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Investing for a world of change

American Franchise: looking beyond the top line

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The fast view

- Investors frequently misjudge intrinsic value by failing to account for revenue quality. Resilient revenue models, such as subscriptions, translate into more durable free cashflow compounding over time.
- American Franchise prefers higher quality revenues streams, with more than 60% of the portfolio's revenue recurring in nature. There are, however, select opportunities in non-recurring transactional models, where competitive advantages and structural growth mitigates the associated risk. Some of the 'Magnificent Seven' are prime examples.
- Although American Franchise trades at a premium to the S&P 500, we believe this is justified given the portfolio's quality attributes and faster rate of compounding. Collectively, the underlying holdings in American Franchise have grown their profits at nearly twice the rate of the broader market since inception.

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Quality, not quantity: why quality revenue growth matters

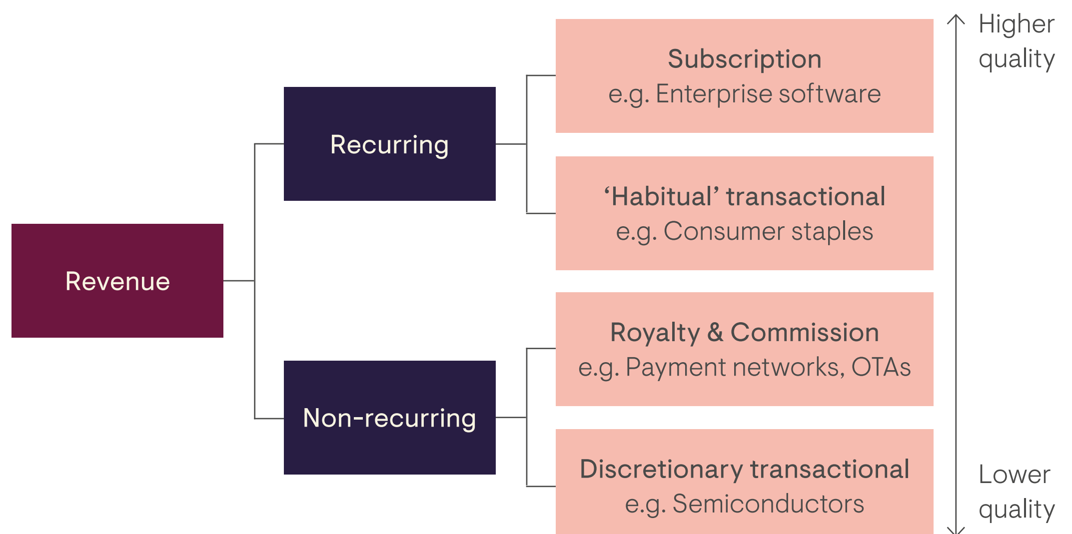
The economics of any business starts with revenues. Yet all too often, investors fail to account for the different types of revenue when evaluating and valuing companies. Not all revenue models are created equal; some are much more resilient to market and economic forces than others.

We spend considerable time analyzing the revenue models of companies in our universe. The reason for this focus is simple. Higher quality revenues typically translate into more predictable and sustainable free cash flow generation, which ultimately drives shareholder returns over the long term. Investors who solely focus on the magnitude of revenue growth, rather than its quality, can misjudge intrinsic value in both directions (often overpaying for high growth companies, whilst passing on stable but lower growth companies).

The importance of revenue resiliency was laid bare during the COVID-19 pandemic. Many businesses saw revenues all but disappear overnight, while others sailed through the turmoil as if nothing had really changed. Most remarkably, some companies remained fundamentally resilient despite being directly exposed to shuttered industries. This was, in large part, down to their advantaged revenue models.

At a high level, we can classify revenue types into four categories. The first two, subscriptions and 'habitual' transactions, are recurring in nature. The second two, royalties and commissions and discretionary transactions, are non-recurring sources of revenue.

