EDGEPOINT

WHAT HELPS US SLEEP AT NIGHT - PART 7

June 20, 2022

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Since our Portfolios were launched 14 years ago, we occasionally go through bouts of volatility. During those times we regularly get questions about how we were able to sleep at night in the face of whatever macro uncertainty was driving the volatility at the time. In response to these inquiries, we wrote notes that walked through examples of businesses we owned and explained why we thought they would thrive over time. We wrote six such notes from 2009 to 2020, which can be found here and we entitled them "*What helps us sleep at night*."

With all the negative headlines recently, we've received a few requests to update our "*What helps us sleep at night*" series. As our partners know, we don't get too fussed by noisy headlines. Instead, we focus on the performance of the businesses that make up our Portfolios. The reality is nobody knows if the markets will experience a pullback, how sharp it could be or how long it might last – although the media would like you to believe otherwise. We don't waste our time trying to forecast such things. We aren't good at "timing" the market and don't believe anyone can consistently do it well. Rather, we consider the facts surrounding the underlying businesses we own and make judgments based on those facts. History has shown that we have been good at determining if we're getting enough for your money during periods of volatility like the one we're going through today. Historical volatility has helped us build those pleasing long-term track records. The downside volatility made it easier for us to buy growth and not pay for it.

Below are some quick thoughts about five businesses that represent approximately 21% of EdgePoint Global Portfolio as of June 1, 2022. These are the things that we think about as we drift off at the end of the day.[i]

Berry Global, Inc.

Berry makes food packaging, the plastic liners on diapers and components of surgical masks and protective medical clothing. We first wrote about this business back in March of 2020 when the world was panicking about COVID. We were aggressively adding to our Berry holdings when it was in the mid-US$30s a share. Leading up to that point in 2020, the business had doubled its sales and more than doubled its earnings per share over the previous five years. Coming out of COVID, Berry has grown its sales by close to 30% and seen its earnings per share grow by almost 75%. The share price reacted favourably to this recent growth by more than doubling from its March 2020 lows to over US$70 a share. The macro fears of the last few months have resulted in the share price pulling back from the low-US$70s to the low-US$50s. Let's try to make sense of that low-US$50s price by walking through some simple math.

Imagine that you bought one share of Berry today for US$50. Now imagine that Berry stops growing. Recall that it has an excellent track record of growth dating back a very long time, so assuming zero growth is quite conservative by historical standards. Now let's assume that Berry uses all of its free cash flow (profits) to buy back its shares in the public market. They currently produce US$1 billion in free cash flow (profits) annually. So every day the company goes into the stock market and buys out shareholders who want to sell at US$50 a share using their billion in annual profits. There are 132 million shares outstanding. Berry has enough free cash flow to buy back everyone's shares over the next seven years assuming the share price doesn't change. So if you don't sell your single share and all your other fellow shareholders do, then in seven years you will own 100% of a business that produces US$1 billion a year for your US$50 investment – and that assumes the highly unlikely scenario where Berry doesn't grow from here. Would you like to own a business that gives you US$1 billion in free cash flow (profits) in seven years for US$50?

The management team that owns a lot of this business today understands this math and in the first quarter of this year they were buying back stock at an annualized rate of 16%. This means they can buy out all the other shareholders in just under seven years. They're likely going to continue at this pace until the market takes notice and the share price rises. We believe we're being offered growth for free.

To make this a faster read, we will use bullet points for the next four ideas.

Restaurant Brands International, Inc.

- One of the world's largest quick-serve restaurant groups – owners of Tim Hortons, Burger King, Popeyes Chicken and Firehouse Subs
- Earnings per share compounded at 12% a year for five years to the end of 2021 (despite COVID)
- Capital-light model – franchisees spend the money to open the store and Restaurant Brands takes a royalty on sales
- Number of new restaurant locations should increase by a rate of at least 5% a year
- Existing-store sales should increase by at least 3% a year and much higher if inflation continues
- Free cash flow yield of 7%. Adding in growth of new stores and same-store sales results in mid-double digit potential returns assuming earnings multiple doesn't change (multiple has been higher greater than 90% of the time since its creation)
- We believe we're being offered growth for free

Anthem, Inc.

