Our investment perspective

ROIC – The Underappreciated Variable in Valuation

Despite what the name might imply, a successful growth investment strategy is dependent on more than simply analyzing company growth rates. Equity valuation is driven not just by anticipated growth, but also a company's ability to generate returns on its capital base (ROIC). Higher ROIC businesses often have more durable competitive advantages and/or strong management. The result of compounding these higher returns over time is superior value generation for shareholders. In our view, the true long-term value of a business reflects the combination of its growth rate and sustainable ROIC.

We aim to uncover undervalued firms by identifying growing businesses whose current market valuation does not fully capture the ROIC potential.

ROIC & Valuation

Return on Invested Capital (ROIC) = (Net Operating Profit After Tax)/Invested Capital)

Conceptually, ROIC reflects the rate of return a company is able to generate on its invested assets. Both ROIC and growth drive a firm's future available free cash flow, which ultimately drives market valuation. Conventional earnings multiples, whether Price-to-Earnings or Enterprise Value/EBITDA, are simply a shorthand version of cash flow valuation. The table below demonstrates what a firm's intrinsic enterprise value multiple should be depending on the combination of sustainable ROIC and growth (assuming a constant discount rate)*.

* *Table formula: Intrinsic value = (NOPAT*(1-(G/ROIC)))/(W-G) where:*

NOPAT = Net Operating Profit After Tax; G = Growth Rate; and W = Required Return

Multiple Valuation at 10% Discount Rate

ROIC →

Growth ↓	8.0%	10.0%	12.0%	14.0%	16.0%	18.0%	20.0%
2.0%	9.4	10.0	10.4	10.7	10.9	11.1	11.3
3.0%	8.9	10.0	10.7	11.2	11.6	11.9	12.1
4.0%	8.3	10.0	11.1	11.9	12.5	13.0	13.3
5.0%	7.5	10.0	11.7	12.9	13.8	14.4	15.0
6.0%	6.3	10.0	12.5	14.3	15.6	16.7	17.5
7.0%	4.2	10.0	13.9	16.7	18.8	20.4	21.7

Company B

Company A

The information above represents a hypothetical example of a company's enterprise value multiple using varying combinations of growth and ROIC. The information assumes a consistent discount rate. This information does not represent actual returns of any KCM investments and is not representative of the performance of any KCM investment or strategy.

Suppose I told you Company A and Company B were both trading at multiple of 10 and asked you to pick the most undervalued company. If you only had the growth rate you would not have enough information to make an informed decision. In fact, if applying the more traditional Price/Earnings to Growth ratio concept you would likely choose Company A, due to its higher growth rate. However, it is not as undervalued as Company B when taking into account the combination of growth rate and ROIC.

In order to accurately value (and find undervalued firms), investors must have a clear view on both the long-term growth and ROIC potential relative to current market valuation. At Kennedy we seek to take advantage of investor's collective failure to appreciate long-term ROIC potential when valuing businesses.

Why is ROIC so important? Because the reinvestment rate in the business matters! The higher the ROIC the higher the available cash to either reinvest in the business or distribute to investors. This reinvestment rate, combined with the ROIC, is ultimately what drives growth in the business. *Growth = ROIC * Reinvestment Rate.* A company's growth does not occur in isolation, rather it is a direct result of the opportunities available for reinvestment and the incremental returns that can be achieved on them.

Traditional valuation often underappreciates these dynamics when comparing higher growth start-ups and mature

Traditional earnings valuation metrics like P/E and the PEG ratio are not as reliable for valuing high growth firms as they do not capture potential ROIC changes. The level of sustainable returns at maturity is often underappreciated at growth stage firms.

companies. A more mature business with a high ROIC is generally able to maintain its growth with limited reinvestment. This results in higher, and more predictable, cash flow to investors via dividends or share repurchases. This predictability means that mature companies tend to be more accurately valued by the market. Companies in higher growth phases typically invest the bulk of their capital in support of higher organic growth opportunities or acquisitions. As a result, long-term ROIC potential and future free cash generation are more difficult to estimate, making accurate valuations more challenging.

ROIC versus Growth

High ROIC is more sustainable than high growth. When evaluating valuation we must look at both the long-term expected ROIC and the average expected growth of a business over its life cycle.

McKinsey and Company has observed that while ROIC levels may have some level of decay over time, they are generally sustainable over the long-term.[1] Why is this? High ROIC businesses tend to have superior products and business models, with a sustainable competitive advantage. Low ROIC businesses have limited profitable reinvestment opportunities, reducing their ability to grow the value of the firm for investors.

On the other hand, high growth rates are generally not sustainable over the long-term. Research completed by McKinsey & Company has shown that over time growth rates converge to roughly 2% no matter what the industry.[1] This reflects the fact that growth is largely a function of the stage of the business (market penetration) and external factors such as strength of the economy and competition. Just as important as evaluating long-term ROIC potential is evaluating the *average growth potential for a firm over its life cycle* versus focusing solely on the growth rate at one point in time.

