This post by Elliot Turner has been excerpted from a letter of RGA Investment Advisors.

During the [first] quarter [of 2017] we commenced a position in Arcadis (AMS: ARCAD). Arcadis is a global design and consultancy firm with specialties in infrastructure, water, environmental remediation and architecture. They work on vital pieces of infrastructure that touch our lives daily: levees, tunneling for subways and water pipes, dams, desalination plants, help municipalities manage flood plains and construct plans, etc. The company's 20,000 plus employees work on 30,000 projects annually around the globe.

The unique specialty and capabilities in water put this on our radar. If you casually followed some of the post-Sandy reconstruction in New York and the discussion of broader coastal protection, it is likely you have come across this name. As we often do, we noted Arcadis' contribution to the reconstruction efforts and put them on a long-term watch list. Over the past year, between a spate of poorly timed (and executed) emerging market acquisitions, an investigation by Brazilian authorities of corruption in the procurement of construction contracts (notably Arcadis is a design, not construction firm) and evolving needs of the formerly very profitable US environmental remediation business, the stock took a beating. Nonetheless, free cash flow remained high. Heading into the new year, the company "parted ways" (aka fired) its CEO Neil McArthur and hinted at a renewed emphasis on operations over growth. To that end, Arcadis hired Peter Oosterveer, the long-time COO of Fluor Corp (NYSE: FLR) who has the right experience and exposure to help streamline operations and restore profitability accordingly.

Arcadis' main input cost is labor capital. The company is not necessarily unique in this respect; however, they are unique in their ownership structure. The single largest owner of shares is an aggregated pool of employee holdings—representing 17.2% of the outstanding shares. There is very little physical capital deployed in the company. As such, capital expenditures are very low and most investment flows through in the form of labor expenses. The company has a shared common knowledge base that is "housed" in its DNA that gets deployed to each project along the way. This knowledge and expertise is something that other companies would have difficulty to replicate both in its scale, its vintage, and its specialty.

Returns on capital are very high at Arcadis (30% ROIC ex-goodwill and acquired intangibles). With goodwill and intangibles the numbers are inferior now—hovering around 8%, due to the sluggish performance of some of the more recent, larger transactions and the downturn in the Emerging Markets business.ROIC ex-goodwill is the best way to judge this company, because when you include goodwill, you are making a judgment on management in addition to the actual business. Looking exclusive of goodwill gives a clearer picture on the cash generation capacity of the business as it stands today. This is particularly relevant here as the company transitions from an acquisitive to an operations-focused CEO. Oosterveer comes in with a clean slate and will be unencumbered by the returns generated on goodwill (ie by the strategic decisions of previous management).

Cash generation is very lush, and supports both the interest expense in its presently over-levered state, as well as a dividend payout of 30-40% of net income. CAPEX has been, and will continue to be low. Since there is little physical capital deployed in the business, fixed costs in the long run are very low; however, they are high in the short run due to certain institutional imperatives and the uncertainty with respect to how quickly cyclical forces will resolve themselves. When the company has clarity (as it does in Brazil) that the problems run deeper than merely cyclical ones, they can right-size the cost base and restore margins fairly quickly. This helps make cyclical margin problems shorter-term in nature, even if revenues don't come back quickly enough. While the company is a cyclical, the infrastructure needs they service are secular. To that end, it is the funding cycles, not necessarily end demand which are cyclical. Working capital does eat up some capital, though that is proportionate to the revenue base at any given time. There are nearer-term problems right now as some oil and gas companies and countries exposed to oil and gas pricing have stalled on payments. These problems will be watched closely, though we believe they should be resolved in the not-too-distant future.

As a company that deploys labor, it's important to mention that most of the projects are staffed locally—projects are staffed with people who are located in the same country as the project itself. The Hyder division brought in global outsourcing centers in India and the Philippines that are used for some elements of design and architecture, though this is mainly for UK-based projects. Only 3% of US-based projects are staffed with outsourced talent. This was particularly helpful in thinking about what may happen to the company were the US to adopt a border adjustment tax.

Further adding to our intrigue in Arcadis is the contribution the company can have to the portfolio's correlations–in particular, flooding events are bad for the economy and especially so for insurance/reinsurance, to which we have exposure by way of Markel (NYSE: MKL) and Exor N.V (MILEXO.MI). If a flood event hurt the reinsurance sector, it is likely that Arcadis would move strongly in the opposite direction (for context, Arcadis rose 5.6% the day Sandy made landfall and enjoyed an especially strong year). At the time of our purchase, we picked up shares for just north of a 10% cash flow yield based on our 2017 estimate. Should multiples remain constant, then we would expect to earn this double-digit cash flow yield over time. This estimate assumes no margin improvement. If margins improve in 2018 (and the company has taken action to effect that outcome), alongside any basic recovery in cyclically weak areas of infrastructure demand, there is the potential for powerfully strong performance. One thing is clear with Arcadis: there will continue to be immense need for the crucial services they provide in making our world more livable, especially in the face of climate change.