- Anthem is one of the largest health insurers in the U.S. Healthcare is largely economically resilient and growing long term due to aging demographics
- Anthem is the largest player in most of their markets which gives them greater scale and cost advantage versus competitors. It reinvests those savings back in terms of lower premiums to attract more customers. Think of this as a virtuous circle
- Half of Anthem's earnings come from their government business, meaning the U.S. government pays the bill. Given budget pressures, more U.S. states are outsourcing coverage to managed-care companies like Anthem who can provide coverage at lower costs
- Like other insurance companies, Anthem gets premiums up front and invests this float before it needs to pay claims. As interest rates increase, Anthem makes higher returns on its investment portfolio
- The business generates significant excess free cash flow; over the last fifteen years the company has repurchased 60% of shares outstanding and the dividend has increased over five-fold in the last decade
- Anthem has grown their earnings per share by more than 16% compounded over 22 years and management forecasts compounded 12% to 15% growth over next five years
- The stock currently trades at 13.5x free cash flow next year (2023)
- We believe we're being offered growth for free

Willis Towers Watson PLC

- Willis Towers Watson (WTW) provides corporate clients with insurance brokerage and actuarial advisory services
- Commercial insurance, health insurance and other actuarial services are required year-in and year-out, regardless of the rate of CPI, prevailing interest rates and expectations of global economic growth
- A broker/advisor like WTW has arguably the best seat in the entire insurance value chain as it sits closest to the corporate customer. In turn, WTW operates with a fee model as opposed to traditional insurance companies that need to use their balance sheet to conduct and grow their business
- WTW's fee model is completely capital light. This means WTW doesn't need to reinvest any of its earnings to grow. As such, earnings can be used for other value-creating items like opportunistic share repurchases
- In early 2020, one of WTW's largest and most sophisticated competitors, Aon, tried to buy WTW for 17x forward earnings. However, one year later, the pending transaction unraveled due to U.S. anti-trust concerns
- A new management team was tapped to steer WTW as a standalone public company. This new management team, in addition to committing WTW to grow at least in-line with its historical 4% annual rate, identified a cost-transformation program that will generate US$300 million in annual savings through 2024
- The combination of consistent organic growth and identified cost savings, along with share repurchases because of WTW's capital-light model, we believe will allow WTW to earn US$21/share by 2024 (~20% EPS compound annual growth rate)
- Based on the closing price on Friday (June 17, 2022) of US$194, this implies that WTW is trading at ~9x earnings. The last time WTW's shares traded at a similar forward valuation was in 2008-2009
- Alternatively, WTW at the same valuation as Aon's 2020 offer suggests a share price that is 85% higher
- We believe we're being offered growth for free

Alfa Laval AB

- Global leader in heat transfer, separation and fluid-handling technologies
- A company that can grow through any energy scenario isn't easy to find in today's market, where the range of outcomes for energy keeps getting wider
- It's the number one supplier of the heat exchangers used in energy-transition technologies like heat pumps, hydrogen, carbon capture, marine fuel cells and energy storage. These are all long-term big ideas that we're following closely. Simultaneously, Alfa Laval's existing customers in the oil, gas, liquid natural gas and marine sectors are relying on Alfa more and more to help improve their energy efficiency and reduce emissions
- It's one of the best-positioned companies we've found to benefit from the trillions of investment dollars needed by governments and corporations to meet their Net Zero pledges, but because orders from all these new technologies made up less than 3% of Alfa's order book last year, the size of the opportunity is underappreciated by the market
- If none of these big energy transition ideas play out, we have the same business everyone else sees which is a high-quality industrial with a great management team, generating mid-teens return on equity and growing free cash at >10% compound annual growth rate. But if just one or two of these ideas play out, we're looking at double-digit organic growth through this decade and into the next, and several opportunities for the business to double

- ~30% of revenue comes from its service business. This is a high-margin, reliable source of revenue which has been growing steadily over the last decade, helped by a strong emphasis from management to develop it. Many of Alfa's products have long life cycles where the service opportunity is much higher than the original sale. The service revenue for a plate heat exchanger for example can be up to 7x the initial equipment sale
- Management has taken advantage of its under-levered balance sheet (Net debt/EBITDA of <0.7x on March 31, 2022) and strong free cash conversion to buy back its shares and announce several strategic bolt-on M&A transactions
- We believe we're being offered growth for free

Conclusion

While we doubt anyone is sleeping like a baby in these markets, we believe you own a collection of businesses where you're getting future growth for free. Berry, Restaurant Brands, Anthem, Willis Towers Watson and Alfa Laval – we believe their fundamentals are strong (even in the face of the many macro headwinds out there) and this helps us sleep well at night.

[i] Insights on the business described are based on internal research and estimates conducted by the EdgePoint Investment team. Examples are for illustrative purposes only and not intended as investment advice. EdgePoint Investment Group Inc. may be buying or selling positions in the above securities. All numbers as at June 20, 2022.

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Published June 20, 2022.