Founder-led businesses present an attractive opportunity for investors as they are buoyed by their leader's desire to outperform, succeed, and leave a legacy. Do they provide a competitive advantage, and what are the things to consider when contemplating a new investment? **Chloe Walker** investigates.

01:
Manny Pohl
founder & executive chair
ECP Asset Management

02:
Andrew Cassar
head of Australasian equities
JANA Investment Advisers

03:
Sebastian Evans
chief investment officer & managing director
NAOS Asset Management

"I eat, sleep and s*** radiators, mate."

These are the words of legendary founder and chief executive Kees Weel in PWR Holdings' company profile. Not the sort of thing you'd typically expect to find in a corporate document. But then again, PWR isn't your typical corporation.

From the humble beginnings of making his first copper and brass radiator in 1982, Weel and his son Paul have taken their Gold Coast based business to great heights as a world leader in automotive industry thermal management solutions. His company now makes some of the best radiators and cooling systems in the world, as evidenced by PWR supplying every Formula One team with their cooling needs.

According to Weel, his "uniquely Australian approach to business" is his greatest strength, where no challenge is too big, and everything can be made with time, money and hard work.

It's this "skin in the game" ethos that has seen Australian founder-owned and run businesses like Weel's soar to success on a global scale.

It also, according to research from Fidelity Investments, comes down to the fact that founder-led firms tend to take a longer-term view, rather than focusing to a greater degree on near-term results—such as beating expectations with the next earnings report.

"A founder chief executive or other decision-maker may have greater motivation to maximise the long-term sustainability of a firm," it says.

"One reason for this perception may be that many founders have a vested interest in the long-term success of their company. Indeed, many can have significant skin in the game—in some cases, much of their life savings or personal assets."

Additionally, Fidelity acknowledges that a founder may think of their company as their life's work, and thus may have extra motivation to see it last through time. Consequently, founders may have a greater desire, compared with non-founders, to ensure the long-term sustainability of the company.

"Of course, simply because a company is run by its founder does not necessarily mean its management is superior relative to other professional leaders, or that the company will outperform its non-founder-run peers," it warns.

"As always, it's prudent to consider seeking out strong companies with earnings growth potential that are trading at attractive prices."

ECP Asset Management founder and executive chair Manny Pohl[01] agrees.

"It does not necessarily follow that because an owner is still involved in a business that the business will have the traits [that you mention]. In fact, it may well be that some businesses have succeeded more due to good luck than good judgement," Pohl says.

It's for this very reason that all companies are assessed through ECP's six-pillar research lens to identify quality franchises that sustainably expand their economic footprint over the long-term.

"Typically, these businesses operate in favourable industries and can reinvest at high returns on capital with talented management leveraging their sustainable competitive advantage. Assessing the management team is central to this process as they will ultimately bring our investment thesis to fruition by delivering on the long-term strategy," Pohl explains.

"In this assessment it is all about finding trustworthy organisations that have a track record of delivering with integrity. One could assume that owners who have a track record of delivering this in the past would be best placed to do so in the future."

Aussie, Aussie, Aussie

Despite risks to the outlook, high inflation and tightening monetary policy, sentiment towards Australian equities cautiously improved over the month of April and investors have remained largely positive on the economic backdrop.

According to JP Morgan's April Monthly Market review, the ASX 200 was a stand-out market in March, gaining 6.9% as Financials and Resources names boosted returns. The Australian market also materially outperformed broader developed markets, and in absolute terms, all sectors in the Australian market posted positive returns for the month.

For JANA Investment Advisers head of Australasian equities Andrew Cassar[02], Aussie equities provide several attractive characteristics which compliment a broadly diversified portfolio.

"JANA considers that Australian equities are more attractive relative to global equities at this point in the cycle," Cassar explains.

"They offer investors attractive dividend yields relative to cash with the added benefit of franking credits, which can benefit a large proportion of Australian investors."

According to Cassar, there are three key factors driving this view.

"Firstly, valuations are more attractive relative to global equities. Secondly, domestic fundamentals remain strong, with earnings upgrades expected over the coming six-12 months," he says.

