MOI GLOBAL

Christian Billinger on Investing in Clusters of High-Quality Businesses

Christian Billinger of Billinger Förvaltning discussed his approach to investing in clusters of high-quality businesses at Best Ideas 2021.

Thesis summary:

As a long-term investor in high quality businesses, Christian tends to focus on a few "clusters" of companies that generate sustainably high returns on capital with limited downside.

Christian presented three of those clusters to the MOI Global community as part of Best Ideas 2021:

- Elevators & Escalators,
- TIC (Testing, Inspection & Certification),
- and Aircraft Engines.

The "clusters" combine resilient top-lines, flexible cost structures, and attractive market dynamics to enable attractive rates of long-term compounding. Christian believes that thinking in "clusters" makes for an efficient way to manage a portfolio.

The following transcript has been edited for space and clarity.

Christian Billinger: I title this presentation, "A Look at Three Clusters of High-Quality Businesses." I won't present a single buy idea. Instead I will present a few groups of companies we are invested in and which might be of interest to other long-term, quality-focused investors. I plan to give you a brief background on our operation because it's relevant to the rest of the presentation in terms of why we're invested in these types of companies, these clusters. The three clusters consist of five companies in total. Then I will go through three different aspects of the clusters that appeal to us. Those are the top-line performances of these businesses, their cost structures and operating margin performance, and the market structures in which they operate. Finally, I'll tie it all together.

Billinger Förvaltning is the company I have run for a few years. We are a privately held company; I own 100% of the company. We don't have any external investors unlike a typical fund or hedge fund. The appeal of that is that we can invest for the long term. We don't have any short-term performance pressures. We can be relatively concentrated. We typically hold about 15. That number has come down a bit. It used to be around 25, and then about 20, and now we're at about 15 high-quality businesses, mainly in Europe. We also have some holdings in the U.S. The permanent capital also enables this concentration. We're long-term. We're concentrated. We're quality-focused. We look at the downside risks first and the upside or the opportunities second, and that's partly to do with the setup. We don't need to worry about short-term performance. We worry primarily about capital preservation, and only thereafter would we be looking at the opportunity for growing our capital base which, of course, is important in the long run. I think in terms of process and mindset. As Charlie Munger often says, we're trying to avoid doing stupid things as opposed to doing smart

things. You'll probably see that reflected in the idea or the ideas I present here because we don't tend to deal in exotic, complex, or special situation investments. Some people are incredibly skilled at doing that and they produce incredible returns over long periods. But it doesn't suit us temperamentally or in terms of our skillset. We also avoid situations where a lot of things need to go right, if you will. The clusters I present will reflect that thinking. The clusters will come from three different industries, but they have similarities in terms of their business models and return profiles.

To put this best idea in context, most of the time we're just preparing to grasp an opportunity by reading and thinking and discussing ideas with other investors, speaking to companies, reading research, reading books, speaking to industry experts. In the spring of last year – February, March, April in 2020 – we invested heavily because during the selloff we found several opportunities mainly to add to existing holdings. We also made a few new purchases. We haven't made any purchases since then. When I thought of an idea to present as part of the Best Ideas Conference today, I felt it would be slightly inconsistent for me to present a strong buy case because we're not currently buying anything. It's more relevant to present these clusters of high-quality businesses that could make it to someone else's – I know they are already on many quality-focused investors' shortlists, but I hope a few people listening to this haven't looked at them before. They're worthy of consideration for inclusion in someone's investable universe. Hopefully, there will be an opportunity to buy these companies at an attractive or fair valuation.

There's a difference between buying and holding something. That's why it's consistent for us to hold these securities but not to advocate buying them. We haven't been buying them, and I'm not necessarily advocating that others buy them now. They're companies that are worth keeping an eye on.

These three clusters of high-quality businesses make up around 45% or 50% of our NAV following some changes we made to the portfolio. The first cluster is elevators and escalators. We are invested in two companies in that space corner, KONE, a Finnish business, and Schindler, a Swiss business. The second cluster is TIC, which is short for testing, inspection, and certification. We're invested in that cluster through Intertek, a U.K. business, and SGS, a Swiss business. There is only one company in the third cluster, but we have other companies in our investable universe in that space. I thought it's fair to include this as a cluster, and that's aircraft engines. We are invested in MTU Aero Engines, which is based outside Munich. We monitor some other companies in that space that might be added to the portfolio sometime.

