS		+6	+7	+11	+12	+14	+18

Exhibit 3: EPS growth contributors for 6 companies in their latest fiscal year
Source: Comgest

...but organic sales growth is the most interesting driver

Leaving organic sales growth aside for a moment, a company can grow its earnings per share by playing on the following levers:

- M&A: Any acquisition is EPS accretive in today's cheap rates world. Some companies are proficient at integrating acquired companies. Thus, a third of SAP or Dassault Système's top line growth over the past decade has come from acquisition and up to 50% for Essilor. But those are exceptions and acquisitions are generally less recurring and thus reduce earnings predictability.
- Currencies: Totally unpredictable.
- Margins: Operating leverage is finite: 100% is the theoretical limit! There have been fantastic margin stories fuelling earnings growth but they generally only last for a while.

  An important point to keep in mind is that the higher the margin, the less powerful the operating leverage: a business with stable sales and a margin rising from 10% to 13% (+300bp) increases its EBIT by 30%; another business with stable sales and a margin rising 300bp from 30% to 33% increases its EBIT by 10% only.
- Financial result: Can contribute significantly to the bottom line in deleveraging stories for cash generative businesses (think Pernod Ricard since 2000 following several mega-deals is just one out of many examples), especially in a world of low interest rates. Conversely, any use of cash, may it be working capital requirement, capital expenditure, acquisitions, dividends, share buyback, has to be financed, weighing on the financial result.
- Tax rate: I would not bet against Mr Taxman.
- Share buybacks: Increasingly part of the EPS growth equation, notably for US companies. Western tobacco companies realize up to half of their EPS growth through share repurchases.

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Contrary to all those levers, organic growth, defined as total sales growth excluding currency movements and acquisitions / disposals, seems to be the most sustainable factor driving a P&L over the long term as its potential is unlimited. In addition, it can be much more consistent than any other contributor to the P&L. Organic growth comes in a variety of forms: mega-trends (ageing population, outsourcing, growing middle-class in emerging markets), market growth (infant milk formula, diabetes, cloud computing, luxury goods) and of course share gains, which can be attained through innovative products or services, new segments, new geographies or the classic but proven combination of store openings and same-store sales growth (Inditex, Sephora). Some of those sources of growth will be revisited in depth in subsequent investment letters.

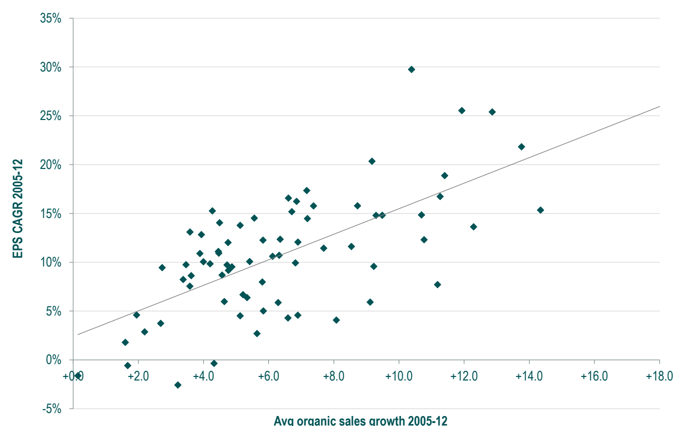

Exhibit 4: Correlation between organic sales growth and EPS growth in Europe (N=90: Comgest Europe investment universe + other European non-financials large caps not included in the Comgest universe)
Source: Comgest

Over the long term, we estimate that top line growth represents more than two thirds of companies' EPS growth and organic sales growth alone more than half. Our analysis shows a strong correlation between organic sales growth and earnings growth, and ultimately total shareholder return.

Of course, the metric is not perfect if growth is too costly, either from a margin (Danone over the past few years) or cash/capital employed standpoint (high WCR or Capex consumption). Or it may reflect high inflation in a weaker currency area (Jeronimo Martins, Colgate-Palmolive, Edenred), which may only partially translate into hard currency profit growth.

Higher growth, lower volatility: are you joking?

Based on those considerations, Comgest has developed a proprietary database with organic sales growth records for hundreds of European companies covering a significant period of time, and at least a full economic cycle. Companies do not always report proper organic sales growth. Thus, each data point has been verified, re-calculated and corrected if needed, may it be to restate for an acquisition (typically badly communicated in some sectors such as IT and software) or conversely to re-integrate the effect of bad news, if a listed company has taken the liberty to adjust its financial communication after the loss of a key contract or product line.