The Compounding Effect

High ROIC companies benefit from what is known as the compounding effect. High ROIC business are able to generate significant value when they are able to redeploy their available cash into similar high return investments (acquisitions, capital projects, etc.) rather than simply distributing the cash to shareholders. Take a hypothetical example of Company A and Company B: Company A (10% ROIC) and Company B (30% ROIC). Both companies reinvest 40% of earnings in the business and both begin in year 0 with $1,000 capital to invest. By the end of year 10 Company A has accumulated $720

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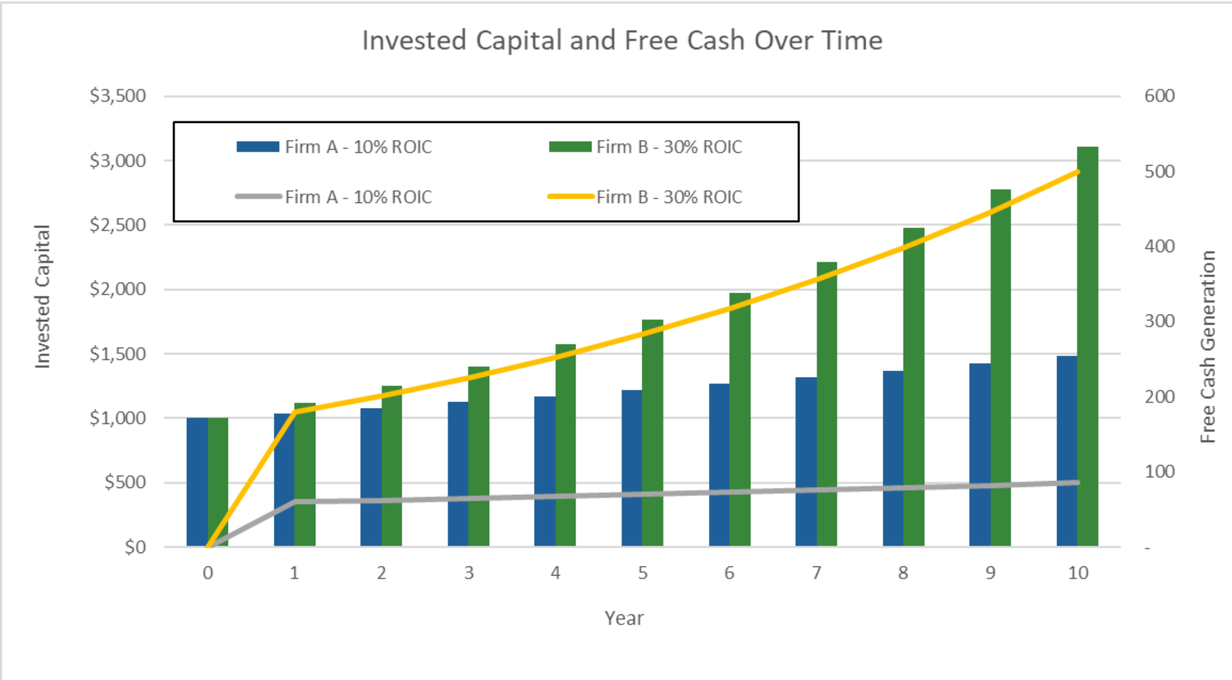
1 Bing Cao et. al. (2006, March 1). Balancing ROIC and growth to build value. https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/balancing-roic-and-growth-to-build-value

1 Bing Cao et. al. (2006, March 1). Balancing ROIC and growth to build value. https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/balancing-roic-and-growth-to-build-value in cash and invested capital has grown to $1,480. Meanwhile, Company B has accumulated $3,159 in cash and invested capital has grown to $3,106. This illustration shows just how strong the compounding effect is.



The information above represents a hypothetical example of invested capital over a 10 year period and does not represent actual returns of any KCM investments and is not representative of the performance of any KCM investment or strategy.

Putting it all Together

Looking at investment valuation solely through the lens of growth leaves out an important variable in determining the true valuation of an enterprise. While higher growth is always desirable, we believe it is generally not sustainable over the long run. ROIC on the other hand, which reflects the quality of a company's operations and management team, is much more durable. While high growth is important, it is much more powerful to find a business with both high growth and high ROIC. Even more powerful is to find a high growth business where the market does not fully appreciate the business's ROIC potential.

The Kennedy Approach

At Kennedy our investment approach uses long-term, fundamental analysis to exploit valuation discrepancies in small and mid-cap stocks. In particular, the valuation of higher growth stage firms tends to be volatile as the variables have not stabilized. Our Growth strategies exploit these opportunities by first seeking out durable business models able to deploy assets into growing sets of opportunities at superior rates of return. Our investment process then aims to identify the firms that we believe are undervalued, either because investors fail to realize the business' growth potential over time and/or its ability to expand ROIC. In particular, we find that reinvestment opportunities are often underestimated. As we have explained in this white paper, with high return businesses the impact that this has on valuation can be significant.