the art of boring™

EP21 | Playing the plan: Mawer's global small cap portfolio

00:22 **Cam Webster**
On this episode, we speak with Christian Deckart, lead portfolio manager of the Mawer global small cap strategy. We talk about a few of the holdings in the portfolio to demonstrate the small cap life cycle, how M&A situations present a double-edged sword, and how we continue to turn over new stones. Thanks for listening!

01:02 **Cam Webster**
Welcome to the podcast.

01:10 **Christian Deckart**
Thank you, Cam.

01:13 **Cam Webster**
Why don't we start with some of the key characteristics of a global small cap business, Christian. What is it? Is it basically a startup with a listing? ... Or is it just a number, like a market cap size? Let's start there and proceed into some of the details.

01:30 **Christian Deckart**
Yeah, pleasure. So, the first part of the answer: yes. It's not just a number to us. There are probably two elements that we would look at most. The first one is what I would call, the position of the company in the small cap life cycle. So, what do we mean by that? Companies start small and usually unknown to the broad public. It will be small; it will have little analyst coverage. But over time as the business is successful and grows, more people will follow that business. The company will be better known—also more appreciated by the public and by the stock market—and maybe at the end of the journey, it goes to an index, maybe a small cap index or large cap index. And so ETFs and passive investments are going to get interested.

02:15 **Christian Deckart**
Even all the household names we know today—most of them started very small and grew. The idea of the small cap life cycle is to participate in that as a company that's starts small, gets more known, gets onto indices, andjust gets more appreciated.

02:36 **Christian Deckart**
On the pure business side...our style at Mawer is, "be boring, make

money" so to be "boring," a company has to be established...ideally, it has a strong position already—there is a proven product or a service. Ideally, it's in some niche where it's well protected. And it has the opportunity to grow just in that niche; grow out of that niche; or, take the business to other adjacent markets—in terms of their products, service offerings, or regions where they operate.

03:15 **Christian Deckart** I'll give you an example for the business and the small cap life cycle: Gentrack, a business out of New Zealand that we bought 2015. What they do is billing software for utilities, so when you get your electrical bill, someone has to do that software that puts together that bill. It's quite important for the customer for the utility because if the bills don't get sent out, well, [then they] can't pay for that. And they also have software for airport operations, so, all the software you need to make an airport run.

03:50 **Christian Deckart** When we first bought that business—maybe three years ago—it was a small market cap. Maybe a couple hundred million New Zealand dollars. It had little analyst coverage, but it was increasing internationalization. They did that through a sensible strategy of staying in their language backyard: they put more emphasis on Australia and the United Kingdom, did some and M&A, and all of a sudden: more people are following it and the companies is in the NZ-50 Index (the index of the 50 largest companies in New Zealand! That, I think, is a good example of how the small cap life cycle can work and how the business cycle works. It wasn't a startup when we bought it. They have been around for decades.

04:28 **Cam Webster** A couple of elements I just want to round back into in your answer there. One could maybe conclude it sounds like it's just a popularity contest... there's this small cap business, and more and more people start following it, the price gets bid up, and it enters an index. This is a pretty clear example of how the life cycle can happen. It's not just a popularity contest, right?

04:54 **Christian Deckart** Good point! Yeah, the business will not get into an index or grow if it doesn't have a competitive advantage. And if it doesn't do good things for customers. So this is where our work really comes in—otherwise, we could, systematically, on auto-pilot, just buy all small businesses and hope they grow. But as active managers, our job is to go out there, look at these companies, interview management teams, read the annual reports,do the whole due diligence, and then find out which businesses have the potential today (although not maybe fully visible to someone who just looks at it on the surface), which businesses have the potential to grow into a larger organization one day, and which company has the intangibles today to become a large company down the road.

05:35 **Christian Deckart** And there is that element, you're right, of other people down the road appreciating [the company] maybe a bit more, but that is more of the result of good research in the first place—and if the company doing good things for customers. So, it's a side effect, which we're happy to take as well, but it's not the main goal of the exercise.

05:53 **Cam Webster** You mentioned keys to success that you're looking for...in terms of informing your investment decision. What types of factors do you evaluate?

06:10 **Christian Deckart** These basically come back to our investment criteria—what we look for in businesses that we buy for our clients. The three criteria are: it needs to be a wealth creating business, run by an excellent management team, and we try to purchase these at a discount to intrinsic value. ... A wealth creating business is a business that generates a return on capital above the cost of capital. Only then, really, is wealth created for shareholders.

06:39 **Christian Deckart** Secondly, we need an excellent management team that's aligned with shareholders, acts in the best interest of shareholders, and takes the business forward. And in the case of small caps, takes it to the next level. Then, obviously, we try to not overpay for these prices because if it was a great business, with a great management team, but the price is too high—well, then the future performance will suffer. So we need a discount to intrinsic value.