Building this database helped us classify companies: Which are growing fast? Which are not? Which are the most consistent / less volatile? Which tend to accelerate? Decelerate? It was no surprise to us to see many of our portfolio companies among the top of the list in terms of growth, or the bottom of the list in terms of volatility, which is what we prefer in accordance with Comgest's quality growth investment approach.

Of course, past performance is not an indicator of future outcomes, but:

- One cannot cheat with historical volatility. There is a good chance that a company which has historically been affected by inventory stocking / de-stocking will be again affected in the future.
- A long historical track record can be useful to challenge our internal sales and profit forecasts: do I really believe that Company Z will post double-digit organic sales growth in 2014 when it has never posted more than 4% in more than a decade?

- We have records of dozens of companies which have never experienced lower organic sales, even in the annus horribilis year of 2009. That is worth something!

Let me finish with some of the most impressive trees of the Comgest European garden. Needless to say these have been among the best contributors to the Comgest portfolios.

Company 1 (Exhibit 5) is ASOS, the UK online fashion retailer, averaging more than 60% organic sales growth over the past decade. Its strength is unrivalled execution in the fast-growing e-commerce market. The company continues to grow at a rapid pace: sales for the fiscal year ending August 2013 surged 39% to GBP769m.

Company 4 (Exhibit 5) is Iliad, the French telecommunication operator. With 23% average organic sales growth over the past 8 years and more than 26% growth in the first half of 2013, it shows that an innovative company can grow even in an ex-growth market by gaining significant share and entering an adjacent market, from the fixed-line high-speed internet to mobile.

Company A (Exhibit 6) is Chr. Hansen, a Danish supplier of natural based ingredients to the food, health and animal feed industries. Chr. Hansen produces cultures and dairy enzymes, probiotics and natural colors. The natural growth of its health & nutrition client base is supplemented by the trend towards more natural based ingredients and the outsourcing of the production of cultures and enzymes, where scale matters.

Company C (Exhibit 6) is Coloplast, a Danish company active in intimate healthcare such as ostomy or continence care. Organic growth has never been below 6% for the company which has only 12% emerging markets exposure and has been very consistent over the years.

Company D (Exhibit 6) is Nestlé, the world's leading food manufacturer with CHF92bn sales posted in 2012. The reasons for its very regular organic sales performance are its balance by geography and by product category combined with strong, innovative brands such as Kit Kat, Milo and Nescafé. Over the years, there has been a significant pricing element in top line growth, which is less true in 2013 to date… In its worst ever year, Nestlé posted 3.9% organic sales growth.

Company	2005	2006	2007	2008	2009	2010	2011	2012	8y CAGR	Volat.
Company 1	+39.0	+116.0	+90.0	+104.0	+35.0	+52.0	+46.0	+32.0	+61.4	54.9%
Company 2		+48.3	+53.6	+46.7	+16.0	+16.4	+17.3	+16.0	+29.6	60.2%
Company 3	+16.1	+31.4	+34.1	+42.4	+25.5	+23.5	+24.6	+21.0	+27.1	30.6%
Company 4	+47.0	+31.2	+29.7	+18.9	+12.0	+4.3	+4.1	+48.6	+23.4	75.3%
Company 5			+30.7	+26.6	+13.5	+16.2	+18.0	+11.3	+19.2	39.8%
Company 6	+19.2	+30.7	+35.1	+22.7	-5.0	+16.9	+22.0	+14.0	+18.9	64.0%
Company 7	+20.0	+22.5	+17.0	+12.0	+9.0	+10.0	+11.0	+14.0	+14.3	34.3%
Company 8	+5.5	+13.6	+19.1	+20.5	+11.4	+13.9	+15.3	+11.5	+13.8	34.2%
Company 9	+15.0	+16.0	+13.0	+12.0	+11.0	+13.0	+11.0	+12.0	+12.9	14.1%
Company 10	+18.5	+27.0	+14.0	+8.0	-9.0	+21.0	+16.0	+9.0	+12.6	86.3%

Exhibit 5: Screening of fast growing companies, ranked by 8-year organic sales growth
Source: Company reports, Comgest

