November 27, 2024

Value Investor INSIGHT

The Leading Authority on Value Investing

Capital Return

In an effort to identify the best potential investment candidates, Bristol Gate Capital has over many years refined where it looks first: at S&P 500 companies it predicts will increase their dividends at the fastest rate over the next 12 months.

INVESTOR INSIGHT

Bristol Gate Capital Partners
Izet Elmazi (*l*), Achilleas Taxildaris (*r*)

Editor's Note: *There is content value in a company's dividend strategy, potentially providing insight into the firm's cash-generating potential, its reinvestment opportunities and even how confident management is about the future. Toronto-based Bristol Gate Capital has built a thriving investment franchise on that signaling potential of dividends, focusing for its U.S. strategy – which has $2.4 billion in assets – exclusively on S&P 500 companies whose dividends it expects to increase the fastest. We spoke recently with Bristol Gate's Izet Elmazi and Achilleas Taxildaris about this unique approach that led them to representative portfolio holdings such as Old Dominion Freight Line and Broadcom.*

You have quite a straightforward approach to identifying investment opportunities. Describe it briefly.

Izet Elmazi: Our investment process starts with a singular focus: predicting dividend growth. Our research tells us that if we know which companies will increase their dividends the fastest in the coming 12 months, a portfolio of their stocks would dramatically outperform the index over time. Our model has evolved and is now heavily reliant on machine learning, but the first step of our process is to predict which companies will increase their dividends the fastest over the next year. Starting from the top of that list, we then through fundamental analysis validate the dividend growth predictions, fully assess and confirm business quality, and estimate intrinsic value.

What we think sets our approach apart is that it's predictive and forward looking, focuses on the speed of dividend growth rather than the size of the dividend yield, and puts primary emphasis on businesses with sustainable competitive advantage. All of this is consistent with the idea that the income stream an asset produces and its value are inherently linked over time.

What are the primary factors that go into predicting dividend growth?

Achilleas Taxildaris: The model is dynamic, using around 1,000 independent variables or factors and learning which factors are most relevant for an accurate prediction at any given time. Generally, out of the 1,000 factors, 100 or so can be relevant to a prediction and about 20 are most prominent. Most of the prominent variables are dividend related, like yield and payout ratio, and earnings related, like earnings growth and consensus estimates, while some are macroeconomic, like GDP growth and the level of interest rates.

IE: Our view is that dividends tell you a great deal about a company's future earnings prospects. Companies that we want to own tend to have strong capital-allocation discipline and are increasing dividends while reinvesting at high returns back into the business. Committing to significant dividend growth signals confidence in the sustainability of underlying earnings power and in future free-cash-flow growth.

For S&P 500 companies since 1945, dividends have grown at approximately 6% per year, earnings have grown approximately 7% per year, and their stocks have returned a bit over that. We consider dividend growth to be a reasonable proxy for earnings growth over the following three to five years, and share returns over time track earnings growth. The stock we've owned the longest, health insurer UnitedHealth [UNH], from September 2014 through the end of last year grew its dividend by 21% per year. Over that time the stock price also went up 21% per year as well.

How does something like new holding Old Dominion Freight Line [ODFL] fit the profile of what interests you?

IE: This had been on our target list for some time but valuation had been a sticking point. When it first appeared we thought, it's a trucker, how good of a business could that be? But that is the beauty of the machine-learning model, it doesn't carry any of the biases we might have and sometimes surfaces ideas we may have otherwise never looked at.

We did the work and concluded the less-than-truckload [LTL] business where Old Dominion plays is very different and with much better economics than other trucking businesses. As opposed to long-haul truckers just taking shipments from point A to point B, LTL shipping requires a more complex network with trucks, warehouse-servicing facilities and regional distribution hubs that are expensive to set up and difficult to run. While LTL shipping accounts for less than 2% of trucking freight tonnage in the U.S., it accounts for close to 10% of trucking revenues, which speaks to the value provided.

The industry backdrop is also quite positive. ODFL is the second-largest LTL carrier in the U.S. behind FedEx Freight, and is widely regarded as the gold standard in the industry, with the best on-time rates, the best safety record, and the lowest claims rates for damaged goods. It operates a scaled, integrated and union-free organization and benefits from good industry secular growth driven by e-commerce and an ongoing retailer focus on more rapidly turning inventory. The industry continues to consolidate following the bankruptcy last year of Yellow Corp., which we believe will incrementally benefit ODFL as a low-cost provider.

