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The power of ideas

"We look for companies with a high conversion of earnings to free cash flow," said John Hughes. "We don't want companies to suffer high recurring encumbrances in terms of maintenance capex or high capital requirements, and we're looking for managements that have the ability and the inclination to invest those free cash flows, hopefully in their entirety, rationally, at high incremental rates of return."

A tall order, indeed, acknowledged our speaker, the founder and president of Quantum Capital Management, LLC, given that the average return on invested capital in the Russell 3000 is only 7%. Then, too, Hughes said, "there's a nasty mean-reverting tendency in returns on invested capital. If you pay a price expecting an incremental reinvestment of 14% and it's on its way to 7%, it can be an expensive lesson. So the only way that a company is going to enjoy this recurring ability to generate high incremental returns on invested capital is if they enjoy some form of incumbent competitive advantage—some advantage in terms of customer captivity, some advantage in terms of input costs, maybe some barrier to entry."

Hughes pulled two examples from Quantum's portfolio: NVR, Inc. (NVR on the New York Stock Exchange) and HEICO Corp. (HEI, likewise on the Big Board).

NVR is a homebuilder, though you probably wouldn't have guessed it by a glance at its astonishing financial performance. The share price has compounded at a rate of 22.1% over 20 years—a 5,000% run. "They have a 3% market share in a fragmented market," Hughes continued, "they build up and down the East Coast, they are the fourth-largest homebuilder in the U.S.—and all of this is of little consequence to us. What matters most is its local market concentration, by design. It's typical of NVR to enjoy a 20% or 30% or more market share in areas where they do build."

What further distinguishes NVR is the perpetual reduction in the share count, down by 67% in 20 years. "So," Hughes added, "it is rare."

Rare, too, is HEICO, "a mini Berkshire Hathaway of aerospace and defense," which, like NVR, boasts a high conversion of free cash flow. "Their earnings are understated," said Hughes. "They are an acquisitive company. They generate amortization expense. Their earnings are understated by 22% vs. their economic earnings. They reinvest the entirety of their cash flow, almost 100% of the free cash flow, in these acquisitions."

"In my 20 years in investing," Hughes marveled, "I have never, ever owned or come across a company so blessed with a combination of competitive advantages, a secular tailwind, a deep bench of executive talent."

Of the HEICO chairman, Larry Mendelson, Hughes used these words: "This capital compounder. This wonderful man."

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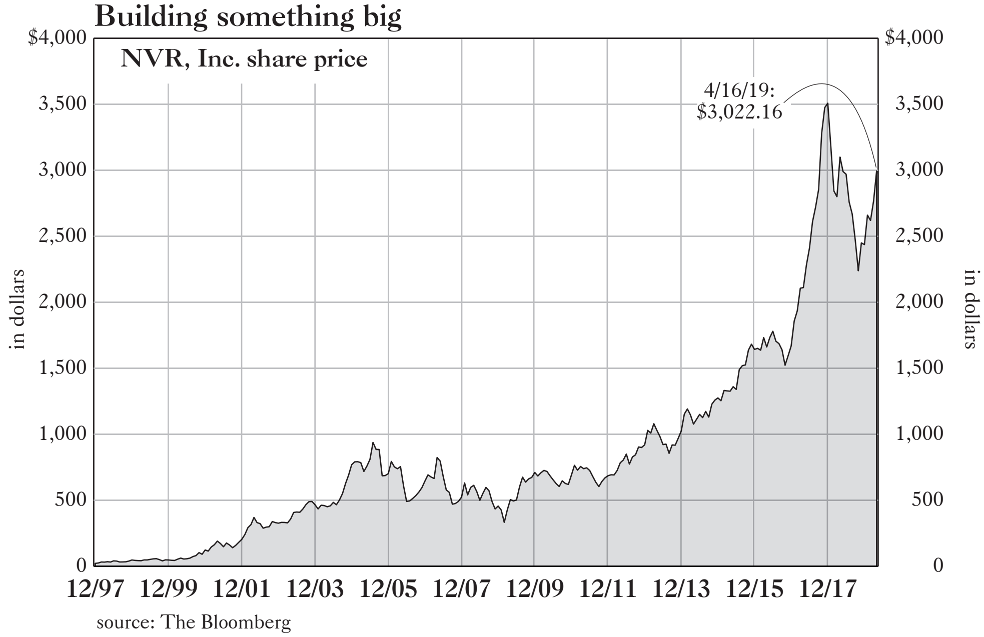
Building something big



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