Figure 1: Simplified breakdown of revenue models



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A business with a purely discretionary or transactional model relies on customers returning and buying a similar quantity of goods/services just to maintain their revenue base. If they want to grow, customers must buy more than they did previously. And if those customers don't return, the business must constantly recruit new customers to stand still. Consider, for example, a manufacturer of heavy capital equipment, like power generators. Such a business is dependent on macroeconomic conditions remaining stable for revenue growth momentum to persist[1]. If the economic outlook changes for the worse, customers will likely reassess investment plans, tighten their belts and ultimately purchase fewer generators. The knock-on effect on our hypothetical business may be severe: if they can't find new customers, revenues will go backwards, decremental margins start to bite and profits shrink materially. This is the definition of an economically sensitive business, and it primarily stems from having non-recurring transactional revenues.

At Ninety One, our quality investment philosophy means we generally steer clear of this sort of business. Instead, we focus on companies which have primarily recurring revenue streams. We prize the subscription model above all others. Many Software-as-a-Service (SaaS) companies, which provide mission-critical infrastructure and workflow solutions for their corporate customers, charge on a subscription basis. With this model, revenues are already locked in at the start of the year, with pre-paid contracts an attractive ancillary feature which benefits cash generation[2]. Rather than having to generate revenue from a base of zero, these companies start where they left off in the prior year and can instead focus on growth.

Autodesk, an architectural design software provider, is a quintessential subscription business. Architects and engineers rely heavily on Autodesk software to perform their daily tasks; we simply couldn't design buildings to modern standards without their solutions. With few competitive alternatives, customers typically only cancel an Autodesk subscription when they go out of business. The COVID-19 pandemic was a perfect illustration of this. With building sites grounding to a halt across the world, many firms in the construction industry suffered, but Autodesk continued to grow its revenues at a double-digit rate. Architects weren't going out of business and, in fact, had already paid for a year's subscription upfront. In short, despite serving an economically sensitive sector, Autodesk's superior revenue model results in far more predictable compounding over time. Although admittedly crude, a comparison with Caterpillar (the world's largest manufacturer of construction equipment) neatly illustrates the downside protection a subscription model provides during periods of economic stress.

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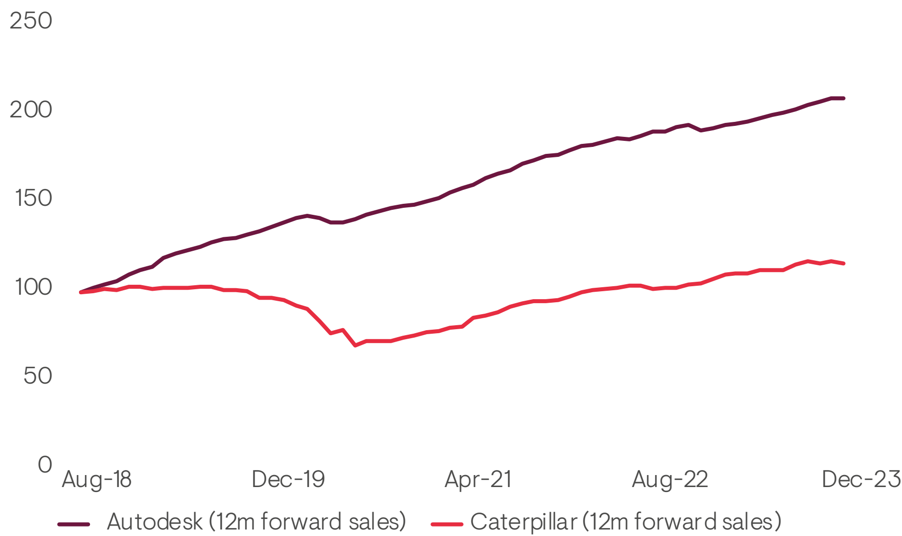
1. Other forces are often at play, for example the company might be benefitting from a supernormal product cycle which boosts demand.
2. Subscription businesses recognize revenues rateably through the year, but often collect subscription dues from customers upfront, resulting in structurally superior cash generation.

This is not a buy, sell or hold recommendation for any particular security. The companies discussed in this piece have been selected to inform the reader about the types of business models that Ninety One's Quality team is typically drawn to.
For further information on specific portfolio names, please see the Important information section.

Figure 2: Autodesk's sales have proven more resilient than Caterpillar over the same period



Source: Company filings, as at 31 December, 2023.