What was going on that made the stock interesting enough to buy in June?

IE: The U.S. freight market has been in the doldrums for about two years now, and the market was disappointed by the company's first-quarter earnings, taking the stock down by 25%. That gave us an entry point into what we consider a competitively advantaged company with a strong owner-oriented culture, that generates 30%-plus incremental returns on capital, and that is a committed and growing dividend payer. That's the type of setup we expect to translate into high prospective shareholder returns.

The stock at 41x forward earnings appears pricey. How are you looking at upside from today's $226 share price?

IE: The stock has come back nicely but we don't think is excessively valued given the cyclical recovery in the business we expect and the operating leverage here as revenues increase. We believe over the medium term that revenues can increase at the 10% or so rate they have historically and that free cash flow can compound by at least 15% per year. We estimate the dividend will increase 30% next year, and with the payout ratio around 20% the capacity for ongoing dividend growth is high.

Charlie Munger used to say that over a long period of time your return as a shareholder, as long as you didn't egregiously overpay, would be very close to the growth in free cash flow the business generates. Given the quality of ODFL's business, the potential growth and the returns on capital, we think even from today's valuation our investors will be well served.

We're surprised to see an AI-related play like Broadcom [AVGO] in your portfolio. Describe your basic investment case for it.

IE: Broadcom has been in the portfolio since 2017 and I'd start the discussion of it with the CEO, Hock Tan, who we'd argue is among the very best operators and capital allocators anywhere. Over nearly 20 years since he took over as CEO of what was then known as Avago Technologies, he's built the company through shrewd acquisitions and a remarkable ability to

INVESTMENT SNAPSHOT

Old Dominion Freight Line
(Nasdaq: ODFL)

Business: Provides regional, inter-regional and national less-than-truckload shipping services through more than 250 service centers located across the United States.

Share Information (@11/26/24):

Price	**225.97**
52-Week Range	165.49 – 233.26
Dividend Yield	0.5%
Market Cap	$48.24 billion

Financials (TTM):

Revenue	$5.92 billion
Operating Profit Margin	27.5%
Net Profit Margin	21.0%

Valuation Metrics (@11/26/24):

	ODFL	S&P 500
P/E (TTM)	39.5	24.7
Forward P/E (Est.)	41.1	23.4

Largest Institutional Owners (@9/30/24 or latest filing):

Company	% Owned
Vanguard Group	10.5%
T. Rowe Price	8.6%
BlackRock	7.8%
CIBC Private Wealth	4.1%
State Street	3.6%

Short Interest (as of 11/15/24):

Shares Short/Float	4.7%

ODFL PRICE HISTORY

THE BOTTOM LINE

The company is the premier player in the best part of the U.S. trucking industry, says Izet Elmazi, benefitting from a consolidating competitive set and growth driven by e-commerce and retailers' higher inventory turns. He believes he will benefit as a shareholder in line with the medium-term 15% annualized growth in the company's free cash flow he expects.

Sources: S&P Capital IQ, company reports, other publicly available information integrate those acquisitions into a broad-based technology powerhouse.

The largest part of the business is semiconductors, with end-market exposure in enterprise networking, broadband access, wireless devices and storage applications. The company has also expanded into enterprise software, most recently with the acquisition of virtualization software provider VMware near the end of 2023. All told the company has more than 25 "sustainable" franchises, which it defines as market leaders in their spaces with 10-plus years of durable cash-flow growth ahead of them. While Broadcom is known for ruthlessly cutting costs after acquisitions, that hasn't proven to be at the expense of research and development and ongoing product innovation.

Just to give one example of the capital allocation here: in 2008 the company bought a business selling bulk acoustic wave filters from European chip maker Infineon for around $30 million. The filters are used in high-end smartphones to help transmit and receive wireless signals across networks. It's not broken out separately, but we estimate that business last year generated more than $4 billion in revenue for Broadcom. While that's an outlier in magnitude, they've shown an ability to do that kind of thing over and over.

