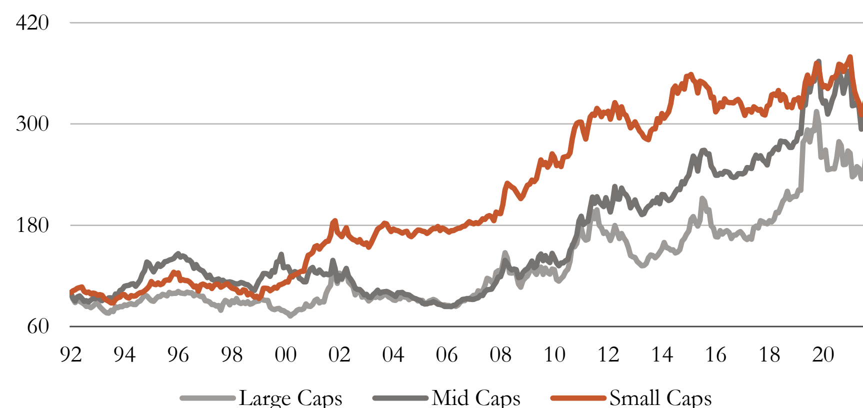
Why quality makes all the difference

All our funds have in common that quality companies are our top priority. Why quality pays off in the long term, what criteria we apply and how our process differs from common index providers is what we want to explore in more detail in this paper.

Why invest in quality stocks?

The fact that quality companies can generate an average excess return compared to the overall market has been proven several times in the literature.[1] A simple backwards projection for Europe in Figure 1 shows that companies with good returns on capital and low debt ratios have generated significantly higher returns than companies with unfavorable financial ratios over the last 30 years. This applies to both small caps and large caps.

Figure 1: Relative price development of high versus low quality stocks for different size classes.[2]



Source: Berenberg, Factset, MSCI, IBES, BofAML European Quant Strategy; as of September 2022.

The importance of both quality and growth criteria becomes even more apparent when looking at individual company examples. For example, ASML, the Dutch manufacturer of complex machines for the semiconductor industry, and Straumann, the Swiss provider of tooth replacement solutions, have been able to increase their profits significantly more than the overall market over the last ten years. As Figures 2 and 3 demonstrate, this has been rewarded for shareholders with a significant excess return over the broad market. For example, since 2012 ASML has grown earnings by

[1] Cf. for example: Asness, C.S., Frazzini, A. & Pedersen, L.H. Quality minus junk. Rev Account Studies 24, p. 38 (2019) for a review on the topic.

[2] Measured as top minus bottom quintile. "Quality" was defined as an equally weighted combination of the factors return on assets, return on capital, return on equity, 5yr return on equity and leverage. Universe: MSCI Europe IMI Index, size classification according to MSCI.

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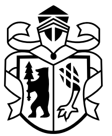
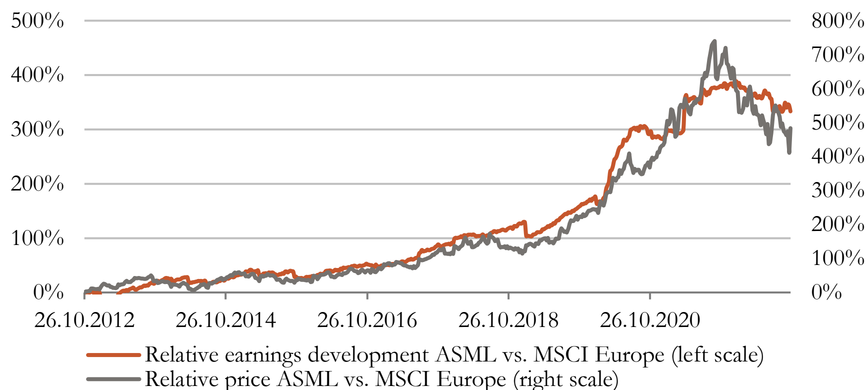