07:03 **Christian Deckart** These are mainly the three criteria you could call the "key ingredients to success of a small cap company" but it also happens to be the three investment criteria we have at Mawer for all our funds.

07:14 **Cam Webster** Can we go back to Gentrack and just cover why Gentrack ticked all those boxes?

07:19	Christian Deckart	There's a recurring nature. In the sense that, once the utilities or the airports have installed that software, they don't want to switch the next year. So there is some pricing power that Gentrack can exercise. And then software always has had the beauty—if you think of Microsoft now, really not a small cap—and hasn't been a small cap in a long time. [laughs]
07:39	Cam Webster	Not at all!
07:40	Christian Deckart	But you write the code once and then you can resell it to many people. So there is a huge cost advantage at getting new customers on your per unit costs. So that is a wealth creating business. Also because your customers are sticky, and because scale plays a role.
07:54	Cam Webster	And management teams. Gentrack's management team...?
07:58	Christian Deckart	We've been very impressed by the people who brought it public. I shouldn't say the founders, but the people who ran it pre the IPO, and the people who run it now...they have track record of acting in the best interest of shareholders in allocating capital in a good way. [Also,] good what we would call, "strategic logic"—the thinking about what they're doing, whether they're expanding. As I mentioned before, the expansion into the UK, Australia—they seem reasonable steps to us. And then finally, discount intrinsic value...when we bought it, it was at quite an attractive evaluation in our opinion.
08:30	Cam Webster	Thanks for that detail on Gentrack. If listeners want to hear a little more detail on kind of that same checklist with other companies, I'd directed them to Episode 7 with Christian. There are three or four other companies that you can listen to Christian talk through.
08:46	Cam Webster	So let's switch gears a little bit, Christian ... and let's talk about how the small cap market has developed in the past few years—maybe the past 10 years. Monetary easing has had a big impact ... as a portfolio manager, what are some of the structural things that have changed in the small cap market?
09:07	Christian Deckart	Yeah, we've had a few structural changes I would say. In the past, a small innovative company would go to the stock market to raise more capital to

expand growth. And...maybe because of the credit cycle, this has changed a bit. So many small innovative companies today don't go public any more. They're incubated in a private environment then go to venture capital. And then once venture capital has gotten them big enough, they're directly sold to the private equity, so totally bypassing public markets.

09:38 **Christian Deckart** That's a shift. I don't know if it's better or worse, but it's certainly a shift. And often the companies that come to the market today—when we look at their balance sheet, well, it's just weak. Often there is lots of debt. Numbers have been, what we would say, "optimized" and...everything is stretched: financials, accounting, the balance sheet. Also, these companies have done price increases over and over and ... but not necessarily increased the value proposition to their customers.
So these are the things obviously that are not of interest/or of little interest to us. But that's a bit how we feel the market has changed.

10:20 **Christian Deckart** And to be clear, a business like that—with stretched financials, stretched balanced sheet, that doesn't create enough value for its customers—that's not the thing we're interested in. So I'm talking about the market in general here. And the situation I'm describing is a bit like...if you go to a restaurant and there are many things on the menu that you don't like ... the challenge is, we still need to find something on the menu that we like, but the stuff coming onto the menu recently, the new arrivals, the new items are [often] just not things we're too keen on.

10:53 **Christian Deckart** There are a few exceptions, but that's the case. ... In a way, it's a problem for us because it creates more work. We have to look at more things. But it's like (if I stay in the restaurant picture), on the other hand, it's not a problem because you only need to find one meal that suits you, so you can ignore the other 29.
And our universe is big. It's thousands of companies so, just because there's some added that aren't our taste—that's not problem per se, but it's certainly one of those structural changes you mentioned.

11:19 **Christian Deckart** In summary, a 10 year bull market has just brought many less palatable items on the menu. So our motto is "choose wisely" in this context. And that's what we're motivated to do every day.