"These will be driven by elevated commodity prices and improved bank earnings from a rising rate environment. Finally, investor sentiment remains robust given the improved market fundamentals."

NAOS Asset Management chief investment officer and managing director Sebastian Evans[03] concurs with Cassar's views.

"I think a lot of people will say that the Australian equity market doesn't stand out because of diversification, but I think you could take an opposite view and say that the market stands out because of the current macro environment," Evans says.

"Our stability in the geopolitical space that we operate in provides a reasonably sound macro backdrop. For example, the Australian government's balance sheet relative to other places around the world is in reasonable shape, and some of the industries that we are exposed to actually have some pretty strong tailwind, for example, the mining sector.

"So, you could definitely argue that the Australian equity market provides a pretty reasonable backdrop compared to a lot of places around the world."

No one works harder than an owner, and we certainly stand by that. Not only are founders aligned in their business, but they're aligned with us as investors.
Michael Higgins

And this view was backed by Wilson Asset Management lead portfolio manager Oscar Oberg during a webinar in late March, discussing small-cap Australian companies.

"Valuations are actually at decade lows when you take out the technology sector and if you look at the United States the differential in valuation between large-cap and small-cap companies is actually the lowest it has been in the last 23 years, so we do feel there is a strong environment for small-cap companies once the market comes back to us and there is a little bit of certainty - and certainly in terms of how we are positioned within the portfolios," Oberg said at the time.

The expectation of rising interest rates is likely to keep a lid on valuations too.

"This combined with our expectation of a 16% improvement in earnings should see the market improve by a similar amount over the next 12 months," Pohl says.

Pohl adds that the Australian market, despite being highly regulated, is characterised by global participants competing with local companies to service a huge land mass and a relatively small population.

"The net result is a highly competitive landscape where local suppliers using a relatively expensive labour force have to be innovative to be cost competitive," Pohl says.

"Any company that is able to compete in this environment has a sustainable competitive advantage when distributing its product globally and is likely to do extremely well in overseas markets."

And when it comes to competitive stock pickings, many believe founder-led companies will lead the way.

Playing the long game

When founder chief executives or chairs take a "long view" of their companies, it tends to align their incentives more closely with other shareholders.

For seasoned stock picker and head of fundamental equities Australia Charlie Lanchester[04], it's imperative for investors to select listed companies with a proven track record of thinking long-term.

"What we've found is that companies that are founder-led, or where boards and management own significant stakes in the businesses, it is much more likely that their decisions genuinely create value for the long term instead of doing

04:
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BlackRock

05:
Michael Higgins
portfolio manager
Milford Asset Management

06:
Jason Huljich
founder & chief executive
Centuria Capital

something to boost near term earnings or hit short term incentive targets to get their bonus," Lanchester says.

"Often companies are rewarded more in the short-term for making an earnings accretive acquisition which boosts short term earnings, as opposed to investing R&D back into their own businesses, which might impact short term profits, but provide a lot of upside in the long term without the same risk of cultural clash or management distraction which can happen when pursuing M&A.

"It will be the cash flows of a business which determine its true value. We think that those management teams making good decisions about capital will succeed in becoming larger companies of the future."

Michael Higgins[05] of Milford Asset Management agrees with Lanchester's sentiments.

As portfolio manager of Milford's Dynamic Fund, Higgins focuses mainly on smaller cap investments where companies are more likely to be founder-led, family-linked or employee-owned. For Higgins, a consistent theme is that these businesses have an exceptional track record of outperformance.

To find out why, Higgins undertook an analysis of the three-year performance data of all the founder-led companies owned in the Dynamic Fund as at July last year [Figure 1].

According to Higgins, these businesses outperformed the small ordinaries index by close to 31 or 32%.

"It's quite fascinating to see the significant outperformance these founder-led businesses have experienced, when compared to the ASX/S&P Small Ordinaries Accumulation Index," Higgins says.

"The founder-led portfolio returned around 41% p.a. over three years against the ASX/S&P Small Ordinaries index return of 9.2%, an outperformance of 31.7% p.a."