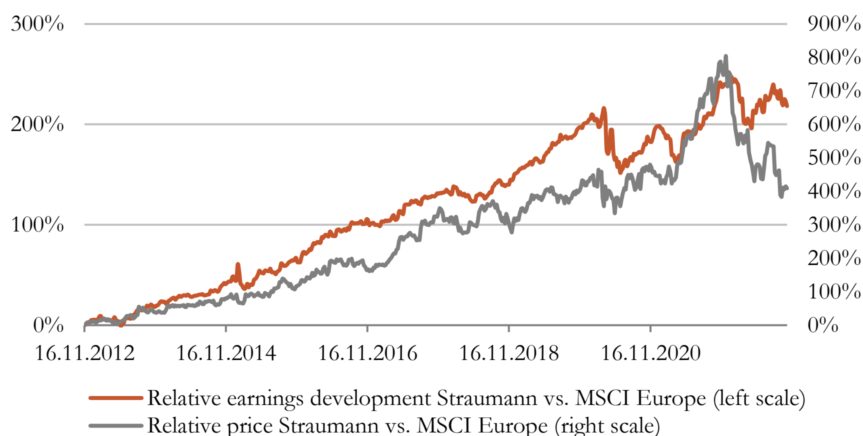
an average of 13% p.a. more than the MSCI Europe, with the stock outperforming the market by an average of 24% p.a. over the same period.[3] The basis for this were quality characteristics, i.e. distinct competitive advantages, solid balance sheets and structural growth drivers, which formed the basis for sustainable growth with high returns on capital for both companies. Our declared goal is to identify such companies and accompany them on their growth course for many years.

Figure 2: Relative earnings and share price development of ASML compared to MSCI Europe.



Source: Berenberg, Bloomberg, based on total net returns.

Figure 3: Relative earnings and share price development of Straumann compared to MSCI Europe.

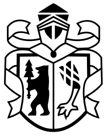


Source: Berenberg, Bloomberg, based on total net returns.

What does "quality" mean to us?

In defining "quality companies", we pursue a holistic approach that includes both qualitative and quantitative factors. Conceptually, we differ significantly from the approach of common index providers. For example, the classification of "quality companies" by the world's largest index provider MSCI is based on the three main

[3] Profit development over the last 10 years, based on the expected annual profit for the year 2022E (Bloomberg). Price development based on the period 01.11.2012 – 01.11.2022.

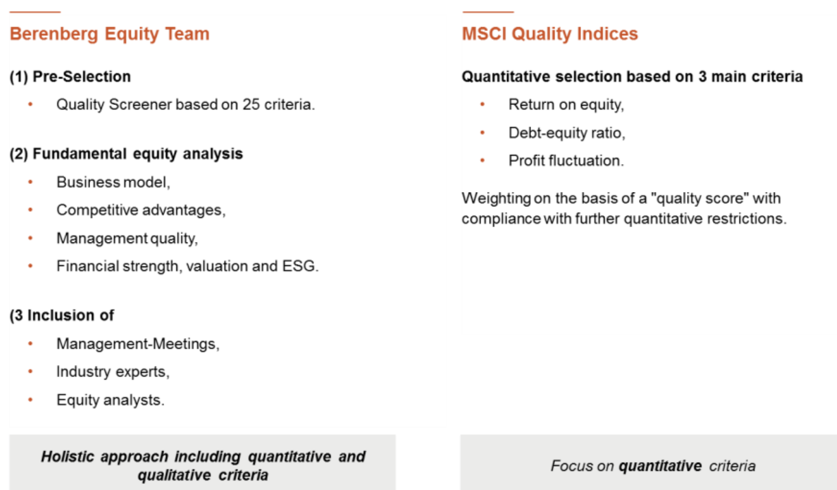


factors (1) return on equity, (2) leverage and (3) earnings volatility. Based on these criteria, a quality score is determined and an index weighting is assigned.[4]
However, in our view, such an approach is not sufficient to reliably identify quality companies. We also carry out a pre-selection based on quantitative indicators to select the global universe of over 100,000 companies for our funds [see Infobox on the right]. However, this is followed by a detailed analysis of the business model. This includes an assessment of the competitive advantages, the structural growth drivers as well as the quality of the management and is described in detail in our handbook from February 2021 [*"The Berenberg Equity Funds Investing Handbook: Our investment philosophy and what our portfolios look like"*].