11:32	Cam Webster	Let's transition to geographies. Are there any tailor-made for global small caps? So, are there any aspects of any single geography that say, "Yup! Great place for global small caps."
11:42	Christian Deckart	Well, I would say all places are great to look. That's why we have a global mandate—so we can look everywhere. But there are some that tend to be more fruitful than others when we look. Often the blueprint is a small country that's protected through regulation or a language barrier and where companies can have focus and become excellent through that focus. (This goes back a bit to small cap cycles.) They have developed that excellence in a protected market, made a competitive advantage out of that, and then applied that competitive advantage to a larger market.
12:13	Christian Deckart	So they left their home market and took that business model to neighbouring countries or global. Switzerland and Sweden are two European countries that come to mind for that. One example ... if you think of Swiss chocolate, just because of the features of that market in the last century, Swiss chocolate companies started competing not on price, but on quality. So, you know Lindt today (you might've had Toblerone), in terms of quality, these are the higher ends...and they took that quality up to a high standard in their home country. Then, when they ran out of room to grow in their home country, they improved the formula there, then took it global.
13:00	Christian Deckart	New Zealand is one to mention as well (and will bring us back to Gentrack that we mentioned before). ... They built strength [in New Zealand] and are trying to roll it out in the significantly larger United Kingdom.
13:10	Cam Webster	So there are certain conditions that help to locally build a niche, then build up operations, and grow geographically. That brings us to a good segue into M&As (mergers and acquisitions)—companies that grow through acquiring other businesses. There are a couple in the portfolio right now that are under takeover offers. Let's just talk about how you make decisions around that within the small cap context.
13:47	Christian Deckart	As I said before, that's part of the small cap cycle. We try to buy businesses when they're unknown or unloved (or both) while they fulfill

our fundamental investment criteria. And as these businesses are successful over time, the market just changes their perception, and eventually a competitor—or some other financial acquirer—gets to notice that, and so they make a takeover offer.

It's a two-edged sword really, because financially in the short-term it's very positive. Usually these deals happen at a good premium and we're happy to get that [laughs].

14:21	**Cam Webster**	Right, right [laughs].
14:22	**Christian Deckart**	But on the other side, it means we have to look for new opportunities, turn more stones, get out there, and do our work.
14:28	**Cam Webster**	So you have a decision to make when a company is either taken over or a company you own is taking over/making a purchase. Let's walk through that process. What are your decision parameters? What kind of decisions do you have to make in the those situations?
14:50	**Christian Deckart**	The first one is, if a business we own buys another business. We obviously look at the deal because it's a capital allocation decision. In a way, the management team of the company we have invested in is taking money that, well, belongs to our client, to us—the shareholders, really. We look at whether we think that has strategic logic, whether that is a sensible thing to do. We look at their historical track record. And we've had cases...companies in the portfolio—after they did an M&A—we thought either more highly of management or not that highly of management anymore—depending on whether we thought that decision was in the best interest of shareholders.
15:29	**Christian Deckart**	So that may lead to trade decisions. From experience, I would say in both directions, either we think, "oh, this was really out of the ordinarily good," or, "it was really not in the interest of shareholders." In one case we might buy more, in the other case we might sell a bit, or sell the whole position if it's really bad.
15:46	**Christian Deckart**	And the second part of your question—if we are on the other end of it, if a company we own gets acquired—we have a choice of whether we sell the

shares right away at that moment (usually trades at a discount to the purchase price), depending on what the market thinks. (How likely the transaction will go through, what the expected time to completion is.) Maybe something better might happen, or the risk that the deal falls through...and depending on how large that spread is, we may or may not take it.

16:19 **Christian Deckart** We had an example this summer where one of our holdings was taken over and the regulator in that industry—the antitrust authority—had blocked M&A deals before, [so] when we looked at that transaction, we thought that in the end, there would be a risk that this transaction just wouldn't go through and the stock might lose a lot of the premium it had gotten through the takeover offer. So that is one where we didn't wait until the last day.

16:45 **Christian Deckart** This is also where our job as active investors come in. We look at the parameters of every single transaction: what are the risks that the buyer can or cannot finance it? What are the risk that there's material, adverse change? Are there material adverse change clauses in the documents? What will the antitrust authorities say?
All these are factors to look at when making that decision—whether we hold an acquisition target until the very end, or whether we sell right after the announcement.

17:13 **Cam Webster** Okay. We're long term investors, so Christian, we usually would prefer to hold the business that we think fit our criteria for 10 years or longer—as long as it keeps hitting those criteria, we're happy to own it.

17:26 **Christian Deckart** Well, to quote Warren Buffett here, "our favourite holding period is forever."

17:30 **Cam Webster** Great! So within that, if we look at the statistics on the Fund in terms of portfolio turnover, that's not reality. I mean, the last quarter you had five new names in and five names out. Let's talk through the decision-making process.

17:46 **Christian Deckart** For new ideas, really, it's driven by opportunity. We're constantly looking at things ... in 2017, we did some 580 company or management interviews. That includes interviews with management where we own the business. But you get a sense that we talked to a lot of new businesses.

So we turn over many stones. When we find something underneath, well, then we inquire, we talk to customers, competitors, suppliers. Eventually, if we like what we find, if the first work on that object has been worth it, then we organize our thoughts in a report. [We] examine the quality of the accounting, do the valuation brief. We do a full due diligence and report on a business.