Digging further, Higgins wanted to identify the key traits of a great founder-led business. The answer: having some skin and soul in the game, along with a long-term mindset.

"Firstly, when it comes to a long-term mindset, these founders typically aren't looking at establishing a business for a short period of time, they're looking very much for a multi-generational timescale. And it's not about short-term incentives; it's very much about establishing a business for the future," Higgins says.

When it comes to skin in the game, Higgins says it's "all about alignment".

"No one works harder than an owner, and we certainly stand by that. Not only are founders aligned in their business, but they're aligned with us as investors. It's not everything, but it's very powerful," he says.

But a founder-led company typically also has soul in the game, Higgins says.

"It's that emotional attachment which in some ways is intangible to measure, but it's that real passion for the business and building legacy that that requires longer term thinking. Someone who's built the business, or has family involved in the business, gets up in the morning and thinks about the company they're working in," he says.

"It's not about the next job or what's next for them. It really is the bigger, broader love of the business and the intent to continue the success they've had into the future. And that's probably the most underestimated attribute and the most powerful.

"We tend to find that they're some of the best managers that we invest with."

As founder and chief executive of Centuria Capital, Jason Huljich[06] understands the significance of having some "skin in the game".

"My fellow joint chief executive John McBain and I formed the company in 1998 and we've worked together since 1996," Hulijch recalls.

"John and I and our families are among the largest individual shareholders in the company and, as the business has grown, so too has our commitment. This gives our investors confidence knowing that the founders are committed to the company."

Over the years, Centuria has grown from a grass-roots operation with five employees to a team of more than 350 today.

"Either John or I continue to conduct the final interview of each prospective employee to ensure they are the right fit in terms of culture, their attitude and drive," he says.

"Having this strong company culture means we can have very high retention rates, remain agile and competitive. This hands-on collaborative approach is something John and I are very proud of."

Hulijch adds: "I sit on the floor with the rest of my colleagues and we all hot desk so I'm sitting next to different members of the team every day. This enables me to always have my ear to the ground and, when I'm in and out of meetings, it provides an opportunity for my colleagues to grab me for a quick chat or bounce ideas around with me. I believe this collaborative approach is really what sets Centuria apart from our competitors.

Founder of Acacia Money, Anil Sagaram[07] also understands the trials and tribulations that come with running a company.

"When you're a founder, you're trying to solve a problem that is close to your heart, and from speaking to other founders whom I respect and follow, generally there's quite a unique insight into that problem space that is the genesis of the business that you've formed," he says.

"I think that passion and the commitment mixed with ideally a unique insight is the magic which brings together that vision. Naturally, founders take a long view of their companies, as they're not just working on a one-year KPI."

Elsewhere, abrdn deputy head of Australian equities Natalie Tam[08] believes that founders are often highly successful at solving problems by creating product, and more crucially, commercialising it. They also tend to take a long-term view, so sometimes they can get frustrated if the market becomes more focused on short-term performance.

The key things to look out for are the key person risk- what happens if they leave or are forced to leave, and tunnel vision.
Steve Johnson

"A big challenge for founders is figuring out when it is time to step down and hand the baton onto the next generation of leaders. This can be a difficult transition to navigate. It can be destabilising for staff, particularly if they have bought into a founder's vision," Tam says.

"A successful example of founder transition is Xero where the original founder Rob Drury stepped down and was replaced by Steve Vamos. Another example is SiteMinder where one of the co-founders Mike Ford remains active in the business as chief technical officer, pursing what he is passionate about – engineering great products. Meanwhile the chief executive role has been passed to an experienced listed company executive, Sankar Narayan."

Picking a winner

A crucial part of any investment strategy is understanding the management teams at the helm and ensuring their incentives are aligned with shareholders. This is where the founder-led strategy comes into play.

Duro Capital portfolio manager Chadd Knights says that equity ownership promotes that long-term thinking.

