

ALISTAIR WITTET

## CASH IS KING, AND THERE'S NO HEIR TO THE THRONE



Alistair Wittet, CFA  
Portfolio Manager

*“Turnover is vanity, profit is sanity, and cash is reality”*  
- Unknown

Wimpy the Moocher, a character in the popular 1960s American cartoon series ‘Popeye The Sailor Man’, is usually shown eating his beloved hamburger at the town diner, but is seldom willing to pay for it. His most common ruse to fellow patrons of the diner is to say “I’ll gladly pay you Tuesday for a hamburger today”. Unfortunately the unsuspecting restaurant-goers would regularly fall for the scam, until one day when the owner of the diner, Rough House, exclaims “I’m wise to him. He’ll get only what he pays for”.

The simple lesson from Rough House is that cash today is worth more than the promise of cash tomorrow, but this principle is one the stock market often seems to ignore. Commentators focus on sales, EBIT and earnings per share, all of which are non-cash items, rather than operating cash flow, working capital and free cash flow, all of which are cash measures.

The market does this for a reason of course: the premise of the income statement is to smooth capital expenditures and match income with expenses to give a better reflection of the economic reality of the business. But in the words of Yogi Berra “in theory there is no difference between theory and practice. In practice there is”. A company’s net income is in fact quite an arbitrary figure, obtained after assuming certain accounting hypotheses regarding accrued revenue, deferred costs, depreciation, amortization, write downs, write backs, taxation, derivative instruments, pension charges...the list goes on.

And for those less familiar with the investment industry it will be surprising to note that on top of these assumptions, companies tend to publish a whole new income statement which includes further, unaudited, adjustments. This window dressing is a remarkably common occurrence and in the most egregious cases can result in fundamentally misleading information.

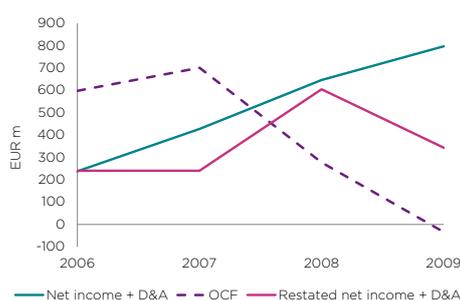
There is no such thing as an “adjusted” cash flow statement. By its nature, cash cannot be fiddled: it’s either in the bank, or it isn’t. Its main drawback remains that it is lumpy, but taken over a number of years it is a far better measure of the economic reality of a business than the income statement.

A good example of this in recent history is Vestas, the wind turbine manufacture and former darling of the Copenhagen stock market. Between 2006 and 2009 the company grew at a breathtaking pace with sales doubling and profits increasing fivefold.

At the same time, however, cash flow deteriorated with operating cash flow turning negative in 2009.

The deterioration in operating cash flow was driven principally by

Figure 1: Vestas P/L earnings and OCF



Source: company reports.

ALISTAIR WITTET

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significant working capital outflows in 2008 and 2009 as a result of a marked increase in accounts receivable. In other words Vestas was booking revenues without receiving the cash associated with them. By 2009 Vestas was reporting P/L profits (here defined as net income + D&A) of over €800m while in cash terms (operating cash flow) making a loss.

In August 2010 the company surprised the market by announcing a change in its accounting policies: rather than account for revenue on a percentage of completion basis, ie book revenue associated with a turbine as they build it, they would book revenue only when the turbine was built and the client had taken ownership of it. With this they restated their 2009 earnings downwards by 78% and from peak to trough the shares lost more than 95% of their value. It should be added that this was not the only issue facing Vestas at the time: increased competition and less favourable regulation were also weighing. But the two are not necessarily unrelated. Just last year Tesco's multiple profit warnings on the back of weak sales were followed by an accounting scandal in which it transpired supplier rebates were being booked before the products were even sold. As Horatio Nelson put it, though in a very different context, "desperate affairs [lead to] desperate measures".

In a note entitled "The Cash Conversion Gap – A Litmus Test For Earnings Quality" analysts at Goldman Sachs attempted to quantify the benefit of looking at cash over earnings in order to adjust for differing accounting practices. In it, as with the Vestas example above, they look at the difference between Operating Cash Flow and its P/L equivalent.

They concluded that high cash flow companies outperformed low cash flow companies by an average of 5% per annum between 2002 and 2014<sup>1</sup>. Indeed accruals are a favourite metric included in many quant models, and for good reason: they work.

Looking at cash conversion doesn't just address the quality of earnings, it also tells us something about returns. For a given level of growth a business which generates cash will have a higher return on capital than a business which consumes all its available cash. Indeed it is a better measure than the more traditional balance sheet return on capital employed calculation as it assesses the marginal return rather than the historic one. Carrefour for many years boasted a very healthy 20% return on capital employed (ROCE) but was cutting back its capital expenditure budget every year. The reason was that the ROCE figure was based on a capital employed of land and buildings from 20 years prior when property was cheap. In actual fact had it built a new hypermarket at the time its return on the investment would likely have been less than 5%. The balance sheet tells us about the past while cash tells us about the present.

