Contact Asset Management

INSIGHTS

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Skin in the Game – Investing in founder-led businesses

A core ideology of our investment approach for BKI Investment Company and the Contact Australian Ex-50 Fund is our unwavering conviction in the importance of alignment. Founder led businesses tend to outperform significantly over the long-term. In this, our latest edition of Contact Insights, we present our findings on how significant that outperformance is. Charlie Munger was certainly onto something when he famously quipped *"Show me the incentive and I'll show you the outcome".*

Studies into the superior performance of founder-led businesses

There is a growing mountain of evidence of the outperformance of companies where the founder (or founding family) plays a significant role in business decisions. Below, we consider two important studies over the past decade from Bain and Company (in 2016) and Credit Suisse (in 2022). Given much of this research is based on global experience, we have created a Contact Asset Management Founder-led Index, to test if the experience holds in Australia. The conclusion is unanimous – founder led businesses outperform.

Bain and Company (2016)

In 2016, Chris Zook of Bain & Company (Boston) wrote an article for Harvard Business Review titled *"Founder-Led Companies Outperform the Rest – Here's Why"*. In it, he wrote how Bain & Company developed a database of all public companies in the global stock markets and tracked their performance over 25 years. He wrote, "We found that the companies most successful at maintaining profitable growth over the long term were disproportionately companies where the founder was still running the business (such as Oracle, Haier, or LBrands), was still involved on the Board of Directors (like Four Seasons Hotels and Resorts), or, most importantly, where the focus and principles of how to operate that the founder had originally put in place still endured (as at IKEA or at Enterprise Rent-A-Car)."

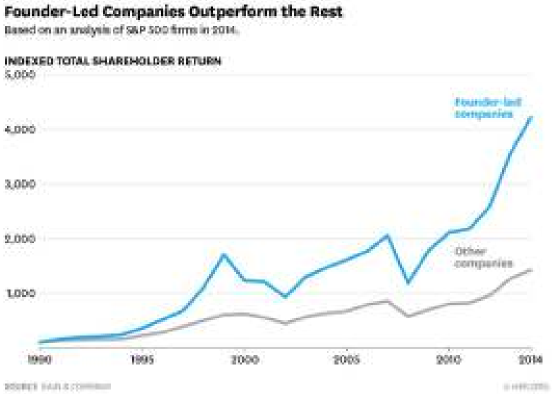
Bain & Company then conducted a series of interviews with executives and founders around the world. They concluded that the success was closely tied to **"the founder's mentality"**, which covered three sets of hard-edged practices and underlying attitudes:

(i) *Business insurgency*, which is the unique, spiky feature, or capability that gives a business special purpose. Many businesses lose this sharp sense of purpose as they grow. Founders seem to maintain the personal engagement to the cause;

(ii) The second element of the founder's mentality is a ***front-line obsession***—as the founder had. It shows up in a love of the details and a culture that makes heroes of those at the front line of the business and gives them power.

(iii) The third element is an ***owner's mindset***, the essence of which is dialling up speed to act and taking personal responsibility for risk and for cost. The article points to AB INBev, the global leader in beer, which has at the top of its principles ""we are a company of owners and act like one".

Bain & Company's in-depth study found an index of S&P 500 companies in which the founder remained deeply involved "performed 3.1 times better" over the 15 years ranging from 1999 to 2014.



Credit Suisse (2022)

The Bain & Company study is complemented by a March 2022 report from Credit Suisse Research Institute[1]. Credit Suisse tracked the performance of 1,000 family-owned companies globally and noted an outperformance of 4% per annum. The conclusions in this report are quite powerful and confirm our thesis that seeking capable founder and families to invest alongside is a worthwhile pursuit. The Credit Suisse report notes:

> *Successfully managed family businesses rank among the so-called blue chips of the equity market. With their strong corporate culture, long-term investment horizon, pronounced culture of innovation, and robust balance sheets, family-owned companies typically focus on sustainable profitable growth.*
>
> *Investing in family-owned companies in phases of rising interest rates is nonetheless worthwhile in our view. We believe the reason for this is their crucial but invisible alpha factor: trust. Thanks to their entrepreneurial loyalty, family-owned companies are more likely to respect the interests of their clients, employees, and business partners, and indeed fulfill their social responsibilities. They are also more likely to reinvest profits in the business. This creates trust, which is the key to their success.*
>
> *In summary, participating in the innovative spirit and vision of family-owned companies over the long term and remaining invested in these stocks holds plenty of appeal in our view.*

Credit Suisse Family Universe: Returns of family-owned vs, non-family-owned companies, weighted by market capitalisation and sector-adjusted

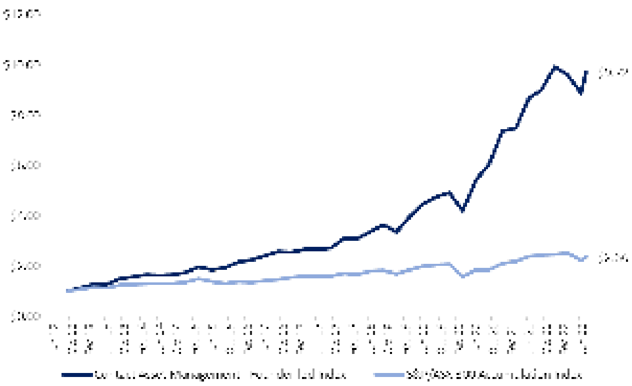
Source: Credit Suisse Research Institute (March 2022)

We consider that investing in businesses with identifiable competitive advantages, strong financials, and capable founder-led management teams, is the best way to navigate through all market conditions.