Infobox
*With our **"Quality-Screener"** we pre-select the global equity universe for promising stocks. It is based on the three sub-factors profitability, growth and security, which together cover more than 25 key indicators and are converted into an overall score. Securities that perform particularly well in the quality ranking and appear promising overall are subjected to a detailed qualitative analysis. The screener is not our only way of generating ideas, but it facilitates access to stocks that do not receive research coverage and are often known to only a few investors due to their small size.*

In addition, our process allows us to combine quality with growth characteristics and to include exchanges with company management, industry experts and sell-side analysts (see Figure 4). Overall, our goal is to find companies that can double their cash flows on average over the next five years. However, for growth to be value-creating for shareholders, the expected return on invested capital (ROIC) must be sustainably higher than the company's weighted average cost of capital (WACC). This requires a qualitative assessment of how long the differentiation from the competition and the growth profile can be maintained. In our view, a purely quantitative screening cannot replace this assessment and therefore falls short overall.

Figure 4: A comparison of the methods used to select quality stocks.



Source: Berenberg, MSCI.

Ultimately, our assessment of a quality company differs from pure index solutions. For example, for the "MSCI Europe Quality Index" MSCI shows the shares of the British consumer goods manufacturer Unilever among the ten largest positions.[5] A deeper qualitative analysis, on the other hand, reveals that the company continues to face structural challenges in the form of rising commodity costs, a CEO change, weak volume trends and a structural devaluation of many emerging market currencies. We therefore recognize considerably better opportunities and stronger structural drivers in many other European companies, which we would not be able to identify without a precise fundamental analysis. Therefore we believe that a mix of qualitative and quantitative factors is the most promising way to identify good investment opportunities.

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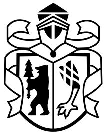
[4] See https://www.msci.com/eqb/methodology/meth_docs/MSCI_Quality_Indices_Methodology.pdf for a complete overview.
[5] See MSCI, 30.09.2022.



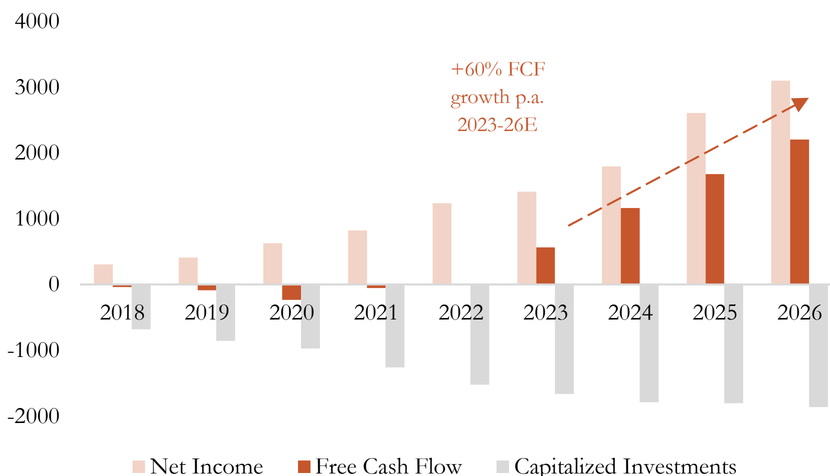
Do we hold any "unprofitable companies" in our portfolios?

Accordingly, we avoid companies with aggressive growth and low returns, no profitability, or no cash flow. However, there may be examples where the structure of the business model or a very early stage of development of a company may lead to negative profit or free cash flow in individual years.

A good example is the Polish supermarket operator Dino Polska. The company maintains around 1,800 shops in the south and west of Poland. Targeting rural areas, the company plans to expand its portfolio by about 300-400 branches p.a. over the coming years.[6] Over the past 12 months, Dino has already made a profit of billions in zloty and has increased its earnings by an average of 40 per cent per year since 2016.[7] However, the profits are reinvested to a large extent in the development of new branches. The free cash flow considers these investments and therefore stayed still close to zero in 2021. This cannot be declared as a lack of profitability in our view. Instead, investments form the basis for a continuation of the growth course, which is reflected in long-term increasing free cash flow expectations and thus ultimately creates added value for shareholders (see Figure 5).

