Disciplined growth investment in times of low interest rates and high valuations

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Investment discipline in periods of high valautions

Having lived the ups and downs of global financial markets since early 1980's, the last couple of years has certainly been interesting and given new perspectives to say the least. Lower US corporate taxes in 2018, followed by easier monetary conditions in 2019 boosted valuations to new highs in late 2019. Only to see a game stop in early 2020 caused by the global pandemic and then a subsequent bull-run in 2020 and 2021 driven by surplus liquidity and strong earnings. Only investors on steroids or something like that would have imagined the 2020-21 run in March 2020.

No matter the overall market mood there're underlying trends that do not stop with lockdowns, high valuations and are to some extend immune to the economic cycles.

Early on in my career I found growth companies more interesting as the have more potential than cyclical and traditional businesses albeit the latter two can also have good managers and business models that create solid returns over time.

Computers, software, and new innovative drugs were obvious hunting grounds for investment ideas back then. The big challenge was however to learn how to hold on to an investment and just let it do the value creation work by itself. As example, I bought Microsoft after the crash in October 1987 as it suddenly was less highly valued. After a decent return it was sold in 1988. In hindsight the sell was a very poor investment decision and boiled down to an observable profit and a young spirit ready for the next hunt. No other investors told me the value of patience at that time, but I wish I had learnt it early on. Unfortunately, patience it's not learnt by one incident so more 'too early sells' had to teach me the discipline.

The Tiger Crisis in 1997 opened up a honey pot of Asian growth companies such as Samsung Electronics. The company is still part of my investment portfolio but has been sized down several times. The financial crisis in 2008 again opened the honey pot to get good growth companies at a low valuation, which helped fuel the performance for the next decade.

700 out of 4.000 largest companies in the world are valued at more than 10x sales

Fast forward from 2008 and to 2021 where more than 700 companies are priced above 5 billion USD and valued at more than 10x sales (Source Refinitiv Global)

There's an easy illustration of the challenge of this kind of valuation; Ferrari, the high-end car brands trades at 10x sales and is a well-know business. With September 2021 consensus EPS for 2021-24 and using the general market earnings yield of 5% for discounting, Ferrari must grow earnings at least 12% per year for the 2025-41 period to support the current stock price. A simplistic view is 75% of Ferrari sales comes from cars and spare parts and 25% from engines, commercial and other. Let's just assume car sales is the key driver for Ferrari, then the company need to sell 100.000 cars in 2041 vs the 10.000 unit current runrate. That might well happen as global affluence increase, and more individuals can afford a Ferrari, but the last 6 years with a roaring bull market Ferrari car sales have grown 6% per year.

The 700 list contain many companies that are completely unknown to most investors and to justify a 50x sales valuation one must be pretty optimistic on the longer term prospects for the business if it's to generate value for investors. I have my doubts that all 700 companies will be successful.

How do the valuation minded investor navigate this market?

With lot's of companies being aggressively value, how do the curious and mindful investor get around it? I spend lots of time to identify the most obvious growth pockets for the next 10-20 years and dig into lots of companies to find the few that might, and might not, be the next 20, 50 or 100 bagger.

CO2 reduction is high on the agenda as well as making Earth resource consumption more sustainable for the benefit of future generations. To change the fossil fuel economy into a renewable energy economy requires billions if not trillions of USD investments. And the journey has only started with momentum within the last 10 years.

Denmark, my home country, was a early bird in wind power renewable and supported by government subsidies for the power produced. It never broke the government bank to do so and along the way the windmill industry developed into being a world leader in the field and with Vestas Wind Systems as the global leader. As a stockbroker and part of the listing of Vestas in April 1998 the arguments against the investment case were many. One argument was that the major industrial power companies such as General Electric, Mitsubishi and Siemens would let Vestas and competitor NEG Micon kick-start the market and then the big industrials would take it from there. Today, the fact is Vestas has much better profitability and stronger market position than their competitors General Electric Renewable Energy and Siemens Gamesa.

Founders are often the best stewards for sustainable and solid value creation. In the Vestas case that was not part of it as the company was founded in 1898 and the founder long gone, however the family continued to develop the business into making wind turbines in 1945 and solely focusing on wind turbines after 1989. Today, Vestas is a institutionalized listed company with no founder culture visible from the outside.

The company I'll highlight at the upcoming MOI Global session is a Norwegian industrials business that has grown from almost nothing in 1995 to a 3.5 billion NOK business today. The founding family is a major shareholder. The journey over the next 10-15 years have only begun after a major reorganization to best possible serve their customers for their CO2 reduction needs.

The investment qualifies for solid long-term growth of at least 10% with good profitability and return on capital employed above 15%. The observable valuation in 2021 is not a bargain, but once we get into 2024-25 the valuation looks like a bargain. So good time to get to understand the business and maybe build a position and wait for the performance and value creation to materialize.

Short pitch 28 September 2021

I'll illustrate my investment thing and method with a Norwegian company; Hexagon Composite. Brief intro:

Low carbon energy transition investment
Hexagon Composite (31 NOK) is a world leader in lightweight composite cylinders for storage and transportation of gases under pressure. The global installed base of pressure cylinders is 1.1bn units and mainly made in steel, while only 19 mill are lightweight composite cylinders.

Hexagon plays several strings in the roadmap for lower carbon footprint. They get a predictable cash flow from low pressure tanks for grill, leisure boat and home use, they grow a substantial business from 2019 to late 2020'ies from large tanks for RNG and LNG storage, trucks, busses and trains and after 2024 a significant growth engine kicks in as high pressure composite tanks for hydrogen cars, trucks, busses, vessels etc really starts to take off.

The 3.5bn NOK revenue stream is expected to reach 8-10bn NOK five years from now and with a EBITDA-margin of 15%, which supports a price objective of 50-60 NOK or equal to 14% return per year.

Risks include short term component shortage while longer term it's competition from cooling of hydrogen instead of high pressure.