We hold several other subscription businesses in our portfolio. Microsoft[3] (enterprise productivity software and cloud infrastructure), Intuit (small business accounting and consumer tax software) and ADP (human capital management software and services) all sit within our top ten holdings, as does real estate analytics platform CoStar. We put these companies in a league of their own given the visibility and consistency their revenue models provide.

Figure 3: Revenue models of the top 10 American Franchise holdings

		Majority subscription?
01	Microsoft	●
02	Alphabet	
03	Autodesk	●
04	Texas Instruments	
05	Charles Schwab	
06	Dolby Labs	
07	Intuit	●
08	Monster Beverage	
09	ADP	●
10	CoStar	●

Source: Ninety One, as at 31 March, 2024. The portfolio may change significantly over a short period of time.

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A second form of recurring revenue are 'habitual' transactions. Our power generator company was an extreme example of a big-ticket, discretionary purchase. Other transactions can be more recurring in nature, and therefore attractive to us as quality investors. Consumer staples businesses are at the other end of the spectrum from power generators. Whilst they also have transactional revenues, purchases are so consistent they almost behave like subscriptions. This is underpinned by the strength of their brands, established in the minds of consumers over decades or even centuries, along with superior distribution and route to market capabilities. When you combine these attributes with frequently purchased, non-discretionary products – we consume roughly the same quantity of food/beverages regardless of the state of the economy – the revenue stream becomes quasi-recurring in nature.

These revenue models exist in other sectors besides consumer staples. One of the more unexpected examples is O'Reilly Automotive[4], a leading auto parts retailer. The automotive sector has a well-deserved reputation for being highly cyclical. However, rather counterintuitively, O'Reilly's revenue model exhibits strong countercyclical properties, with vehicle owners more likely to fix up their cars in a bad economy, driving demand for spare parts. This inherently defensive revenue model is complemented by O'Reilly's market leading distribution capabilities and a consistent history of market share gains, making the business a compelling proposition in an otherwise unattractive sector.

Finally, there are royalty or commission-based revenue models, where a company's revenue is derived directly or indirectly from the revenue of other companies. We hold several businesses in this category, including Visa (collects an effective royalty on merchant payment volumes), Booking (receives a commission on hotel stays) and Dolby (collects a royalty on consumer electronic sales which incorporate its audio-visual technology). Whilst these are undoubtedly non-recurring revenue streams, the scale and diversity of ultimate customers, coupled with secular growth drivers (conversion from cash to card for Visa, or penetration of online hotel bookings for Booking, etc.) make these relatively less volatile and easier to predict over time than non-recurring transactional revenues.

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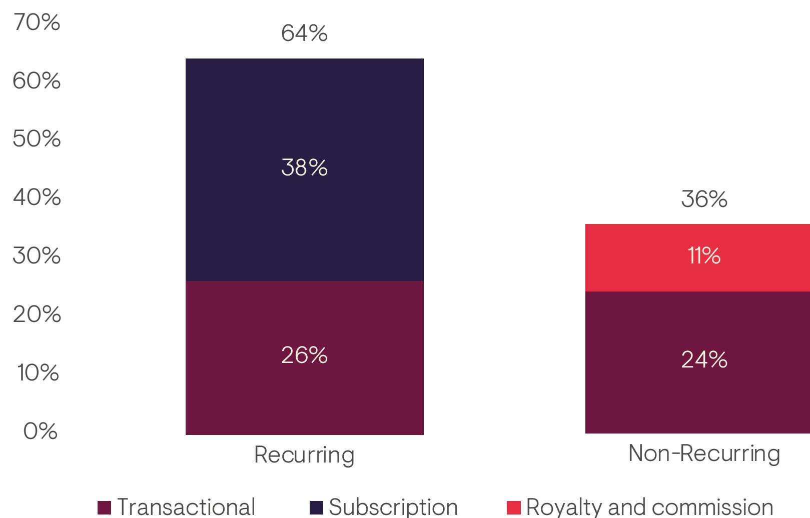
American Franchise's exposure

The positioning of American Franchise reflects our long-standing preference for recurring revenue models. More than 60% of the portfolio's revenue is recurring in nature, with highest-quality subscriptions accounting for more than a third. Whilst it is difficult to replicate our bottom-up revenue analysis at an index level, we are confident that American Franchise has much higher exposure to recurring revenues than the S&P 500. To this point, the S&P 500's economic exposure to cyclical sectors and industries is approximately 57%, a metric which likely understates the proportion of non-recurring transactional revenues. Whilst the long-awaited, much-prophesized US recession has not yet materialized, we believe our focus on revenue quality, and the resulting composition of the portfolio, positions us well should material economic weakness ultimately emerge.

