

Why the long term matters more than the short term

By Andrew Evans, CFA, Fund Manager

In light of recent global media coverage of the coronavirus epidemic and the ensuing stock market reaction, we offer some thoughts on how to think about investing in these environments. Stock sell offs are hard to stomach, even for seasoned investment professionals. But how should an investor react to news of this type?

As an introduction, the strategy of our Sanlam Active UK fund is to buy a concentrated portfolio of high-quality businesses at attractive valuations, and then own them for long holding periods to benefit from a rising stream of free cash flows. The entire ethos revolves around owning a portfolio of strong businesses and benefitting over time from their attractive underlying economics.

Buying a stock means becoming a part owner in a real business. While successful investors like Warren Buffett have a huge following and have spawned thousands of books, how many people truly follow his advice to buy and hold good companies? An entrepreneur building a business wouldn't dream of selling up just because there was some short-term news item scaring the stock markets. If you owned the best hotel in the middle of a growing town, or owned a long-established profitable family business in that same town, you would likely take little notice of the talking heads on CNBC, or the latest monthly global economic/trade news. In the fund we invest in stocks with the same ownership mentality.

First, some theory. The true value of a business (generally referred to in industry jargon as "intrinsic value") is the present value of all free cash flows it will produce in the future, not just the cash it will produce in the next year or two. For a business that has long term potential to grow its cash flows, what happens in the next year or two has only a small impact on its intrinsic value. To demonstrate this, take a company with 3% growth into perpetuity, and a cost of equity of 10%, which produces \$100 in cash flow in the first year. The intrinsic fair value of this company is \$1,428. Stress testing the impact on value of short-term disruption, by halving the cash flows expected for the first two years, but leaving all other cash flows into perpetuity the same, reduces the intrinsic value of the company by 6% - not insignificant, but not hugely destructive. Share price reactions often ignore this and move far more than the underlying intrinsic value of a company. The short term is not very important if the long term remains attractive.

A good example of our strategy in the real world is our current portfolio holding Intercontinental Hotels Group (IHG), which we have owned since March last year. IHG is a high return on capital, hotel franchise business with over 5,000 branded hotels and 883,000 rooms around the world. Franchisees own and operate the physical hotel properties, and they pay IHG a royalty on each room night for using one of IHG's 13 hotel brands (Holiday Inn, Intercontinental Hotels, Crowne Plaza, Kimpton, Regent, etc.), for using IHG systems and for access to IHG's loyalty programme. Most of IHG's business is derived from the US, but they are growing very fast around the world, especially in China (less than 10% of current profits, but more than 30% of the group's pipeline for new hotels). IHG earns a Return on Capital of over 100%, which is exceptionally high, because the capital of putting up a new hotel is put up by the franchisee, and IHG just collects cash royalties from each guest night sold. Had you invested in IHG fifteen years ago, you would have earned 14% a year in USD, compared to 9% a year in the S&P500 Index. That is the past, but we think the opportunities to grow and provide exceptional returns to investors in the next fifteen years are just as exciting. IHG allows investors the chance to benefit from the growth in the emerging middle class in Asia and around the world, in a vehicle that is very cash flow generative.

The coronavirus and IHG's China exposure

There are now cases in 26 countries, and it is spreading. China is worst affected, with confirmed cases in every single province. In severe cases the virus can cause pneumonia, severe acute respiratory syndrome and even death. There was an initial negative stock market reaction globally, which has generally bounced back in the last three weeks, and another sell off in the past few days. History has shown that stock market concern around epidemics tends to fizzle out after a few months.

However, we really don't know how this will unfold. New countries are being infected and the situation appears to be worsening. Only 15% of IHG's current room base is in China, but China comprises 30% of their total future pipeline. The company wants China to be its second "home market" after the USA. Though it accounts for less than 10% of group profits, its exposure to China is higher than that of other global hotel companies. IHG's shares are down 18% year to date.

What it really means for valuation: testing a major coronavirus impact for IHG

When we invest, we have a view on what the shares will do over three-to-five years or longer, but we have absolutely no idea what the share price might do in the next few months or even in the next year or two. While a share price going down is never comfortable, our approach of owning better businesses allows us to generally view it as an opportunity to buy more, rather than panicking and trying to trade out of a position.

Our current fair valuation for IHG shares is around \$71 a share, or £56. We have run a basic “stress test” for a severe coronavirus impact – in this case we assume significant falls in their room occupancies worldwide for the next two years, as well as reducing their daily room rate significantly. This stress test results in drops in revenues not far off those in the financial crisis in 2008-2009, and we also assume profits fall more than revenues do. In this two-year stress test, our Free Cash Flow to the Firm (FCFF) estimates fall in 2020 and 2021 by around 20%. The intrinsic value for IHG on this stress scenario falls from \$74 to \$71 per share, compared to today’s share price of \$55. This is a minimal and manageable fall in the valuation of the company for what is a severe short-term hit to profitability. As such, we think there is a significant margin of safety at the current share price and the shares remain undervalued.

Humility is important: we have no idea how this very severe and escalating health crisis will unfold. We know travel companies are being disproportionately impacted by this virus. While the share price has been down significantly since December, it could very well sell down more. However, what we can say with confidence, is that we believe Intercontinental Hotels remains very well positioned for the future, that they continue to grow their room count by about five percent a year, that they continue to expand in areas of the world where there are emerging middle classes and need for good hotels, and that they continue to generate very good cash flow.

Important Information

The Fund invests geographically in a narrow range, there is an increased risk of volatility which may result in frequent rises and falls in the Fund's share price.

The value of this portfolio is subject to fluctuation and past performance is not necessarily a guide to future performance. The performance is calculated for the portfolio and the actual individual investor performance will differ as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. All terms exclude costs. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. Do remember that the value of participatory interests or the investment and the income generated from them may go down as well as up and is not guaranteed, therefore, you may not get back the amount originally invested and potentially risk total loss of capital. Therefore, the Manager does not provide any guarantee either with respect to the capital or the return of a portfolio. The Manager has the right to close any Portfolios to new investors to manage them more efficiently in accordance with their mandates. Collective Investment Schemes are traded at ruling prices and can engage in borrowing and scrip lending. Collective Investment Schemes (CIS) are generally medium to long term investments. A schedule of fees and charges and maximum commissions is available on request free of charge from the Manager, the Investment Manager or at www.sanlam.ie.

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