Punching Above Their Weight Class: High Value-Added Bottlenecks

Artisan Partners International Small-Mid Team

PORTFOLIO MANAGER Viewpoints

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Rezo Kanovich
Portfolio Manager

25 Years Investment Experience

Our Investment Framework

We seek to be long-term owners in high-quality businesses exposed to structural tailwinds that should drive sustainable growth in end markets. We look for opportunities that emerge at the intersection of growth and change and focus our interest on the subset of well-run, innovative companies with meaningful competitive advantages, structurally high returns on capital, strong balance sheets and the ability to self-finance growth. Wonderful businesses, however, are rarely available at attractive prices, so we look for ways to acquire them in a contrarian fashion in times of adversity or perceived adversity. We aim to double our investors' money over five years and identify smaller companies that can become the industry leaders of tomorrow.

Identifying high value-added "bottlenecks" is a meaningful aspect of our investment approach. The term often conjures up a negative connotation as a critical point of congestion in a manufacturing or flow process that delays throughput. In manufacturing, bottlenecks are the source of many painful inefficiencies. In hospitals, bottlenecks result in longer wait times and potentially worse medical outcomes. Our process looks for companies that *solve* issues related to bottlenecks and provide solutions to customer problems.

Defining High Value-Added Bottlenecks

What makes a bottleneck high value-added? We consider a company to have high value-added bottleneck positioning when its products or services occupy a particularly important position in an industry's value chain but represent only a small portion of the end product's total production cost. Having an outsized value relative to cost is particularly important for many smaller companies that can rarely compete on scale with larger competitors. A company that plays a mission critical role is likely to have the following characteristics: strong market position, brand recognition, product differentiation and high customer intimacy due to factors such as reliability, safety and ease of use. We find such companies also are resilient because they have lower risk of being disintermediated, assuming they continue to innovate.

Over time, smaller companies with these characteristics have demonstrated a greater probability to generate structurally higher returns on capital, higher margins and working capital efficiency as well as command sustained pricing power. Throughout our investment history, we have identified such companies across industries and geographies through our fundamental company research and industry value chain analysis.

For example, let's look at flow control systems for chemical plants or water treatment facilities, which we'll discuss in further detail in the next section. The pipes are the commoditized portion of the industry value chain, having minimal differentiation. On the other hand, pumps, valves and actuators are high value-added bottlenecks that perform mission-critical roles, yet they represent a fraction of the whole system's cost. Another example, which we'll also discuss further in the next section, is food ingredients. Consistent taste, the ability to respond to customer preferences and traceability of ingredients matter—a lot—to consumer product companies. The value a purveyor of ice cream flavors provides far exceeds the price it charges its customers, and furthermore, the cost of flavors is a tiny percentage of the overall cost of the final product.

Inflation

During the pandemic, inflation began to be problematic. Debate and intense market scrutiny arose whether it was temporary, due to supply chain issues, or more persistent. Our stance then, and now, has been to focus on companies with high value-added bottleneck positioning, which affords them with pricing power and high returns on capital. Both are important for inflation protection.

Mission-Critical, Differentiated Sources of Reliability, Safety and Customer Loyalty

The following examples—whether they serve customers that operate in the industrials, information technology or consumer space—provide a mission-critical, differentiated product and/or service that represents a fraction of their customers' total product cost.

Linchpins for Energy Efficiency & Plant Safety

Buildings consume nearly 40% of the world's energy and are a significant source of carbon emissions. The desire to decarbonize and improve buildings' energy efficiency is growing stronger worldwide. Remote monitoring, temperature control and power efficiency measures for new construction as well as the retrofitting of existing buildings will take many years to implement, and these enhancements have only recently begun.

To enable a smart building, you must place sensors and actuators behind the walls. Once installed, these devices remain there for decades, given their initial expense and difficulty to remove. Thus, reliability is paramount. Companies with intellectual property around software-driven, sensor-connected control systems for pumps, valves and actuators allow for predictive maintenance and tend to be bottlenecks, with strong market positions and sustainable pricing power.