Figure 4: American Franchise portfolio revenue breakdown



Source: Ninety One, as at 31 March, 2024. The portfolio may change significantly over a short period of time.

Opportunities in non-recurring transactional models

As Figure 4 illustrates, about a quarter of the portfolio is exposed to non-recurring transactional models. Whilst generally an inferior model, in our view, there are some high-quality companies in this category, which can have other attractive, compensating features. We pay particularly close attention to a company's market position and secular growth outlook. Texas Instruments, for example, falls into this category. As makers of analog semiconductor chips – used in everything from cars to fridges to smartwatches – its business has natural economic sensitivity. Offsetting this, though, is the sheer diversity of its business: Texas sells more than 80,000 different products to thousands of individual end customers. Tellingly, 50% of revenue is derived from products that are more than a decade old, which illustrates the durability of its franchise.

Revenue models behind the 'Magnificent Seven'

We've had FANG, FAAMG, MAMAA and now, the Magnificent Seven[5]. Market commentators have attached various labels to the cluster of large-cap technology businesses that now account for a significant proportion of the S&P 500. We have always been a bit bemused by these classifications: the companies included seem to shift to suit the prevailing narrative of the day. In any case, there are plenty of interesting opportunities in technology outside of the mega-cap names. Regardless of the ever-changing labels, our quality approach to analysing these businesses remains the same. It starts, of course, with an understanding of revenue models.

American Franchise's Magnificent Seven positioning reflects our preference for more resilient revenue streams. We currently hold two of the seven and held two others until February this year. In an update to this paper that was first published in November 2023, we provide further insight into our thinking about this cohort of mega caps which dominate the headlines.

Microsoft, a holding since inception, has the highest quality revenue model of the group. The company has transformed the way it sells and prices products during the last decade from simply licensing the products to building a subscription model across all their business units. Its products and services are focused on every organization, every employee and across the entire IT stack, and Microsoft is the platform of choice on which AI-driven products and services are being built. Turning to Google's parent, **Alphabet** has an effective monopoly in search with a highly valuable advertising model. While the advertising royalties ebb and flow with the broader industry cycle, this risk is sufficiently offset by its exceptionally strong position in search.

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5. Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta.

Figure 5: American Franchise - Magnificent Seven positioning

	MSFT	GOOG	META	NVDA	AAPL	AMZN	TSLA
Held in American Franchise	● (Held)	● (Held)	● (Covered)	● (Covered)	● (Covered)	● (Excluded)	● (Excluded)
Revenue model	Subscription	Royalty	Royalty	Transactional	Transactional	Transactional	Transactional
	Recurring	Non-recurring	Non-recurring	Non-recurring	Non-recurring	Non-recurring	Non-recurring

● Held ● Covered ● Excluded

Source: Ninety One, as at 31 March, 2024. The portfolio may change significantly over a short period of time.

Although **Meta** has a predominantly royalty-based revenue model, the business has more data on users and advertisers than anyone else, allowing them to deliver engaging content and targeted ads which are better for both the user and the advertisers. In the US, for example, it's estimated every advertising $1 spent on Meta services generates $3.31 for advertisers. However, the business has materially higher long-term risks than a typical franchise stock, namely headwinds relating to data privacy. Furthermore, calibrating the steady state growth of the business is difficult given recent earnings dynamics. Given our valuation discipline, we chose to exit the position in early 2024 after a holding period of more than six years.

Similarly, **Nvidia** is a company which has an excellent financial model, with high gross margins, low capital intensity, solid cash conversion and a net cash balance sheet. Although possessing a non-recurring transactional revenue model centred on its leading GPUs, it is extremely well placed for the increasing need for computing power, especially from AI. We invested in Nvidia in 2022, predicting a strategic shift from a pure growth stock to a company prioritising reliable quality, largely driven by its expanding datacentre business. However, the recent and somewhat unpredictable AI boom of 2023/2024 has significantly clouded long-term datacentre sales projections, and this impacted our confidence in the future growth trajectory, leading us to exit the position in February 2024.

