



## MAGELLAN EXPLAINS: Finding quality companies

### What are quality companies and why does it matter when you are investing?

#### What does it take for a company to be classified as quality?

Quality is a frequently used term in investing, but from Magellan's experience definition really does matter.

There are thousands of companies listed on stock exchanges around the world and finding companies of sufficient quality to consider for investment requires a rigorous evaluation of the economics of the business and the industry in which it operates. This evaluation isn't downloadable or traceable, it's deep fundamental research where we analyse information from a wide range of sources to make a determination of quality, with a forward-looking lens.

At Magellan, we define a quality company as one that has unique attributes that enable the company to earn attractive sustainable returns over the long term. This definition is forward looking. Active fundamental research is key to understanding how sustainable future earnings can be.

#### Attributes of a quality company

Below are some examples of what Magellan considers to be attributes of a quality company. The more attributes the company has, the more we consider it likely that the company will be able to earn sustainable returns into the future.

**Barriers to entry:** This is how difficult it is for new entrants to break into the industry and take market share from the incumbents. We consider that the more barriers there are, the higher the quality of the existing businesses.

**Brand:** A business might own a unique brand or franchise that resonates with its customers, conferring it with true pricing power.

**Network effect:** A network effect or two-sided market is incredibly difficult to unwind. The more users there are in the network the stronger it grows.

**Economies of scale:** This is where a business might have a structural or size advantage that enables it to be the lowest-cost producer and beat its competitors on price.

**High switching costs:** These exist where customers of a particular company would incur a cost to leave that company and go to a competitor, enabling the existing company to keep more existing customers whilst growing new ones at a premium price.



A **two-sided market**, also known as a **two-sided network** exists when both buyers and sellers meet to **exchange** a product or service, creating both bids to buy and offers (asks) to sell.

This can occur when two user groups or agents interact through an **intermediary** or **platform** to the benefit of both parties.

## What are Magellan's assessment criteria for quality companies?

At Magellan, we research the attributes of a company and the industry in which it operates and score them against our proprietary quality scorecard, looking at the following 6 quality factors:

- 1. Moat:** This involves identifying the attributes listed above that enable a company to generate sustainable earnings over the long term. The research process isn't a simple 'checkbox' exercise; it requires understanding the industry, the consumer, the regulatory landscape and the company's position
- 2. Moat Trend:** We then want to know the trend of that moat, meaning how a company's competitive position changes over time. We consider this competitive direction is an important indicator of future opportunity for the company.
- 3. Business Risk:** This may be risk generated by the economy, the company's business model, or geopolitical issues. All of these risks may impact the predictability of the company's earnings.
- 4. Agency Risk:** The management of a company act as agents for its shareholders, so management's ability to deploy capital appropriately and manage the risks in the business are paramount.
- 5. Reinvestment Potential:** If a company can generate strong returns and then reinvest that money back into the business to enable product and service expansion, then it gives us greater certainty on future cash flows.
- 6. ESG Risk and Opportunity:** Here we are focused on the materiality of Environmental, Social and Governance issues that can impact the cash flows of a company both in a positive and negative way.

This scorecard gives us conviction in the company's ability to generate sustainable returns through different market cycles. Our approach to defining quality requires active, fundamental research, debate, investment committee oversight and continuous review.

## What are the financial attributes that are important in a quality company?

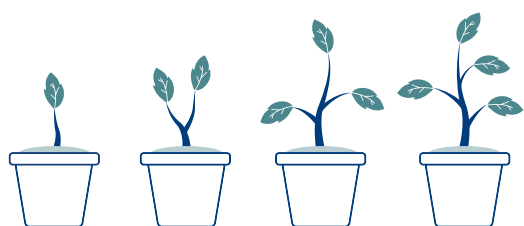
There are a number of financial attributes we consider quality companies have including:

- Free cash flow yield: this is the ability to generate cash after obligations (free cash)
- Earnings resilience: this is the sustainability of earnings in the future
- Returns stability: this is the ability to generate attractive returns, and reinvest in the business
- Margin of safety: this is the difference between the intrinsic value and market price, and
- Creditworthiness: this is the riskiness of a company to meet its debt obligations



## Why does investing in quality matter to you as an investor?

From our experience as quality investors, there are 3 key reasons why we think investing in quality should matter to you:



1. It can provide greater conviction in the sustainability of the company's earnings.
2. When investing long term you may generate compound returns. Over time, this may lead to substantial growth in your investment.
3. Investing in quality can allow you to invest through different market cycles. This is an important feature when considering volatility in the investment horizon.

**Magellan believes it's important to look to the future when defining quality.**

## How do you find quality companies?

At Magellan, we scour the world for the best companies that we believe have a sustainable competitive advantage that will compound returns for our investors over the long term.

We define what quality means to us and we then spend time assessing business models, business types, and how companies reinvest in their business to get stronger over the long term, which enables us to score those companies against our quality criteria. We talk to CEOs, company employees, former employees, industry experts, suppliers and competitors. The risks of each company are assessed, including environmental, social and governance issues. We focus on the company's ability to manage the impact of their exposure to all business risks.

All of this active, fundamental research enables us to form a high conviction view on each company, which we are constantly monitoring and reviewing.



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