A CAPITAL CYCLE REVOLUTION (March 2014)

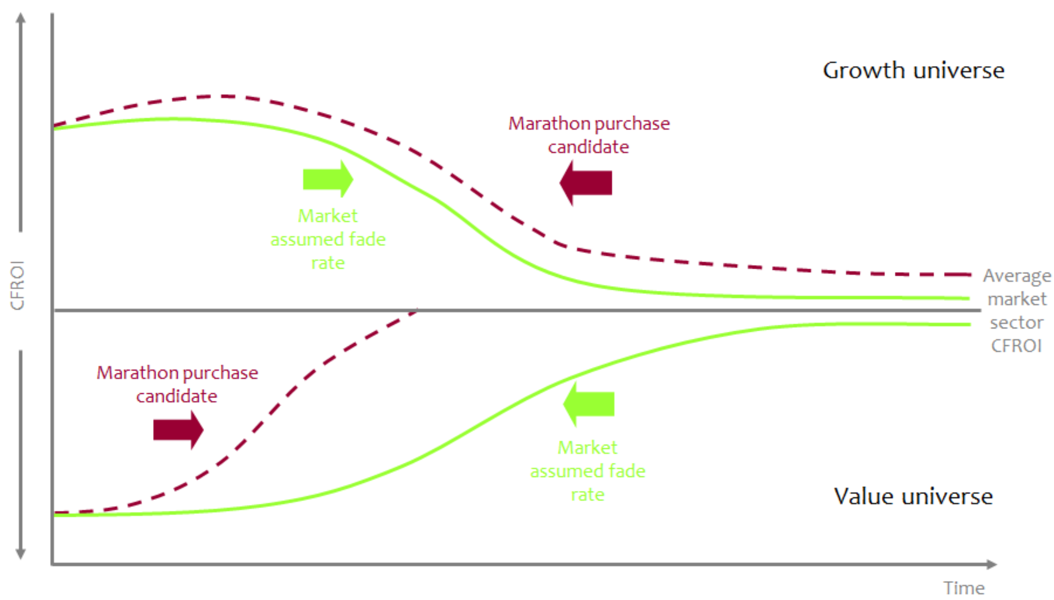
A Scandinavian wind turbine maker experiences the ups and downs of the Capital Cycle

"…the end of all our exploring
Will be to arrive where we started
And know the place for the first time."

T.S. Eliot, "Little Gidding"

Marathon looks to invest in two phases of an industry capital cycle. From what is misleadingly labelled the "growth" universe, we search for businesses whose high returns are believed to be more sustainable than most investors expect. Here, the good company manages to resist becoming a mediocre one. From the low return, or "value" universe, the idea is to find companies where improvement potential is generally underestimated. Surprisingly, the ugly company starts to look less bad. In both cases, the rate at which a company reverts to mediocrity (or "fade rate") is often miscalculated by stock market participants. Marathon's own experience suggests that the resultant mispricing is often systematic for behavioural reasons and hence unlikely to be arbitraged away.

Chart 1 illustrates the "fade rate" of corporate returns, an idea developed by Holt Value Associates (now part of Credit Suisse). Holt's concept of the stock market-implied fade rate chimed well with our focus on competitive conditions within industries and the flow of capital into (and out of) high (and low) return industries. Using this framework, the two purchase candidates are identifiable. Purchase Candidate A is a company capable of sustaining high returns beyond the market's assumption (the upper dotted line) – that is, the company remains above average for longer than average. Candidate B is a company which can improve faster than the market generally expects (the lower dotted line).



Marathon's experience suggests that the stock market is often poor at pricing superior fade characteristics. For Purchase Candidate A, mis-pricing stems from a number of sources. One is the underestimation of the durability of barriers to entry. Another is the under-appreciation of the scale and scope of the addressable market. Management's capital allocation skills are also often over-looked. A recent meeting with the CEO of Bunzl, the leading specialist business-to-business distributor, was instructive in this regard. Whilst sell-side analysts covering the stock have made reasonably accurate forecasts of returns from the core business, they have consistently failed to give management credit for adding value via bolt-on acquisitions, despite 20 years or so of supporting evidence. Investors also appear to be biased against "boring" high return companies, such as Bunzl, which do not offer the prospect of immediate high share price appreciation.

The conditions leading to Purchase Candidate B often stem from the market misjudging the beneficial effects of reduced competition as weaker firms disappear, either through consolidation or bankruptcy. Alternately, an unruly oligopoly may tire of excess competition and enjoy an outbreak of peaceful coexistence. The turn in the capital cycle often occurs during periods of maximum pessimism, as the weakest competitor throws in the towel at a point of extreme stress. When the pain of losses coincides with a depressed share price, investors can find wonderful opportunities, particularly if they are willing to take a multi-year view and put up with short-term volatility.

Management skill at dealing with problems may also be overlooked. This is especially true when a new leader is recruited externally, maximising the possibility of change. The turnaround achieved at Fiat by Sergio Marchionne in recent years is one outstanding example.[1] Highly competent managers are often attracted by the challenge of turning around a troubled company, not least because of the financial rewards. This factor was evident in a recent meeting with Rupert Soames who is shortly to take on the role of CEO at Serco, the embattled UK outsourcing company.

A recent example from Marathon's European portfolio illustrates the perils and opportunities faced by investors in low return companies. In the case of Vestas Wind Systems, Marathon's initial investment took place in 2003 when the company was suffering from a temporarily weak US market due to change in tax incentives. Partly in response, Vestas acquired a local rival. Subsequently, demand for wind turbines recovered and the shares rose by 1,900 per cent from trough to peak in 2008.

The good news didn't last. With the advent of the financial crisis, wind farm projects around the world were quickly shelved at just the point when the new wind turbine capacity came on stream. Although we had reduced clients' holdings by a quarter at near-peak levels (see Chart 11 below), the residual holding then suffered an ignominious "Return to Go" with a 96 per cent decline in value.

Vestas had become a victim of the alternative energy capital cycle. Its capex-to-depreciation had risen from just over 1 times in 2005 to nearly 5 times in 2008, contributing to excess capacity in the wind turbine sector. With the benefit of hindsight it would have made sense to dispose of our entire holding after the crisis struck as the share price subsequently endured four more years of under-performance. This would have saved us having to answer

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[1] Sergio Marchionne was appointed Chief Executive of Fiat SpA in mid-2004. Since that date, Marchionne has revitalized Fiat's car operations and spun off the company's agricultural equipment division (Case New Holland). An investment in Fiat at the time of Marchionne's appointment was worth 183 per cent more by the end of 2014 (based on the combination of FCA and CNH's share prices, excluding dividends.)

awkward questions from consultants and clients about why our position had been maintained!

Nevertheless, continued contact with the company provided the opportunity to buy more shares at a later date, an option which might have been lost had we washed our hands of the embarrassing position. Following a meeting with the impressive new Swedish chairman in early 2013, Marathon bought more shares, increasing the holding by 90 per cent and becoming the company's largest shareholder. New management has since been able to implement significant restructuring at a time when investor fears about weak industry demand have proved too pessimistic. Capex has been slashed to 0.4 times depreciation in 2013, boosting cash flow and helping to repair the weak balance sheet. The subsequent 360 per cent share price rise has partly spared our blushes from failing to sell more at the peak.

The example of Vestas shows how a company can morph from being a 'value' buying opportunity to being an expensive 'growth' stock and then cheap value again in the course of a few years. Investors can take advantage of Mr Market's shifting moods. Our Vestas experience also demonstrates the benefits of well-timed contrarian purchases, notwithstanding the valid questions the case raises about selling discipline.