I wanted to cover these three aspects of the clusters, their operating and financial characteristics. The first one is top-line resilience. We look for companies that provide some form of essential or critical product or service where there's a low risk of substitution. One of the classic examples of this is elevators and escalators. Going up and down a building is one of these activities which is hard to see being replaced by some other form of technology or by becoming obsolete. It certainly qualifies as a critical product or service with low technology risk. I'm not saying there's no technology risk in any of these clusters. There always is some, but we find change happens slowly enough in these clusters, so we hope to have time to detect what's going on and reduce our exposure if that's the conclusion we reach. Another aspect of having a resilient top-line apart from the nature of the product itself is having a diverse customer base. "Diverse" could mean many customers in different industries or different geographies. Generally, these companies are diverse; the exception is in aircraft engines where MTU sells to a concentrated customer base, but there are other reasons that business still qualifies as a high-quality business. Finally, these companies

usually generate some form of recurring revenues because there are regulatory requirements. For instance, you need to serve as a lift or an aircraft, or you need to have products certified and inspected before they can be launched in a certain market. It could also be out of commercial considerations and reputational risks. These three clusters include companies with resilient top lines.

One of our ideas is – once again, appealing to Charlie Munger – I heard him say Berkshire wants to buy great paper records, and that's certainly something we look to do as well. We look to buy into companies that have produced strong top-line track records over long periods. For the companies presented here, I chose a top-line track record long enough to include the great financial crisis, 15 or 16 years. That period includes the Euro crisis, Brexit, and, more recently, COVID. I include data points for most of these companies in most years. There are a few exceptions where I felt the data wasn't of high enough quality because of structural changes in the companies. Over this period, the group has averaged about 6% organic growth. If we include the first nine months of 2020, only seven out of 76 of those company years, if you will, were negative organic growth outcomes. The low point was minus 13% for MTU in 2020. That's quite striking to begin with, especially if you consider that MTU is, after all, operating in a highly cyclical end market. If you exclude 2020, only three out of 71 company years had negative organic growth. That's incredibly robust and resilient performance during a period with all these events.

We're certainly not looking for companies with zero cyclicality or variability in the top line. If that's what you're looking for, you'd probably be more interested in some elements of fixed income or even in the equity space. You might be looking at more highly regulated businesses like utilities. But we look for companies where the volatility tends to happen on the upside. For the group overall, for instance, the worst outcome until last year was essentially a flat performance in 2009. That's extraordinary if you look at the performance through the financial crisis. There's certainly variability. It tends to happen more on the upside though, as in the worst outcome we've seen from this group has effectively been flat performance excluding the minus 6% in the first nine months of last year. But there has been variability to the upside, so you have some years here both pre- and post-financial crisis where growth has been high single digits or even low double digits. We find that attractive.

That's on the top line side of things. Let's move on to the second aspect of these clusters, their cost structures and operating margin performance. We look for companies that lack economies of scale, which to some probably sounds counterintuitive. By this I mean if you find investment ideas, you write about them, and they keep growing, then you probably want high operating leverage because you get much higher earnings growth for a given increase in revenues. Given the fact we first look for a limited downside, we want limited operating leverage so that if we're wrong on the top line – I've covered several reasons why we feel these clusters provide robust top lines, but we want to add another layer of security or protection. We're saying to ourselves, what if we're wrong about the top-line performance of these businesses? How can we then limit the downside in terms of the earnings performance? That's where the flexible cost structures come in. This is partly to do with their business models, and it's partly to do with the way these companies tend to invest for the long term. You'll see that even as the scale of these businesses has grown significantly over the last 15 years; they haven't seen huge margin expansion. That's partly because of their business models, but it's also partly because these are companies that tend to invest to strengthen their market positions often because of family control.

In terms of the aspects of their business models that explain these flexible cost structures, there's a second point which is the high proportion of outsourced components. KONE and

Schindler, for instance, are largely assembly operations. Similarly, much of what MTU does isn't what you would traditionally expect of an industrial or engineering company. I encourage people who have the opportunity to visit the production facilities of some of these companies to the extent that they exist. It's impressive. That's on the elevator and escalator side. On the other hand, the TIC companies, SGS and Intertek, can manage their cost base over time. That relates to the idea of flexible or semi-fixed cost base. Their large cost items relate to their headcount. You could argue that's a fixed cost in the short- to medium-term, but over time, they're able to manage that cost base depending on the ups and the downs of the business even if they tend to take a long-term view. As a group, these companies have low capital intensities, and that means that's another aspect of managing or reducing the operating leverage.

If we look at operating margins for the group over the last 15 or 16 years, performance or the operating margin has been between 11.7% and 14.8%; the lowest operating margin was in the first nine months of 2020, and the 14.8% rate was in 2019. Even if you look at the average operating margin for the group – I suspect if you only had these operating margin numbers to go by and you weren't aware of what was going on in the world around you, you'd struggle to suspect anything dramatic had happened in the environment during that time. If you go back to the financial crisis, operating margins went from 13% in 2007, to 13.5% in 2008, to 13.9% in 2009, and 14.4% in 2010. The only time you might have suspected something was going on is if you look at the number for the first nine months of last year where operating margins for the group were down by about three percentage points. Even then, I suspect you'd struggle to imagine that something as severe as the COVID pandemic was going on in the world in which these companies operate. This just goes to show how robust these companies are in terms of earnings performance.