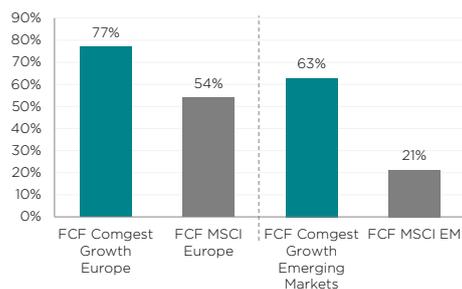
We at Comgest place due importance on cash generation and this is

<sup>1</sup> The exercise involved going long the top quintile of cash converters and going short the bottom quintile in Japan, the US, Europe and Asia ex Japan. The portfolio was rebalanced quarterly.

ALISTAIR WITTET

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**Figure 2: Comgest portfolios FCF\* conversion.**



Source: Factset

\*FCF conversion is defined as operating cash flow, minus capital expenditures, divided by adjusted net income. Average of 2011, 2012 and 2013

reflected in the superior free cash flow conversion profiles<sup>2</sup> of our portfolios. Renaissance Europe, Comgest's flagship European fund, has generated on average 80c of cash for every euro of profit, compared to 50c for the index (ex-financials)<sup>3</sup>. The more capital intensive nature of emerging market companies (more infrastructure, fewer services) means the conversion is lower at 60c for Magellan, Comgest's flagship EM fund, but still significantly above the index at just 20c (again ex financials).

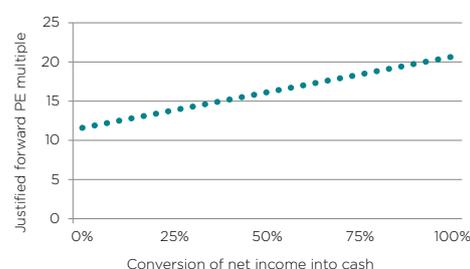
What is more, the companies in our portfolios, despite spending less, have grown faster than the index (on an organic basis). This is testament to their superior returns on marginal capital employed.

Such strong cash generation leaves the quality growth companies Comgest selects with the (rather nice) dilemma as to what to do with it. Management has three options: make acquisitions, return it to shareholders or pay down debt. As most of the companies we invest in have little to no debt (itself a function of the cash generation) it's really a debate between the first two. Some companies are serial acquirers such as JBS, the Brazilian company which spends all its FCF on consolidating the global protein market. Some make no acquisitions at all, such as apparel retailers Inditex and H&M or semiconductor leader TSMC, who return substantially all their free cash flow to shareholders. And some do both, like Essilor who split their free cash flow equally between acquisitions and shareholder returns. For Comgest's European portfolio as a whole from 2011 to 2013 the split has been 43% acquisitions, 48% cash returns and 9% debt repayments. For our EM portfolio a little less is spent on acquisitions (19%) with a little more on shareholder returns (73%).

Whichever way one looks at it, we believe superior cash generation is good for shareholders.

This naturally also has implications on valuation. Two businesses growing at the same pace, one accumulating cash, the other debt are worth very different amounts. The chart below plots, from a purely theoretical standpoint, the relationship between cash conversion and the justified forward price earnings multiple (P/E)<sup>4</sup>. Assuming 10% growth over 10 years the business converting all of the profit into cash "justifies" a price to earnings (P/E) multiple of 20.7x compared to a multiple of 11.6x for the business which has consumed all that cash in order to fund the growth.

**Figure 3: Conversion of net income into cash**



Source: Comgest

<sup>2</sup> Free cash flow conversion defined as operating cash flow minus capital expenditures divided by adjusted net income.

<sup>3</sup> We exclude financials from the calculation since the nature of their business makes cash conversion percentages meaningless.

<sup>4</sup> In this exercise we have used a DDM and equated the cash conversion to the payout ratio. It is important to note here that we are referring to net cash after all investments be they capex or acquisitions, but before financing. This is free cash flow post acquisitions. The inputs are  $K_e = 10\%$ ,  $\text{growth} = 10\%$ ,  $\text{duration} = 10 \text{ years}$ ,  $\text{terminal growth} = 2\%$ .

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Or put differently, the cash generator is worth almost twice as much as the cash consumer. This is perhaps not surprising but it is remarkable how rarely discussions about valuation incorporate this critical dimension.

It is worth noting that this theoretical framework is capable of explaining much of the price earnings premium typically enjoyed by our portfolio over the index, as the companies Comgest select tend to convert far more earnings into cash than the average.

Perhaps above all, cash is intuitive. A colleague once attended a presentation by Richemont in which the Chairman said, when questioned by an analyst about his ROCE/WACC<sup>5</sup> spread and what it meant for value creation, "I measure value creation by the amount of cash accumulating at the bank". This disarmingly simple approach is exactly how an individual would assess his personal wealth and is common to most business owners be they tradesmen, selfemployed entrepreneurs, owners of multibillion dollar global enterprises or Rough House. And yet it is a measure investors often lose in the wash. They do so at their peril.

<sup>5</sup> WACC = weighted average cost of capital



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Alistair Wittet graduated from the University of Durham and is a CFA® charterholder. Alistair started his career in 2006 working as an investment analyst for Standard Life Investments before moving on to cover pan European food retail stocks as an equity analyst at Citigroup in 2009. Alistair joined Comgest in 2012, specialising in European equities.

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