One such company is Azbil, which manufacturers automated control systems for HVAC equipment. Azbil has a dominant market share in industrial and commercial buildings in Japan. Its product remains behind a wall for an average of 30 years, making reliability extremely important to its customers. Azbil's return on capital (ROC) of 20% remained steady throughout the pandemic, demonstrating its brand strength, and its multi-year service contracts are sources of durable revenue growth.

Another company providing mission-critical solutions is Rotork, a leader in electric actuators that provides fluid controls for water, chemical, and oil and gas plants. Electric actuators are structurally gaining market share from pneumatic and hydraulic actuators, which have less precise control, require more maintenance and emit hazardous pollutants. The industry's electric mix shift and Rotork's market share gains have historically added 50-100bps to Rotork's annual organic growth rate. An actuator could comprise just 20% of the price of the valve on which it is placed, and valves make up a modest percentage of a process plant's total cost. However, the actuator is critical to controlling process parameters and—when necessary—responding to emergencies. The cost of a $3,000 actuator failing could cost a process plant tens of millions of dollars in lost revenues. While actuators may seem like fertile ground for competition, there are high barriers to entry due to the intensity of specialization required. Rotork's superior products allow it to price at a premium to competitors and even win projects over competitors who also supply the project's valves. Furthermore, Rotork is improving customer efficiency via digitalization and has a growing, durable revenue stream from service contracts, which currently account for a fifth of total revenue from just 5%-10% of its nearly 4 million installed actuators. We expect Rotork Site Services to expand.

Quiet Heroes of the AI Revolution

The Artificial Intelligence (AI) revolution has ushered in a transformative era and is still in the early stages. The ability to analyze vast amounts of data, recognize patterns and perform complex tasks, increases productivity and places AI squarely at the forefront of innovation across a host of broad-based applications. From machine learning algorithms that enhance decision-making, to natural language processing that enables human-like communication, AI has begun to reshape how various industries operate, and has changed the profitability structures within certain parts of industry value chains.

We are only in the early innings of this disruptive technology. Substantial investments, both in hardware and software, will be required to support AI's expanded application. While many market participants have narrowly credited a select group of big tech companies and leading chipmakers for driving AI's proliferation, we have approached the vast investment landscape with nuance, spending our time analyzing industry value chains in search of structurally high margins and higher ROIC. As is routine, this work coincides with deep fundamental research to understand the competitive advantages, strategic plan, and idiosyncratic drivers of individual companies. Market myopia has created meaningful dislocations between the stock prices and long-term value propositions for many in the landscape, presenting an opportunity with "quiet heroes of the AI revolution", representing lesser-recognized AI-enablers with high value-added bottleneck positioning. Our findings, coupled with our contrarian approach to valuation, have resulted in early investments in companies we believe can have sustainable competitive advantages.

One example is Thailand-based Fabrinet, a contract manufacturer of advanced optical photonics that are needed for high-end connectivity within data centers. Fabrinet's products handle tasks such as data processing, analysis, training, and testing and deployment. Increasingly, large companies are outsourcing this manufacturing for greater efficiency, and Fabrinet is a clear leader. Not only is Fabrinet's expertise essential for AI infrastructure, but its unique ability to scale manufacturing while maintaining production quality has positioned it as the only company currently capable of fulfilling the materially higher demand from chip maker NVIDIA. In addition to its asset-light model, Fabrinet has an intelligent contract structure that uses customer prepayments to fund capacity expansions. As one of the few reliable, high-quality and cost-effective manufacturers of complex components and systems, Fabrinet plays a mission-critical role in empowering the ongoing AI revolution and is well positioned to benefit from the continued expansion of AI applications.