The final aspect I want to cover about these three clusters – there are many more, but these three aspects should be sufficient to give you a feel for why we find them so attractive – is to discuss the market structures in which they operate. These companies tend to operate in market structures or competitive environments that are both stable and relatively concentrated. If you go back 5 or 10 years, you'd probably see the same companies occupying number one to three or number one to five in their respective industries. Elevators and escalators are more highly concentrated in most markets where the four large companies dominate that market. Testing, inspection, certification, slightly less so, but that industry is still consolidating, and the listed companies like Intertek, SGS, and Bureau Veritas – we're not invested in Bureau Veritas – have strong positions and have had strong positions for a long time. It's not a dynamic environment in that sense, which we find is helpful because it makes it easier to perform the analysis in terms of mapping the competitive environment. It also helps these companies generate sustainably high returns on capital by providing better pricing power, higher barriers to entry partly because you need a certain network density if you look at elevators and escalators, or because switching costs are high if you look at aircraft engines or many aspects of testing, inspection, and certification. This is yet another aspect of these three clusters that make them attractive for a long-term quality-focused investor.

In conclusion, our approach is that investing in two or more companies across a few different clusters or industries provides some diversification in terms of reducing company-specific risk. Often, if you look at elevators and escalators, there are some nuances in how these companies are positioned. KONE, for instance, has been much more exposed to the Chinese new construction market, which is sometimes good, sometimes bad; Schindler, less so. What's helpful in our approach is we don't – often, it's difficult to establish that one of these

companies has a better positioning or exposure than the other company. If we own two or more across a few of these attractive clusters, we eliminate some of that company-specific risk. We also find it's helpful when it comes to resourcing or analytical capacity because it's easier to stay on top of a handful of industries where you might have two or three holdings in each and make a portfolio of say 15 holdings across five different clusters or industries as opposed to staying on top of 10 or 15 different industries. That's partly because you read-across between companies. If we know something about Intertek, we also know something about SGS and vice versa. The same thing for KONE and Schindler, and similarly for MTU. You tend to develop a deeper understanding of these industries. There are also opportunities for replication between industries. That's the core of what I've been speaking about in this presentation: Although they operate in very different industries, these companies and clusters share similar characteristics in terms of business models and financial characteristics that suit us. I hope these companies interest some of you who are more focused on the quality end of the spectrum and that they may be worthy of inclusion in your investable universe.

The following are excerpts of the Q&A session with Christian Billinger:

John Mihaljevic: Christian, thank you for these remarks and for outlining the three clusters in which you find opportunity. Could you talk a little about how you value the businesses in each of the three clusters? What are some of the key metrics or criteria you look at?

Billinger: By design, I didn't mention valuation. Perhaps the most important reason is we tend not to look at valuation nearly as much as we look at the qualitative characteristics of these businesses, and that's to do with going back to our setup and the permanent capital and being long term. We look to capture the underlying returns of these businesses we own. While it does matter to us at which valuations, we can buy these companies – that's the reason we invested so heavily in the spring of last year – that matters a lot less than the operating and financial characteristics of the companies themselves.

One of the advantages of investing in these types of clusters and companies with resilient top lines, limited operating leverage, and other properties I mentioned, is they're much easier to value; it's easier to figure out – let's call it underlying earnings. That earnings number doesn't tend to move around a whole lot. Yes, in the first nine months of last year, for the full year when numbers are released, some of the companies in this group, especially MTU, saw a meaningful earnings hit. But it's an unusual time, and if you go to the annual reports of these companies, you will see their earnings and cash flows develop in a relatively orderly fashion.

We look at fairly simplistic valuation measures, John. We don't build large spreadsheets and that sort of thing. I used to in a previous life, but we don't anymore, and that's also a conscious decision. We look at things like free cash flow yield. We also look at P/E ratios because they're easier to communicate. After all, these companies tend to convert most of their earnings into cash flow, at least before growth CAPEX and acquisitions. What you can see is if you look at trailing 12-month P/E ratios for this group, they are at a meaningful premium to the market. If we look at these numbers until the end of June last year, these companies were trading in a range of around 30x to almost 40x earnings. But keep in mind, this is just for simplification; this is trailing 12-month earnings. If we look at, say, 2021 or 2022, we might be in the high 20s or somewhere there as opposed to the mid-30s. That is a meaningful premium to the market. Having said that, there are good reasons they should be trading – I will almost always find that these types of businesses are undervalued because of

institutional reasons like the time horizons of large mutual fund managers.