18:31	**Christian Deckart**	So for new ideas really, it's driven by: "what's the opportunity out there?" And we need to turn many stones. But as I said, that's our job as active investors.
18:40	**Christian Deckart**	For existing companies that are in the portfolio, what's driving the weight there or whether we sell it—that's "The Matrix" process as we call it. What is The Matrix? You have to think of it as two dimensions: on one dimension, we rank the quality, and on the other dimension, we rank the return potential of a business of a security. And that, here at Mawer, is really our key tool for portfolio construction. We constantly compare the quality and the valuation of our investments. And if things become either too expensive, or are our assessment of the quality of a business, the quality of management goes down—we might trim or sell the position altogether.
19:22	**Cam Webster**	Just to connect the stones analogy: we're turning over stones constantly (the new opportunities), but we're also evaluating the existing portfolio and comparing against those unturned stones that we've done due diligence on.
19:37	**Christian Deckart**	We're comparing it against the turned stones—the things we have looked at, and where we have an opinion, but that we don't own already—yes.
19:42	**Cam Webster**	Got it!
19:42	**Christian Deckart**	So we're constantly comparing what's in the portfolio. In a way, ... well, the way we think of the global small cap portfolio, is, it's a platform on which small companies from around the world compete for capital. And we try to make that competition as hard for these companies as possible, so we only allocate to those where we really think the quality, valuation, combination makes sense for our clients.
20:04	**Cam Webster**	Okay. Let's hit those examples. Maybe that'll help pound it home.

20:12	Christian Deckart	One was dormakaba out of Switzerland. I think that's a good example. First of all, on the business, they're the global #2 door lock access control company. So if you think of either the key you need to unlock a door, or the card to get into an office, there's an element of recurring there, because once you have the lock, you might need a new key or you might need a new card if you lose it. So we like that—that replacement demand. There are engaged owners; there are actually two families that own large chunks of the business.
20:45	Christian Deckart	I think this one is also a good example of how our process works at Mawer. We first met the CEO two years ago in Switzerland at a conference. At the time, we didn't think valuation was right. And then things changed in the market and their stock price came back. ... We kept track of it all the way and we like what they do, and so now we thought it deserves a place on The Matrix in terms of the combination of quality—which hasn't changed that much. But valuation has changed. So now it deserves a place in the portfolio.
21:16	Cam Webster	So Dorma's a good example of something we bought—sounds like patiently. What's an example something exiting the portfolio and the reasons behind that?
21:25	Christian Deckart	From the recent past, Origin Enterprises is a good example. That is a business that mainly does agricultural distribution in the UK and in some eastern European countries and now also other parts of the world. That has just moved on The Matrix. So again, the comparison of quality and valuation. We had several changes here that we followed. One main one, really was outside management's control—that's Brexit. When we looked at the situation here several months ago, we thought, "yeah, the negotiations are tough and the odds are not great (that there's going to be a good deal)," particularly for the agricultural business in the UK. Farmers in the UK depend on relatively cheap labour from eastern European countries—so that might get cut off.
22:13	Christian Deckart	Also, selling from the UK into Europe might be more difficult, well in five months' time. And finally, farmers in the UK get subsidies—partly from the European Union. So there's a bit of uncertainty there.

So when we look at the risks of this business, we thought that, "yeah this has a worse risk ranking now" and so it moved on The Matrix to a point where it just didn't deserve a place in the portfolio anymore. Or, to say it differently: we have another stone that we thought looked a lot better in terms of valuation and quality so put that in there and sold out of our Origin position.

22:49 **Cam Webster** Great! Those are two good examples, Christian. We've had a good discussion of process, The Matrix, some good examples...volatility has picked up in the markets lately. I just want you to give us a sense of how you manage in a volatile time.

23:05 **Christian Deckart** The process really isn't different in volatile times, so it's important as investors to stick to our process. The Matrix is the main tool here. (I mentioned that we have the two dimensions of quality and of return potential.) When stock prices are volatile, the "return" acts as how attractive the stock is. That can change very fast. ... What we've actually seen not just in the last weeks, but in our opinion over the last maybe six months, is more dispersion between single stocks and so that allows us to replot things on The Matrix...to look where they stand [now] in terms of return potential. And if something looks more attractive, we can add to that. And if something looks less attractive—maybe because it's gone up a lot—then we can take out.

23:52 **Christian Deckart** So it's really the same two dimensions that we always use. But there is more, I would say, a bit more activity in ... looking at things and thinking about them than in actual trading. We look a lot at valuations these days, and price changes. And we ask ourselves where we can allocate capital for our clients to get a better return potential.

24:12 **Cam Webster** Thanks for giving us a really good overview of global small cap. We will have you on again, I'm sure! With that, thank you for listening, and thanks to Christian.

24:21 **Christian Deckart** Thank you.