"The research on the outperformance of founder-led firms versus professionally managed firms is pretty clear. For example, Bain & Company's analysis of S&P 500 firms between 1990 and 2014 found that the stock performance of founder-led businesses outperformed their professionally managed peers by 3.1 times over the period," he says.

The two main drivers of this outperformance are financial and cultural, Knights adds.

"Charlie Munger has a good quote where he says, 'Show me the incentive and I'll show you the outcome'," he says.

"When the incentives are short-term focused, you'll tend to find more corner cutting, such as cutting the R&D budget to meet a KPI which may look good now but can seriously hurt long-term value.

"At the end of the day, their firms tend to their life's work and mission, and they try not to leave anything on the table… They're also less likely to empire build- in other words, engage in value destroying acquisitions. And they're less likely sorry to undergo acquisitions that will take them away from their core business."

Steve Johnson[09], chief investment officer and founder at Forager Funds Management, also prefers founder-led businesses, citing advantages such as alignment, incentives and a proven track record which he believes are much harder to find in other businesses.

Nevertheless, Johnson warns investors to tread carefully.

"It is nowhere near as simple as blindly buying these businesses as they come with addi-

07:
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08:
Natalie Tam
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09:
Steve Johnson
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tional risks. Corporate history is littered with founder-led disasters, too. Think Eddie Groves, Nathan Tinkler and more recently, the Magellan saga," he says.

"The key things to look out for are the key person risk - what happens if they leave or are forced to leave, and tunnel vision. Founders' singular focus is what makes them successful, but also what makes it hard for them to accept structural changes to their industries."

A recent report by local investment firm TDM Growth Partners states that founder-led businesses will spend about 22% more on research and development and 38% more on capex than non-founder led. They also have about 30% more patents than the average S&P 500 company, as well as 52% lower debt to equity than the S&P 500.

The mean stock ownership of founder chief executives is 11%, while non-founder chief executives have a mean ownership of just 2%. Of all founder chief executives, 13% hold more than 25% of the outstanding shares of the firm.

"They're also less likely to empire build- in other words, engage in value destroying acquisitions. And they're less likely sorry to undergo acquisitions that will take them away from their core business," Knights says.

A great example of this on the ASX is accounting firm Kelly+Partners, he says.

"Brett Kelly with his wife Rebecca founded the business over 15 years ago and have grown revenues in excess of 30% per year over 15 years. Kelly holds about 50% of the company, and if you look at how he deploys capital, it's probably the best example I've seen of a founder led firm here in Australia," Knights says.

NAOS's Evans concurs.

"Of course, all founders have their shortcomings, for example, they tend to micromanage and despite being talented in some areas, do not necessarily make good chief executives," he asserts.

"But as a business is growing, it needs to develop a competitive advantage as well as grow and gain distribution, and so many believe that founders are the right people to do that because they're passionate and energetic."

Evans says ASX-listed software company Objective Corporation is a perfect example of a company that fits this mould.

"Objective Corporation's founder Tony Walls owns 70% of Objective Corporation, and today it is capped at almost $2 billion," Evans says.

Luminary Investment Management founder and managing director Lawrence Lam is considered an expert in founder-led pickings.

"Our companies possess a source of outperformance tracing back to an aligned governance and decision-making structure at the core. We find this a profitable universe to play in, as founder-led companies have achieved a 7% outperformance over other companies since 2006," Lam says.

"As you would expect, the source of an alpha investment is not wide. This is a scenario where you would rather delve deep than go wide and become a specialist rather than a generalist."

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Lawrence Lam

BlackRock's Australian Fundamental Equities team is constantly weighing up new investments against existing positions in the portfolio.

Lanchester says prospective investments are looked at through several filters before any allocation is made, with these filters largely focused on the management team and how much debt the business has.

"We also want to easily understand how the company operates with a clear path to profitability and making sure that they have a stance on environmental, social and governance issues," he explains.

Once a company passes all the quality filters, the team then looks at it from a valuation point of view.

"We particularly like looking at the cash flow returns within the business and the ability of management to reinvest capital. Put all that together, and we're building a high conviction fund with around 20 to 30 names," Lanchester says.

