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Races are Won in the Turns

By M. Tucker Brown, Research Principal

“The most important element to racing is the line—the path that defines the fastest way around any turn, the curving path that connects the entrance to a turn and the exit from it.”¹

Auto races are not won in the straightaways, where all drivers put their pedals to the floor as cars are aimed straight ahead. Rather, races are won in the turns, where cars are forced to slow down temporarily and drivers’ skills and cars’ engineering are differentiated. The winner is determined by a driver’s ability to pick the best line through the turn and apply the right amount of power at the right time to make the most of a car’s potential. The winning driver is able to come out of turns at higher speeds, enabling him to pull away from the pack in the straightaways.

Just as car races are won in the turns, we believe that superior financial results and shareholder returns are determined by how successfully companies perform through challenging turns in the environment and position themselves for the recoveries. In our view, after the sharp turns of the past couple of years, we are entering a period where the quality of secular growth opportunities, business models, management teams and balance sheets will be especially important factors differentiating performance. It is our expectation that unlike recent heady times, the straightaway coming after the current turn likely will be uphill due to the effects of high levels of unemployment, consumer deleveraging, higher taxes and tighter credit markets. Fewer companies will thrive and thus superior performance likely will result in a wider lead.



A Well Positioned Portfolio

At SGA, we invest our clients’ capital in a focused portfolio of high quality growth companies that have differentiated themselves in the current downturn and have gone on the offensive in order to pull away in the developing recovery. Our investment discipline is driven by three core tenets of repeat revenue, pricing power and global reach, as well as other important considerations such as strong balance sheets, robust cash flow generation and strong management teams. These qualities provide businesses the resources, resiliency and talent to make the most of challenges and turn them into opportunities. Across our portfolio are numerous examples of companies taking different “lines” through the downturn to enhance predictable and sustainable growth in the future. These “lines” include **the integration of strategic acquisitions and accelerated investments in new markets and innovations**, each of which we expect to help generate sustainable revenue growth. In addition, our companies are **tightening expenses and enhancing cash flow**, actions that should generate meaningful operating leverage and help sustain high levels of business reinvestment in the future.

Strategic Acquisitions

Several SGA companies are in the process of closing important strategic acquisitions as we come out of this latest turn. Aided by their strong balance sheets and prodigious cash flow, they are able to press their offense while others are constrained. Teva, the world’s largest generic pharmaceutical company, is well on its way to integrating Barr Pharmaceuticals, significantly increasing its presence in the European marketplace. Staples is successfully integrating its Corporate Express acquisition, strengthening its market presence in the US office supply delivery business while gaining critical mass in a very fragmented but promising overseas market. Oracle is currently working towards closing its acquisition of Sun Microsystems that will enable the company to provide a more fully integrated solution at the high end of the database market and an expanded presence in storage. PepsiCo is acquiring its two largest bottlers in the US, transactions that should lead to a more effective go to market system in

¹ George C. Larson, Air & Space Magazine

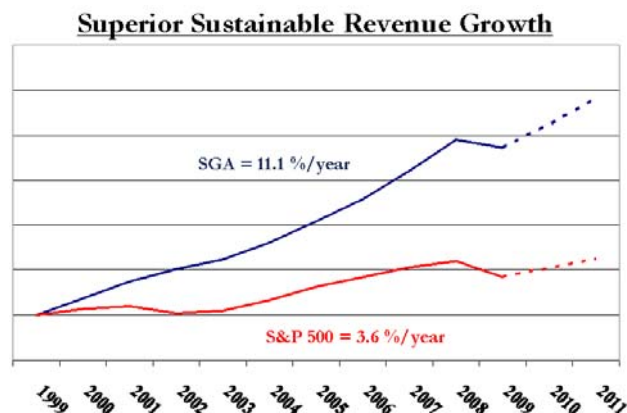
addition to substantial cost synergies. Lastly, State Street recently announced the acquisition of Intesa Sanpaolo's Securities Services business, enhancing its European fund administration capabilities while many of its bank competitors are capital constrained.

Accelerated Investments

Companies with the characteristics we seek are better able to generate superior profitability which facilitates substantial reinvestment in the business in the form of research & development, enhanced selling capabilities and new market development even in tough times. These efforts enhance and extend the long runways of revenue growth that we value highly. Examples of companies poised to reap the benefits of research & development investments coming out of this latest turn include Apple with its compelling iPhone, Microsoft with its Windows 7 and Office 2010, Monsanto with its game changing SmartStax product, Amazon with its highly successful Kindle reading device, and ADP with its GlobalView platform, the only truly multinational outsourcing payroll system solution. On average, these companies have increased their research and development expenditures by over 20% annually in the last two fiscal years. Examples of investments in selling capabilities driving deeper customer relationships and new account growth include Fastenal and Staples. Lastly, examples of companies poised to benefit from investments in new markets include Coca-Cola's advances in emerging markets and Lowe's expansion in Canada, Mexico and Australia.

Sustainable Revenue Growth

Enhanced by strategic acquisitions and accelerated investments, we believe our portfolio of companies is poised to continue to deliver superior sustainable revenue growth, the most important and highest valued component of sustainable earnings growth. On average, as shown in the chart on the right, portfolio companies have generated double digit revenue growth over the past ten years, about 3 times that of the average S&P 500 company. Going forward, as we emerge onto the next straightaway, our companies should be able to sustain strong growth while revenues of much of the rest of the corporate world may remain subdued due to economic headwinds.



Tighter Expenses and Enhanced Cash Flow

During this latest economic downturn many of our companies have undertaken intense efforts to sharpen their expense structures and enhance cash flow, positioning them for meaningful operating leverage and sustainable business reinvestment as we exit the turn and head into the next straightaway. The management team of Henry Schein, for instance, was among the first to recognize the pending economic downturn and adjust their financial planning accordingly. Lowe's has sharpened its distributions and store operations, improving its fixed costs leverage. Starbucks has rationalized its store base and corporate expenses while making tremendous progress in workflow. Coca-Cola is making significant progress squeezing costs out of its supply chain, and FedEx has managed to reduce its operating costs to the point that the company should be able to deliver 30% incremental margins as business recovers.

Widening the Lead

Our portfolio companies have performed well during the latest downturn and have positioned themselves to widen their leads during the uphill leg of the economic recovery. Aided by strategic acquisitions, accelerated investments, tighter expenses and enhanced cash flow, we expect our companies to generate exceptional, sustainable earnings growth in the coming years. In an environment in which growth will be scarce, we believe this performance will be highly valued by the market and, while the future is always uncertain, should help sustain the strong performance of our client portfolios.

*The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice.
Past performance is no guarantee for future results.*