Also related to this conversation about multiples is the fact that it’s most important to look at the operating performance. Rarely do you see companies experience multiple contractions when they continue to have strong operating performances for long periods. It’s still more important to look at the business characteristics. Ideally, we want to buy these companies on weakness. Normally, we’re almost fully invested. We happened to have a meaningful amount of cash in the spring of last year, so we were lucky that we could add to some of these holdings at attractive valuation levels. But even otherwise, the premium is more than justified by the quality, the balance sheet, the earnings growth of these companies.

Mihaljevic: Your point on wanting to benefit from the returns of the businesses themselves speaks to your long-term approach. When you look at a company like MTU Aero Engines, how broad do you go in terms of the sector or looking at other companies that might be similar or related? How deep do you go on understanding the business itself?

Billinger: I tend to look at several aspects of the industry in which these companies operate. One of the advantages of looking at companies that are in industries with relatively stable and concentrated market structures is that you know which are the companies to look at. For MTU, for instance, at least annually I read the research and speak to experts on the airframers, so Airbus, Boeing. I look at and I speak to the engine manufacturers, so Rolls Royce and Pratt & Whitney. Sometimes these are not independently listed companies, but you can often speak to the parent company or speak to someone in one of the divisions you’re interested in. I also speak to the customer base, i.e., the airlines. That way, I try to develop a relatively deep understanding of the value chain and where the value is generated and captured in that chain. I look at their competitive positioning and their strengths and weaknesses in terms of technology and which programs they’re on. I look at it broadly both by speaking to the companies all across the value chain and by selectively reading sell-side research. We effectively use one provider we think is good, and we also use experts. We speak to former employees of these companies and competitors of these companies, and we try to develop an understanding especially of the weaknesses of these companies.

You asked about MTU specifically, John. Some of the questions I asked these people concern how well positioned they feel MTU is in terms of which aircraft programs they’re on and whether they think they’re investing sufficiently behind next-generation technology. Also, I asked whether it’s hydrogen or something else. Should we worry about a Chinese or a Russian player impacting the dynamics in the airframe space, emerging competitors to Airbus and Boeing? We look at it broadly. One of the reasons we like these clusters is because little tends to change, and when it does change, it changes slowly. I find that makes it easier to analyze, and it gives me much more comfort to take meaningful positions in these companies.

Mihaljevic: Can you talk a little about businesses in the technology space? Would you consider those? What would it have to come down to for you to look at software businesses, internet businesses, and the like?

Billinger: We have done that in the past. We certainly look at a large number of companies across a large number of industries, and software and related businesses are certainly some of those we have looked at. We have occasionally been invested. “Technology” is a broad term. We are interested in some less cutting-edge parts of the tech space. Do you consider, say, MasterCard or Visa to be a technology business or the London Stock Exchange? In which case, we are interested, and they’re certainly part of our investable universe. Yes, certain

types of technology businesses are of interest to us, but they need to exhibit some of the characteristics I've touched – top-line resilience, low or moderate technology risk, limited operating leverage, and relatively predictable market structures.

First, I've found it more difficult to get comfortable with those types of companies in many parts of the tech space. Second and maybe even more importantly, it's to do with our circle of competence. We gravitate toward companies in consumer goods, industrial-type businesses, and a few other industries. We are less comfortable with most of what we label tech. We don't have much experience in it. It doesn't seem to suit our skillset or temperament quite as well. That's one reason they don't make up much of our portfolio. Of course, we want companies that benefit from technology trends, but we tend not to invest directly in the providers of that technology. Given what's been happening in markets over the last 5, 10, 15, or 20 years with some of these companies becoming incredibly powerful and impacting almost any industry you look at, you must keep an eye on them and try and understand them. We do, and we speak to some of them, and we read the research. But I also want to move slowly, perhaps sometimes too slowly. But that comes back to this idea of worry about the downside first. There are so many other opportunities for us to generate a reasonable track record and a reasonable performance, so far we haven't felt the need to move in that direction.

Mihaljevic: Makes a lot of sense. I encourage our members to follow up with you directly with their own thoughts or questions on the clusters you outlined or anything else that might be of interest. Thank you for taking the time to be with us.

Billinger: Thank you, John, for putting together a great conference. I'd be delighted if anyone's interested in having a further conversation about these topics.

About the instructor:

Christian Billinger is an Investor at Billinger Förvaltning, a family-held investment company with no external capital. The simplicity of the setup as well as permanent and patient capital provides Christian with the proper environment to pursue his strategy of identifying long term compounders.

Christian focuses first on the qualities of robustness and resilience which limit downside potential before determining the mix of returns on capital and scope for reinvestment opportunity that accounts for the upside. Often, these factors overlap with family-controlled management teams that more conservatively finance their operations.

Prior to Billinger Förvaltning, Christian worked as a European Equity Analyst for various investments funds. Before that, Christian was an associate at PwC. He holds an MS in Accounting and Finance from The London School of Economics as well as Karlstad University. He is also a CFA charterholder. He splits time between London and Sweden.

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