The Contact Asset Management Founder-Led Index

We have created a proprietary Founder-led index of Australian listed companies, which tracks the performance of such businesses. The evidence is compelling – over the past decade, founder-led businesses have outperformed the broader Australian market by a factor of 3.5 times. The following chart is illustrative.

Contact Asset Management – Founder-led Index
Growth of $1 over 10 years



Source: Contact Asset Management, Factset. The Founder led portfolio is market cap weighted based on a basket of 78 companies

[1] Credit Suisse Research Institute (2022), Trust – the alpha factor for family-owned companies

The results underpin our core ideology at Contact Asset Management – that is, our unwavering conviction in the importance of alignment. Founder-led businesses tend to outperform significantly over the long-term. This is driven by:

- Influence and Guidance – a Founder who holds a position of influence and who can offer long-term guidance;
- Alignment – Founders think long-term and have invested a sizable portion of their life savings into their companies; and
- Experience and Skillset - Founders know their business better than anyone and are more likely to direct the business in the right direction.

How have we (and how do we) implement Founder-led investing at BKI and Contact Asset Management?

BKI listed in December 2003. Over its near twenty-year history, we have successfully invested in many founder-led businesses and watched them grow from small caps to market leaders. Some examples of this include Ramsay Healthcare (RHC), TPG Telecom (TPG) and Goodman Group (GMG). Other wonderful long-term compounders that are founder-led that we have invested in include ARB Corporation (ARB) and Reece Limited (REH).

The success of investing in Founder-led businesses was a key driver in the development of the Contact Australian Ex-50 Fund. We have created a Fund where we seek to invest in a portfolio of quality companies that will become tomorrow's leaders. Where possible, we invest in companies that are founder-led or have an important strategic partner. Almost 70% of the stocks in the portfolio meet these criteria. The following graphic provides an insight into some of these types of companies in the portfolio.

The Contact Ex-50 Fund holds almost 70% of its positions in founder-led/strategic partner companies

A case study: ARB Corporation

ARB Limited (ARB) is an Australian success story and an outstanding example of the effects of long-term compounding in a founder led business. Consider, $1 invested at the initial listing of ARB in the late 1980s has increased to almost $400! This assumes the reinvestment of all dividends. The success is testament to the founder's mentality as described by Bain & Company.

As per the ARB website, the origins of ARB go back to 1975, when company founder, Tony Brown, was inspired by a 4WDing trip through the top end of Australia. Back then, 4WDers relied on homemade or ill-fitting equipment that was not designed for extensive Outback expeditions. Damaged bull bars and broken roof racks ensured Tony's expertise was regularly called upon, and through this experience an idea was born – well engineered, durable equipment that would meet the vigorous demands of 4WD owners.

Upon his return to Melbourne, Tony put theory into practise, and began working in the family garage to address some of the product deficiencies he'd encountered on his trip. It was exactly what Australian 4WDers had been waiting for, and ARB, the initials of Anthony Ronald Brown, was founded. Today, ARB is Australia's largest manufacturer and distributor of 4×4 accessories. The company now has a vast international presence, with offices in the USA, Europe and the Middle East, and an export network that extends through more than 100 countries around the globe.

We remain optimistic on the continued success of ARB and the stock is owned by both BKI Investment Company and the Contact Australian Ex-50 Fund. We maintain a consistent and rigorous investment process. Below, we assess ARB using our six key factors.

- **Principal Activity:** ARB Corporation ("ARB") has been designing, manufacturing, distributing and selling 4WD vehicle accessories and light metal engineering works since the 1970's. ARB boasts a globally recognised brand and its focus on innovation and R&D has been a core part of the Company's strategy since inception. The company operates in Australia, Thailand, New Zealand, USA, Czech Republic, UK and the UAE, and employs approximately 1,070 people. The Exports business has been generating strong growth – in FY21, the division increased revenue by >50% and now accounts for 37% of sales. The ARB outlook is strong with the order book almost 3x historical levels and increasing penetration in the US SUV market.
- **Income:** ARB has an excellent history of dividend growth. The payout ratio has been within the 40-60% target range, and this appears sustainable going forward. Despite the low headline yield, management has done a good job of balancing dividends and reinvesting for growth.
- **Financial Strength:** ARB is net cash and has traditionally maintained a strong Balance Sheet. Return on Equity (ROE) is over 20% and Free Cash Flow (FCF) generation is solid.
- **Management:** ARB is a founder led business that was started by Anthony Roger Brown in 1975. His sons (Roger and Andrew) are now Chairman and CEO. The executive team is aligned and collectively own 9.5% of the Company. They have sold some shares in past year but alignment still significant.
- **MSCI ESG Rating:** BB. Rates highly for Governance but MSCI expresses some concerns around labour and potential product safety risks which we consider are misguided as they reflect the whole industry rather than ARB itself.
- **Valuation:** Contact calculates over 30% upside in ARB based on a DCF valuation. The company has experienced a material step-up in sales in the past two years. While this may ease domestically as borders reopen, we expect significant growth from offshore. ARB has a strong brand and reputation for quality. A large build-up of cash on the balance sheet also offers growth and capital management opportunities.

Conclusion

Founder-led businesses outperform. We consider that investing in businesses with identifiable competitive advantages, strong financials, and capable founder-led management teams, is the best way to navigate through all market conditions.

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