One of the companies to pass through BlackRock's filters with flying colours is Australian e-commerce giant Kogan.com.

Chief executive and founder Ruslan Kogan recently shared his success story and future ambitions with Lanchester for BlackRock's *Expert to Expert* series.

"I'm going to be 40-years-old in a couple of years, which isn't that young but I'm absolutely in love with the business, the company, the people I get to work with," Kogan said.

"I've got a few investments outside of Kogan.com and when I make those investments in the same way as you [Lanchester], I look for investments where the key decision makers have skin in the game, where the key people are heavily invested in the business, because when incentive structures align you ensure that everyone is trying to achieve the same goal."

Follow the leader

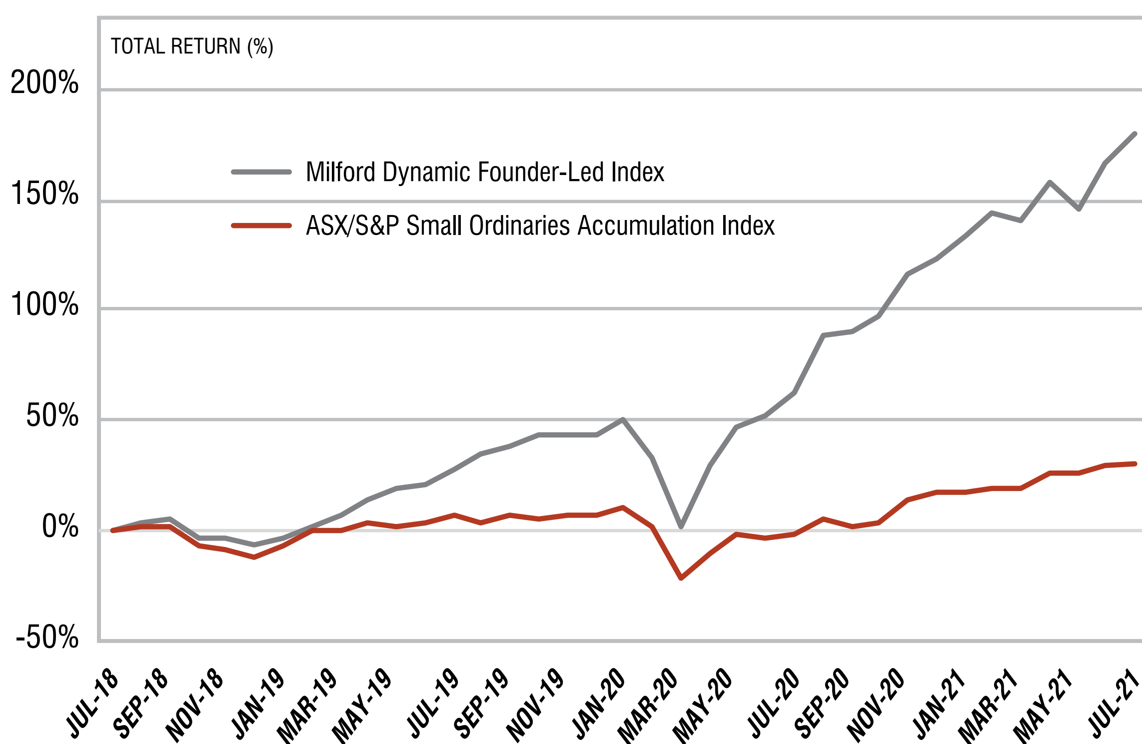
While the Australian equities market outlook moves towards an upward trajectory, it remains relatively uncertain, and investors must be prudent when evaluating both corporate and founder-led businesses.

Experts say one needs to consider what it is that the company does, the markets in which it operates in, the prevailing trends in the market and how the company achieved its historical financial results. The key objective of this assessment is to identify the extent to which the historical financial results are sustainable and can be replicated into the future.

The pros of investing in founder-led companies are well documented by academics and practitioners alike, with many highlighting the competitive advantages of founders with a long-term mindset, a mandate to act and a passion hard to replicate.