We should probably ask early on about the AI angle here.

IE: There are two constraints in data centers now. One is getting the GPUs (Graphics Processing Units) you need and the other is having access to the power to run them. For companies with massive platforms, there are applications big enough where it makes sense to augment your GPU set with custom chips that can provide better performance per power input for your application. Broadcom is a leader in these types of chips and is already making them for hyperscaler customers like Meta and Google. The company's AI-related revenues have gone from under $2 billion two years ago to an expected $12 billion this year, and that could be $20 billion or more over the next few years.

INVESTMENT SNAPSHOT

Broadcom
(Nasdaq: AVGO)

Business: Acquisitive, broad-based and global provider of technology solutions, with two primary business segments focused on semiconductors and enterprise software.

Share Information (@11/26/24):

Price	**164.74**
52-Week Range	90.31 – 186.42
Dividend Yield	1.3%
Market Cap	$769.43 billion

Financials (TTM):

Revenue	$46.81 billion
Operating Profit Margin	31.5%
Net Profit Margin	10.9%

Valuation Metrics
(@11/26/24):

	AVGO	S&P 500
P/E (TTM)	139.4	24.7
Forward P/E (Est.)	27.8	23.4

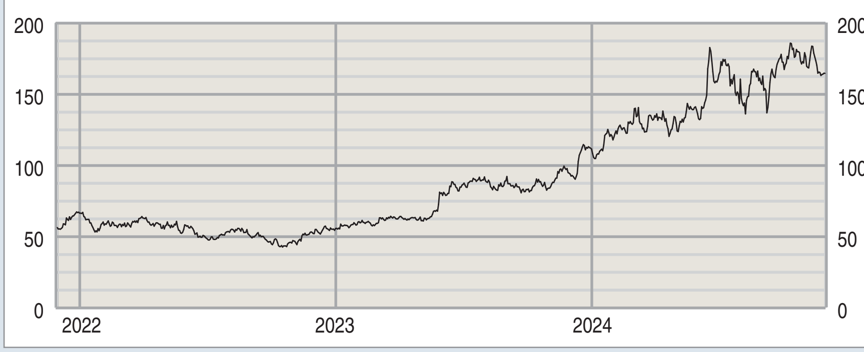
Largest Institutional Owners
(@9/30/24 or latest filing):

Company	% Owned
Capital Research & Mgmt	10.7%
Vanguard Group	10.0%
BlackRock	7.6%
State Street	3.9%
Geode Capital	2.1%

Short Interest (as of 11/15/24):

Shares Short/Float	1.5%

AVGO PRICE HISTORY



THE BOTTOM LINE

CEO Hock Tan is "among the very best operators and capital allocators anywhere," says Izet Elmazi, leading a company benefitting from prospective secular and cyclical growth and with upside from the ongoing integration of acquisition VMware. Elmazi expects free cash flow to grow at a 15% annual rate and for shareholders to benefit commensurately.

Sources: S&P Capital IQ, company reports, other publicly available information

Another growth driver is that the traditional semiconductor business is starting to recover from cyclical lows stemming from companies post-Covid pulling back on infrastructure capital spending. We also see material upside in enterprise software, particularly as the VMware business is further integrated. We expect that business to go from producing roughly $3 billion in EBITDA when it was acquired to generating $8 billion or so in two or three years. Increasing cash flow in general will be used partly to pay down debt, after which we'd expect the company to be on the hunt for its next big acquisition.

How are you looking at valuation here at the current $164.75 share price?

IE: The stock today trades at about 28x forward earnings. Given the revenue growth, cash-flow generation and returns on invested capital, we expect free cash flow over the next five years to compound at 15% per year or better – which is consistent, by the way, with the level of dividend growth we predict in the near term. Given the cyclical nature of semiconductors we would not be surprised if we saw some multiple compression at some point over our forecast period, but we still expect as shareholders to benefit from the attractive underlying profit growth of the company.

How would you expect your strategy to hold up if the market were to correct sometime in the near future?

AT: We've tended to underperform both near the top of the economic cycle when things like consumer staples and utilities do very well, or coming off the bottom of the cycle when lower-quality ideas start to bounce. In general, though, companies with growing dividends tend to be all-weather businesses that are growing independent of the economic cycle and are able in hard times to improve their competitive positions. We want to own such businesses all the time, but would argue that makes even more sense in an environment like today's. VII

Please note that this document is a condensed summary of the full interview conducted by Value Investor Insight which is linked above.

