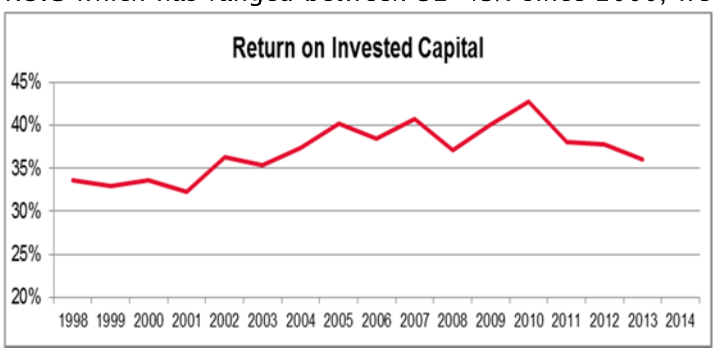
Mathew Hermary, CFA

Great and Getting Better

Great businesses can be classified as having enduring franchises whose stable earnings grow shareholder value consistently over time. However, achieving such status is rare, as it requires durable competitive advantages which are generally hard to achieve and harder to maintain.

Procter & Gamble (P&G), a recent purchase in the global equity portfolio, is a business which exhibits such attributes. With a myriad of household brands including Gillette, Tide, Pantene, Crest, Pampers and Olay, P&G's products are cemented within consumer purchasing patterns, often serving as a first choice when buying razors, detergent or toothpaste. The proof of the franchise's strength is in the numbers. P&G has consistently built shareholder value over many decades, raising dividends for 59 consecutive years, growing earnings at 8.4% annually over the last 25 years, and generating consistently strong profits in good years and bad.

At the core of any great business is an ability to earn an above average, sustainable return on its capital base. This is what truly differentiates a good business from a great business. Return on Invested Capital (ROIC), a calculation which compares a company's operating income to its net working capital and fixed assets captures this concept well. Looking to P&G's historical ROIC which has ranged between 32-43% since 2000, we see a quantification of the company's staying power. To offer comparison, the current median ROIC of more than 4,900 global companies with market capitalizations greater than one billion USD is 12%, far less than half of shareholders. This is no small feat.



Source: Capital IQ

Although some franchises can often survive on the success of their legacy businesses for a long time, remaining great requires sound management. When investors try to characterize great management, catch words like shareholder focused, disciplined, or risk averse are often used. Management's success over the long term however, is ultimately determined by their ability to profitability reinvest a business' cash flows at acceptable rates of return. The incremental ROIC (IROIC) is one way to measure the marginal return on these cash flows. IROIC can be a choppy evaluation metric with some limitations, but its trend over time greatly helps determine whether management has been building or destroying the franchise.

From 2000 until his retirement in 2009, Procter & Gamble's CEO A.G. Lafley oversaw innovation with new hit brands like Febreze, a refocusing towards core brands, and the massive acquisition of Gillette in 2005. The franchise flourished as high incremental returns on capital improved the company's overall returns and earnings per share grew from $1.23 to over $4. From 2010 to 2012 however, poor incremental returns on capital under the new CEO Robert McDonald caused profitability to falter and P&G's business to languish. Amidst investor pressure, McDonald retired in 2013 and the board of directors called Lafley from retirement to reinvigorate the company's stagnating performance. In the time since, Lafley's actions look to be focused on improving returns on capital once again. This May he sold the majority of the company's underperforming pet food business for $2.9 billion. More recently, P&G announced that it will jettison up to 100 noncore brands to focus on its biggest brands which represent over 95% of profits. Although only small steps have been taken so far, they look like strides in the right direction.

Of course a great business isn't always a great investment. Great investments are also determined by the price that is paid. P&G trades at 18.5x 2015 expected earnings, slightly below its long term median, it has a 3.1% dividend yield and we believe that ongoing improvements should still offer investors decent returns at much lower risk than we think is commonly available in the market today.