There are several aspects of the investment case for **Apple** that would meet our quality criteria: the ubiquity of its products; the strength of its brand; growth via premiumisation, coupled with multiple add-on services and its net cash balance sheet. However, there are idiosyncratic concerns facing the stock. The revenue model is about 20% subscription, and the remainder transactional. Equally, forward growth is reliant on high penetration of the smartphone market coupled with ASP inflation in addition to a greater push into emerging markets and, therefore, increasing prices may be harder to sustain given affordability concerns. Finally, there are various regulatory threats.

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The two remaining members of the cohort fall outside of our quality philosophy. **Amazon** has a lot of attractive traits which make it worthy of consideration within our universe. However, its ultimate cash flow profile is unclear and can be volatile, with its core ecommerce business tending to be lower margin. In addition, Amazon possesses a relatively more capital-intensive business model than our typical portfolio holdings. Finally, **Tesla** simply doesn't meet the quality attributes we seek. This capital-intensive business operates in highly cyclical end markets, and possesses a relatively immature financial model, and as such has not proven its ability to compound over many market cycles.

Therefore, American Franchise is underweight the Magnificent 7 cohort but also many of the other mega cap names. This differentiated approach allows us to find alpha opportunities further down the market cap spectrum in quality companies that meet our quality attributes: enduring competitive advantages, dominant market positions, strong balance sheets, lower cyclicality, low capital intensity, sustainable cash generation and disciplined capital allocation.

Figure 6: Looking beyond the mega caps

Market cap breakdown

	Portfolio	Index	Difference
$200bn+	27%	53%	**-26%**
$100bn – $200bn	22%	17%	**5%**
$50bn – $100bn	21%	12%	**8%**
$25bn – $50bn	14%	11%	**4%**
$5bn – $25bn	12%	7%	**6%**

Source: Ninety One, as at 31 March, 2024. The portfolio may change significantly over a short period of time.

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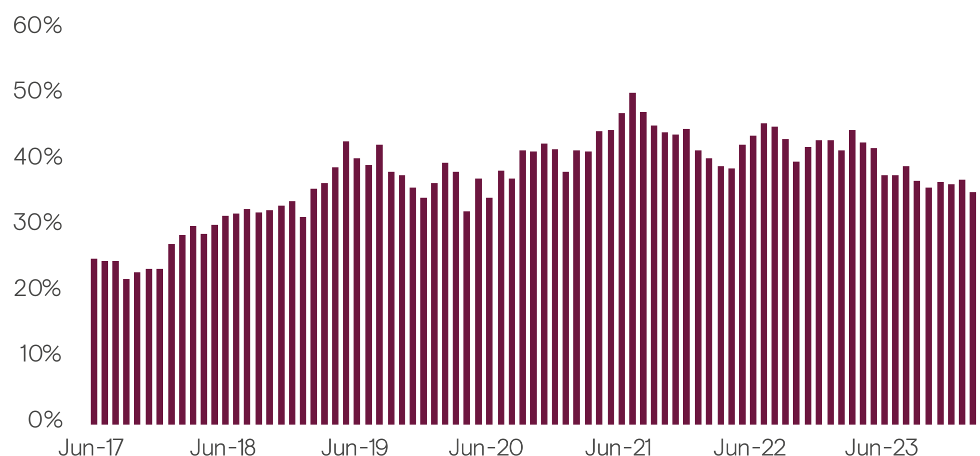
The importance of balance

Given our stated preference for recurring revenues, why not fully expose the portfolio to such models? Well, as with all things in life, balance is important. We strive to build a well-rounded portfolio, with an appropriate blend of offensive and defensive characteristics. This is clearly illustrated by the balance of market caps held across the portfolio. Recurring revenues are less attractive in a more buoyant economy, all else equal, so we complement this exposure with a handful of transactionally driven companies. We also look to maintain an appropriate balance across sectors and business models. A portfolio of entirely subscription-based revenue streams would have an extreme – and frankly imprudent – bias towards the information technology sector.

