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PARTNERS

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ANATOMY OF A COMPOUNDER PART 1:

A close look at a foundational element of our investment process.

Over the course of 2023, we would like to go into more detail about a foundational element of our investment process. This is the official launch of our series on "The Anatomy of a Compounder." The remainder of the Insight pieces can be found through our website (stay tuned for details), but we felt it was important to begin our journey in our market commentary.

We believe every business we own is, or has the potential to be, a compounder. Over the course of the series, we will give Langdon's definition of a compounder and provide examples of different types of compounders via companies we currently own. We will also illustrate how companies fail to become compounders and lastly, why smaller companies are a great segment of the market to find compounders.

What is a compounder?

There is no "source of truth" for what defines a compounder. In our opinion, a compounder is a company that can consistently grow its intrinsic value at a high rate for a long period of time. For us at Langdon specifically, a high rate is approximately 15%

and a long period of time is ten-plus years. Intrinsic value is in some regards a subjective measure. Thus, we use a combination of InvestedCapital[1] and Free Cash Flow[2] per Share as our proxies.

Most often, compounders are companies that reinvest their excess free cash flow (FCF) each year back into the business at a high and sustainable rate of return. They have a long runway of opportunity to reinvest this cash flow, and skilled management teams capable of both deploying the capital and operating the business. If returns on invested capital (ROIC)[3] hold constant, invested capital and FCF will compound at the prevailing ROIC. A hypothetical example is below:

Year		1		2		3		4		5		6	Growth
Invested Capital	$	1,000	$	1,150	$	1,323	$	1,521	$	1,749	$	2,011	15%
ROIC		15%		15%		15%		15%		15%		15%	
EBIT	$	150	$	173	$	198	$	228	$	262	$	302	15%
Reinvestment Rate		100%		100%		100%		100%		100%		100%	

EBIT =Earnings before interest and Taxes

A second type of compounder are Companies that can grow without the need for capital reinvestment, which is extremely valuable. Imagine growing at 15% annually while also getting a dividend every year? We will explore both types of compounders in more depth in parts 2 and 3 of this series.

Why do we look for compounders?

We are firm believers that over time, a stock will grow at the rate at which the business has grown its intrinsic value. Over the last 96 years, US small caps have returned approximately 12% annually while US large caps have returned approximately 10%[4]. If we can find companies that can consistently grow their intrinsic value at well above that rate and buy them when we think they are materially undervalued, we think we will be able to outperform the index.

There maybe money to be made through other methods, such as buying mature businesses at low multiples and hoping for the multiple to expand, or trend following, or buying growth at any price. This works for many investors, and we commend them for their performance. However, this leads to higher turnover in portfolios, which is expensive (trading costs and taxes), and creates reinvestment risks for us as investment managers. It is hard to find great ideas, we are very selective. Owning compounders allows us to have a lower turnover portfolio, as management teams we back have intimate knowledge of their own reinvestment

1 Invested Capital = Book Value of Equity + Book Value of Net Debt

2 Free Cash Flow = Cash from operations less maintenance capital expenditures

3 ROIC =EBIT/Invested Capital

4 Including Dividends. Source: Ibbotson SBBI Data

opportunities, enabling us to compound with less friction and at lower cost.

What to do when you find a compounder

We think that if we can find a few businesses with durable competitive advantages and long runways for reinvestment, so long as we do not overpay, we can earn high rates of return for our clients. We are very cautious of the price we pay, and we do not underwrite multiple expansion. That is not to say the work stops when we buy. We continue to research our businesses thoroughly and are always testing our hypotheses. However, in an ideal world we merely continue to own and in fact add to the positions over time when price materially dislocates from value.

The relentless pursuit of compounders

Oftentimes, compounders trade at higher multiples, which leads some to believe they are “expensive” and “risky”. Although that may be the case in many situations, we believe successful compounders have proven to be cheap in hindsight due to their ability to continue growing at a high rate for longer than people believe. Humans are not very good at thinking exponentially and it can be scary to model such growth in a spreadsheet. Despite these inherent difficulties, we trust our process to find quality compounders, and are on a relentless pursuit to find companies that will create value for years to come.

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