Performance Disclosure (As at November 30, 2024):

PERFORMANCE RESULTS [USD]

						ANNUALIZED				
		1M	3M	YTD	1Y	3Y	5Y	10Y	15Y	Since Inception*
Bristol Gate US Equity Strategy	Gross	5.7%	4.0%	18.3%	26.7%	9.1%	12.5%	12.2%	15.1%	16.0%
	Net	5.6%	3.7%	17.2%	25.5%	8.1%	11.4%	11.1%	14.0%	14.9%
S&P 500® Total Return Index		5.9%	7.2%	28.1%	33.9%	11.4%	15.8%	13.3%	14.2%	15.2%

		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Bristol Gate US Equity Strategy	Gross	13.5%	15.8%	19.0%	39.8%	18.7%	5.3%	2.9%	20.3%	0.8%	35.6%	11.4%	30.2%	-18.0%	25.1%
	Net	12.4%	14.7%	17.9%	38.5%	17.6%	4.3%	1.9%	19.2%	-0.2%	34.3%	10.3%	29.0%	-18.8%	23.9%
S&P 500® Total Return Index		15.1%	2.1%	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%	-4.4%	31.5%	18.4%	28.7%	-18.1%	26.3%

*Since Inception May 15, 2009

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US Equity Strategy returns in this report refer to the Bristol Gate US Equity Strategy Composite (the "Composite"). The Composite consists of equities of publicly traded, dividend paying US companies. The Composite is valued in US Dollars and for comparison purposes is measured against the S&P 500 Total Return Index. The composite's Investment Advisor, Bristol Gate Capital Partners Inc., defines itself as a portfolio manager, exempt market dealer and investment fund manager (as per its registration in Ontario, its principal regulator in Canada) and is also a Registered Investment Adviser with the U.S. Securities and Exchange Commission (the "SEC"). The Investment Advisor's objective is to select companies with positive dividend growth, and which collectively will generate over the long term a growing income and capital appreciation for investors. The inception date of the Composite is May 15, 2009. The US Dollar is the currency used to measure performance, which is presented on a gross and net basis and includes the reinvestment of investment income. The composite's gross return is gross of withholding tax prior to January 1, 2017 and is net of withholding tax thereafter. Net returns are calculated by reducing the gross returns by the maximum management fee charged by Bristol Gate of 1%, applied monthly. Actual investment advisory fees incurred by clients may vary. There is the opportunity for the use of leverage up to 30% of the net asset value of the underlying investments using a margin account at the prime broker. Thus far no material leverage has been utilized. An investor's actual returns may be reduced by management fees, performance fees, and other operating expenses that may be incurred because of the management of the composite. A performance fee may also be charged on some accounts and funds managed by the firm. Bristol Gate claims compliance with the Global Investment Performance Standards (GIPS®). GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. To obtain a GIPS Composite Report, please email us at info@bristolgate.com.

The S&P 500® Total Return Index measures the performance of the broad US equity market, including dividend re-investment, in US dollars. This index is provided for information only and comparisons to the index has limitations. The benchmark is an appropriate standard against which the performance of the strategy can be measured over longer time periods as it represents the primary investment universe from which Bristol Gate selects securities. However, Bristol Gate's portfolio construction process differs materially from that of the benchmark and the securities selected for inclusion in the strategy are not influenced by the composition of the benchmark. For example, the strategy is a concentrated portfolio of approximately equally weighted dividend-paying equity securities, rebalanced quarterly whereas the benchmark is a broad stock index (including both dividend and non-dividend paying equities) that is market capitalization weighted. As such, strategy performance deviations relative to the benchmark may be significant, particularly over shorter time periods. The strategy has concentrated investments in a limited number of companies; as a result, a change in one security's value may have a more significant effect on the strategy's value.

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These forward-looking statements are subject to various risks, uncertainties and assumptions about the investment strategies, capital markets and economic factors, which could cause actual financial performance and expectations to differ materially from the anticipated performance or other expectations expressed.