The valuation conundrum

Keeping on this theme of prudence, it is imperative to not overpay for a business. But it is important to remember that trading at a premium does not mean something is expensive. On a forward basis, the collective holdings of American Franchise trade at a 33% premium to the S&P 500, as illustrated in Figure 7. However, in our view, this premium is understandable given the more cyclical and lower quality attributes of the index, in contrast to the higher-quality attributes of the portfolio. Furthermore, given our purist quality philosophy has remained consistent over time, the current valuation is in line with its historical average.

Figure 7: Premium to S&P 500



Source: Ninety One, FactSet, Bloomberg, based on constituents of S&P 500, as at 31 March, 2024.
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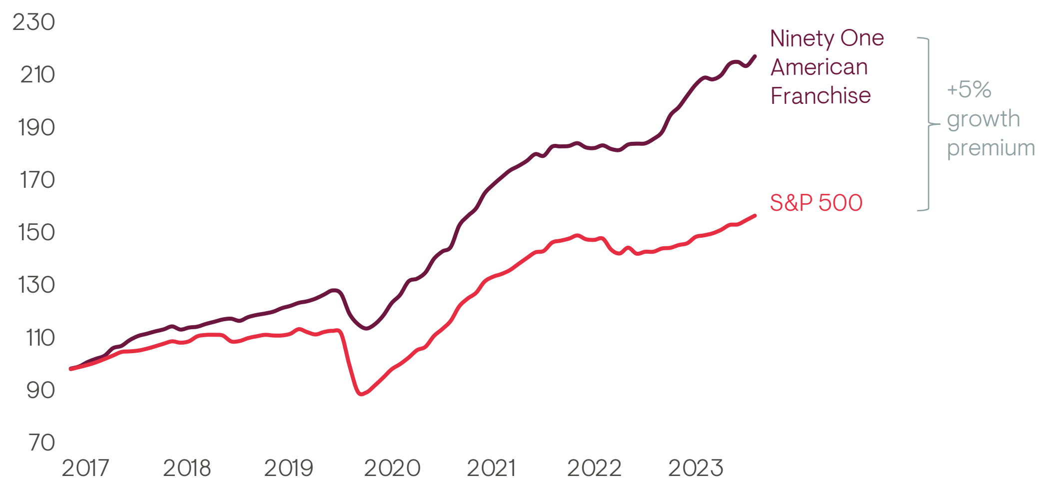
But how is it possible to still generate outperformance with such a valuation premium? The answer — we believe — lies within the fundamentals of the companies that we own.

American Franchise has compounded profit faster than the broader market and also has been more resilient is economic drawdowns, such as COVID. The portfolio has grown profit around +5% per annum faster than the S&P 500 (12% vs. 7%) since inception. This significant profit growth differential is the primary way the fund has managed to deliver alpha. We believe that this profitability growth premium should prove supportive of alpha generation even if there were to be convergence in the portfolio's valuation to the level of the broad market over time.

Figure 8: Profit (EBIT) growth



Source: Bloomberg, Ninety One. March 31, 2024. EBIT = Earnings before interest and tax.

In an increasingly uncertain world, we believe greater certainty is a compelling goal. Investing in businesses with a diverse set of quality revenue streams can provide earnings resilience, robust growth and drive long-term shareholder returns. A common theme in all of these companies is their greater profitability than the broader market, and capturing this justifies paying a premium, especially when securing exposure to long-term structural growth, critical in an uncertain environment.

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Figure 9: American Franchise performance summary

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
American Franchise I Acc	9.8%	-3.9%	20.2%	20.3%	1.2%	32.3%	24.3%	25.8%	-23.0%	32.8%
S&P 500 NR*	13.0%	0.7%	11.2%	21.1%	-4.9%	30.7%	17.8%	28.2%	-18.5%	25.7%
Active return	-3.2%	-4.6%	8.9%	-0.8%	6.1%	1.6%	6.5%	-2.4%	-4.5%	7.1%

Past performance does not predict future returns; losses may be made.

Source: Morningstar, 31 March 2024. Performance is net of fees (NAV based, including ongoing charges, excluding initial charges), gross income reinvested, in USD. Manager tenure start date June 30, 2017. On July 1, 2017, the investment team of the Fund changed from Value to Quality.

*Benchmark: S&P 500 Net return.

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