Another example is the Swiss company Lonza Group AG, which manufactures drugs for clinical trials and the commercial phase on behalf of pharmaceutical and biotech companies. As shown in Figure 6, the company has significantly increased its investments in 2021 and 2022 compared to previous years. The free cash flow has thus been negative over the last 12 months. Nevertheless, the investments will make it possible to increase production capacities from 2025 onwards. About 70% of the newly created capacities have already been pre-booked by customers. Lonza's growth profile should therefore accelerate over the coming years with good visibility and low cyclical fluctuations due to expanded investments. Lonza generates a clear double-digit return on capital employed and shows EBITDA margins above 30 percent. The temporary negative cash flows are therefore not an expression of a lack of profitability or poor corporate governance but are directly related to long-term growth opportunities.

Figure 5: Development of profits, investments and free cash flow at Dino Polska (in PLN million).



Source: Bloomberg Consensus estimate, Berenberg, 21.10.2022.

[6] Dino Polska Annual reports and Earnings Calls.
[7] Annual growth rate of net profit between 2016-21, see Annual Reports.

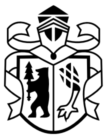
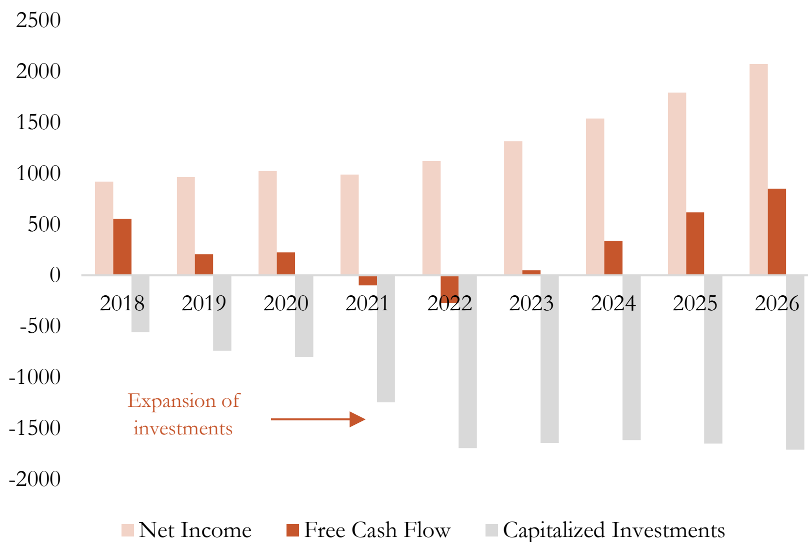


Figure 6: Development of profits, investments and free cash flow at Lonza Group AG (in EUR million).



Source: Bloomberg consensus estimates, Berenberg, 21.10.2022.

An example from the small caps area is Soitec. The technology leader in the field of silicon on insulator coatings, which increase the efficiency of silicon wafers thanks to lower transistor leakage, has successfully demonstrated its strategy change in recent years. In 2015, they shed the then loss-making photovoltaic business and focused on their core business, in which they clearly lead with a market share of up to 70%. Although Soitec's very good market positioning in the structurally growing RF-SOI but also FD-SOI end market was known, the market remained skeptical when they announced significant capacity expansions in both production sites Bernin I and Bernin II in 2017 and 2018. This skepticism was probably based on the fact that the investments at the time outweighed the full operating cash flow. Soitec's business model involves phases of investment that will weigh on free cash flow and will be extended by phases in which Soitec benefits from its operational leverage. In contrast to 2019, however, the company has now reached a size where the operating cash flow covers the capital investments. The temporary phase of negative free cash flow was therefore not an expression of poor company quality but was directly related to Soitec's long-term growth opportunities. With relatively continuous organic revenue growth of 30%+ p.a., Soitec was able to prove that the strategic investments were important to leverage the significant growth potential in diverse application areas such as smartphones, but also automobiles and IoT. Soitec's returns on investments also returned to well into double digit levels.

In summary, out of 420 stocks in our equity funds, about 7% have a negative free cash flow or return for the last 12 months. As described, however, this does not contradict our definition of quality, but rather reflects investments that, in combination with high incremental returns on capital employed, contribute to an improved long-term profitability and growth profile. For us, it therefore always depends on the overall context whether short-term negative earnings or free cash flow figures create long-term added value for us as shareholders and therefore justify an investment.

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