Whilst it is true that not all founders are made equal, and some fall short of glory, it seems there is simply no substitute to having some "skin in the game". **FS**

Figure 1. Equal Weighted Founder-Led Companies vs the Small Ordinaries



Source: Milford Asset Management

Australian equities: Stay the course

Volatility makes it ever harder to stay committed to an investment strategy. But there's good reason to do just that, says BlackRock's Australian Fundamental Equities team.

01:
Charlie Lanchester
head of fundamental equities
BlackRock Australia

There's no getting away from the fact that the past nine months have been challenging for smaller industrial stocks in the market.

Yet it's hardly surprising. As BlackRock head of fundamental active equities Charlie Lanchester points out, we've entered a much tougher environment in recent times.

"In quick succession we've had COVID, huge stimulus followed by supply chain disruption, inflation pressures for the first time in many years and now the threat of world war," he says.

The problem is, the resulting large macro swings in the market tend to hit small stocks hardest and that can be daunting for investors. It doesn't mean we should give up on them though. Lanchester's suggestion rather is to "stay the course". As he says: "It seems scary, but these are the times when you really need to stick to your convictions."

The resilient small cap

BlackRock's Australian Fundamental Equities team tend to avoid over-analysed large caps, instead looking for up-and-coming industrial names well placed to be the large index players of the future. As such, the team of four is well versed in the highs and lows of smaller stocks.

In fact, they've invested through three periods of dislocation in the market since the GFC. It's why Lanchester is confident that the current underperformance of many small stocks is temporary in nature. He points to the similar long-term performance of small industrials versus the S&P ASX 50 and notes that for the decade to June 2021 they had both returned close to 10% pa. Since January of 2022 the ASX50 companies have outperformed small industrials by over 15%. This is despite small industrials having 16% earnings growth pa for the next three years vs just 1% growth for the ASX50 companies, according to Factset consensus.

"History tells us that the underperformance we've seen does correct in the following six months," Lanchester says.

During the spikes in volatility in 2008, 2018, 2020 we saw the same thing happen yet six months later performance returned strongly.

"The average outperformance of small industrials vs large caps was 21% in each of these examples," he says.

Rising interest rates

One of the major issues is rising inflation and the response function from central banks. This is something the BlackRock team is watching closely. There is currently a lot of noise in the data and we are being careful to not extrapolate anything in this environment. There has been unnatural demand creation in some sectors and demand destruction in others. Supply chain issues have been exacerbated by COVID-19 but many of these pressures won't last forever, argues senior portfolio manager Madeline Beaumont.

Until then, it's a matter of finding companies that can withstand rising costs.

"We are looking for companies with high margins and pricing power," Beaumont says.

"That's even more important in this environment."

Mining services

The market is clearly buying resource companies as an inflation hedge and commodity prices have been strong. In a market where it can be difficult to find value we think some of the mining service companies look well placed to benefit from the pickup in capex from the big miners says portfolio manager Nick Corkill.

Portfolio manager Sam Theodore agrees, pointing to the fact that many mining services companies are offering attractive valuations.

"Some are trading below NTA (net tangible assets), so you can liquidate these companies for more than their current marketcap," Corkill says.

These companies have the potential for uncorrelated returns, providing downside protection.

"The capex cycle for miners doesn't necessarily equate to the economic cycle," Theodore explains.

"When there's a slowdown, miners are still spending."

The quote

If we look forward, we are still very excited by the names out there. For now, it's a matter of staying the course.

Online offerings take a pause

Admittedly, not every sector is well placed. Indeed, e-commerce companies face several headwinds at the moment.

During lockdown, the sector enjoyed incredibly fast growth. But, as Lanchester points out, this brought cost blowouts.

"2021 was all about catching up and making that business cost-effective and sustainable," he says.

Plus, they are still relatively small operations, which makes it difficult for them to deal with supply chain issues.

In fact, the fund is no longer investing here. Nevertheless, the team remains upbeat about the sector's long-term prospects. As Lanchester says, these headwinds won't last forever.

"Australia is far behind in terms of retail penetration. That will grow," he says. **FS**

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