Company	2005	2006	2007	2008	2009	2010	2011	2012	8y CAGR	Volat.
Company A		+7.2	+9.4	+9.8	+10.0	+11.0	+10.0	+11.0	+9.8	13.1%
Company B	+15.0	+16.0	+13.0	+12.0	+11.0	+13.0	+11.0	+12.0	+12.9	14.1%
Company C	+8.0	+8.0	+10.0	+7.0	+6.0	+7.0	+6.0	+6.0	+7.2	19.2%
Company D	+6.0	+5.9	+7.1	+8.2	+3.9	+5.9	+7.5	+5.9	+6.3	20.8%
Company E		+8.2	+5.8	+7.6	+5.5	+4.3	+6.0	+5.1	+6.1	22.7%
Company F		+14.4	+11.0	+13.4	+11.1	+8.7	+8.5	+8.2	+10.7	22.9%
Company G	+5.7	+5.9	+7.4	+7.5	+6.2	+6.4	+4.1	+3.7	+5.9	23.5%
Company H	+8.6	+11.3	+11.9	+9.7	+5.0	+13.4	+9.8	+14.5	+10.5	28.4%
Company I	+6.7	+9.7	+7.2	+8.4	+3.2	+6.9	+7.8	+5.4	+6.9	28.5%
Company J		+5.0	+5.0	+7.0	+5.0	+3.0	+7.0	+4.0	+5.1	28.5%

Exhibit 6: Screening of «Swiss clocks» companies, ranked by 8-year ascending volatility in organic sales growth
Source: Company reports, Comgest

To sum up, we spend a disproportionate amount of time analyzing the top line, which is of utmost importance in quality growth investing. Our European equities portfolio comprises many fast growing, low volatility companies, as illustrated in the chart below. Finally we try to keep in mind that trees generally do not grow forever: we look for signals of maturing sectors, companies or business models and sometimes take the decision to make room for new species in the grand Comgest garden.

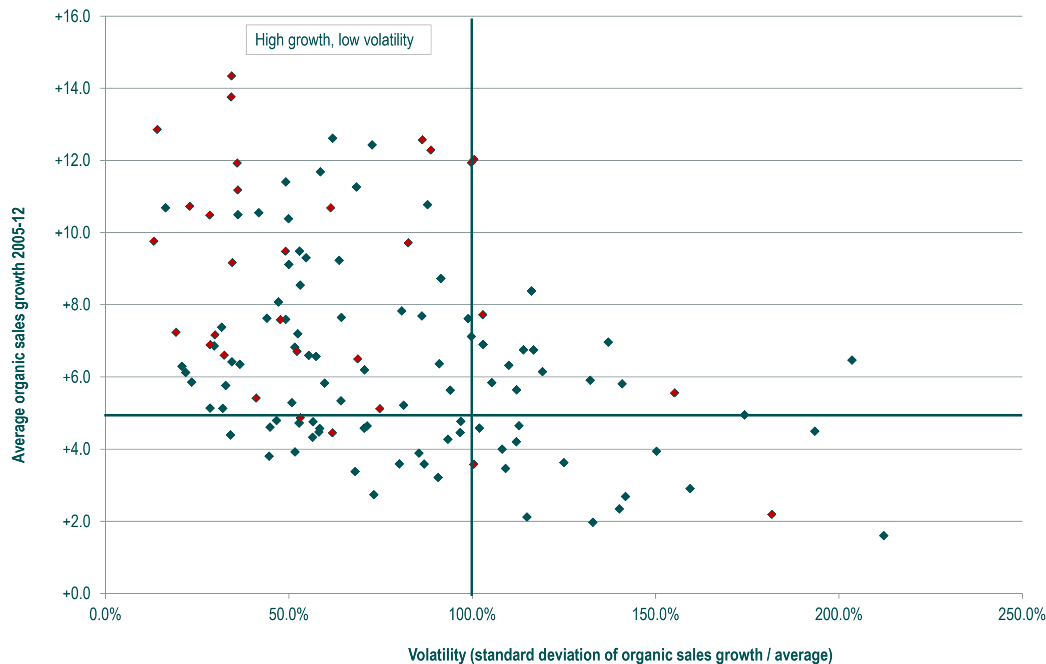

Exhibit 7: Organic sales growth and volatility in organic sales growth in Europe 2005-2012 (N=125. Red dots are portfolio companies)
Source: Comgest

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