

There are two different types of people in the world, those who want to know, and those who want to believe.

... Friedrich Nietzsche

Laurus prefers to describe our investments as “emerging blue chip companies” as opposed to the traditional industry term “small cap”. Our deep fundamental investment process uncovers businesses that create long-term wealth for our investors. Unlike many of our competitors, we don’t spend our energy trying to predict short-term stock price movements, preferring to take the long view on the prospects of excellent companies that can be purchased at a reasonable price. As we’ve mentioned in the past, our portfolios are focused on the quantity, quality, and timing of the cash returned to investors by each investment.

There are three core tenets to what comprises an “emerging blue chip company”. First, experienced management teams that have a strong command of their business, a good track record of capital allocation, and a focus on maximizing shareholder value. Second, recognizing that even a poor business cannot generate wealth despite a good management team, we look for intelligent and understandable businesses – those that have a clarity of purpose, have the ability to out-manuever the competition, and can remain opportunistic through prudent financial management. Finally, the business must have a sustainable competitive advantage and be able to withstand irrational competitor competition.

The contrast between a company we analyzed recently that didn’t make it into our portfolio – Concordia Healthcare (CXR-T) – and a longtime portfolio holding— Enghouse Software (ESL-T) — illustrates some of these key investment precepts.

Spurred by an aggressive acquisition pace, Concordia Healthcare’s stock price rose from \$7 when it was listed on the TSX in late 2013, to \$117 as of the beginning of September 2015.

Since then the stock has declined significantly due to fears of price regulation in the US and deal uncertainty, which spurred us to examine the business and assess the opportunity. The company’s business model is based on acquiring out-of-patent pharmaceutical products with long-tailed consumer demand, which it promotes through its distribution network. Their most recent deal was for a UK-based pharma company, paying 13X trailing EBITDA, financed by debt costing 7.25% and equity issuance which dilutes existing shareholders. Serial acquisitions have levered Concordia’s balance sheet, with net debt/EBITDA at 5X proforma the acquisition. The company does not pay a dividend, and free cash flow for the next 12-18 months or more will be consumed with debt repayment. We opted not to add the stock to our portfolio.

Enghouse Software too has an acquisition-based business model, buying up enterprise software solutions primarily relating to customer interaction, such as call centre and workforce optimization. However, unlike Concordia its balance sheet is healthy with no debt and \$91 million of cash. CEO Steve Sadler pays cash for acquisitions rather than issuing equity, and looks for a 5 to 6 year cash-on-cash payback period. The strategy has worked as shareholders have enjoyed 5-year revenue CAGR of 23% and EBITDA CAGR of 36% with no equity dilution. Thanks to ample free cash flow generation, Enghouse has paid a regular dividend since 2007 and has raised the dividend every year since 2009. Finally, management is well-aligned with shareholders, with 23% of shares outstanding owned by insiders. The stock has been an excellent contributor to our portfolio.

These examples compare a company that creates shareholder value (wealth) to one where the investor might buy on the expectation someone will purchase his holding in the future at a higher price. This works for some – but we prefer to sleep better at night knowing our portfolio owns great companies destined to improve our shareholder wealth over the longer term.