Purveyors of Ingredients for Flavors, Scents, Nutrition & Personal Care

What is the value of consistent taste and fragrance, safe production processes and traceability of ingredients to consumer products companies? How do these factors shape customer experience, brand reputation and customer loyalty (i.e., willingness to pay)? Ask companies focused on food and nutrition, perfume, cosmetics and personal care, for instance, and you'd hear a common sentiment—value far exceeds cost. Perhaps surprisingly to some, ingredients for flavors, scents and enhanced nutritional properties often influence customer perception more heavily than splashy marketing campaigns. Companies that dependably provide these critical inputs and have the agility to cater to changing customer preferences have an extremely high level of bargaining power, sustainable profitability and high customer lifetime value, despite their small portion of the cost and volume of the end products.

We have been long-term shareholders of Symrise and IMCD, both of which operate in an industry with 3%-4% annual growth globally but have, in our view, higher-than-average growth prospects. Symrise manufactures fragrances, flavorings and cosmetics base materials for over 30,000 household products worldwide, including perfumes, hair and skin care products, toothpaste, food, pet treats and beverages. The company has also added unique value with taste balancing solutions for reduced-sugar concepts and responsibly-sourced, organic options that consumers are increasingly demanding. On average, people interact with products that contain Symrise's ingredients 20-30 times per day. Symrise enjoys gross profit margins of approximately 40%, earnings before interest, taxes, depreciation and amortization (EBITDA) margins of approximately 20%, and operating cash flow that has increased almost every year for the past decade, regardless of economic environment.

Global leader IMCD buys specialty chemicals and ingredients from big suppliers and then mixes or alters them to sell in smaller packages to small customers in industries ranging from food and nutrition to personal care to pharmaceuticals to industrials who cannot buy in bulk. The company also co-creates formulations with its customers that embrace industry trends, requiring precision, an established global supply chain network and production efficiency with digital capabilities. Due to the specialization and typically small percentage of these ingredients relative to a customer's total end product, there is no transparent pricing in the market. Hence, IMCD can fairly easily pass on price inflation to its customers and add a margin for itself. Alternatively, IMCD does not have to reduce pricing to the same extent when there is price deflation. Highlighting the company's privileged bottleneck positioning, year-over-year gross profit margins grew in 2020 amid a global pandemic, product shortages, and supply chain disturbances and thus far in 2021 amid an economic recovery.

A Side Note on Inflation, Pricing Power and High Returns on Capital

The surge in inflation over the past few years has been a defining crosscurrent in the economy and a key obstacle for many companies. While in the short term investors may attempt to hedge inflation with speculation on commodities, we believe the best way to combat inflation over the long term is to invest in businesses that command sustainable pricing power and have volume growth, such as companies with high value-added bottleneck positioning.

Persistent inflation could also lead to higher long-term interest rates. We're constantly evaluating the profitability structures of our portfolio companies. The importance of investing in structurally high return on capital businesses is a key point for consideration since the value of a business is driven by the spread between the cost of capital and return on capital. For example, if the cost of capital rises from 2% to 3%, a low return on capital business is massively disadvantaged and would have most of its economic value-add eliminated. In comparison, a high return on capital business would be much less impacted.

A company's capital structure is also important, especially in a high rate environment. We look for companies that can self-finance growth. As such, our companies typically carry little to no debt, and increases in the cost of capital would have negligible effects on their interest costs or their bottom lines.

Compounding returns in companies with the previously discussed characteristics over a multi-year horizon, in our view, is vastly superior to trying to forecast copper prices. We remain highly price disciplined and continue to focus on structural trends and company fundamentals.

Summary

As always, we are focused on investing for the long term in attractively priced, high-quality businesses that are backed by structural tailwinds. High value-added bottlenecks fit well with our investment approach. By providing their customers outsized value relative to cost, reliability and peace of mind, they are rewarded with resilient business models, sustainable pricing power, structurally high ROC and long-standing customer relationships. High value-added bottlenecks' ability to inextricably link to an industry's value chain and generate strong profitability metrics are what attract us to these long-term investment opportunities.

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Portfolio Manager: Artisan Partners International Small-Mid Team—Rezo Kanovich

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