



June 6th, 2014

Dear clients and colleagues,

***Innovation, a value creator.***

Innovation is an important theme in our portfolio. It is tricky to define what innovation is, Wikipedia defines innovation as "...the application of better solutions that meet new requirements, unarticulated needs, or existing market needs. This is accomplished through more effective products, processes, services, technologies or ideas that are readily available..."

We often get asked "so you like the technology sector!" The answer is yes, but innovative companies can be found in all industries.

So, innovation means a better way of doing business, or a new business altogether. In the 70's and 80's, Wal-Mart, Home Depot, Ikea, reinvented the retail industry. Today, Amazon, Alibaba and others are trying again to reinvent that industry, the largest segment of the economy. None of these companies have invented any new product. The innovation that the former used was better inventory management, for example, Wal-Mart was the first to install satellite communication in its stores to communicate real-time inventory data. Amazon did not invent the internet; it just found a better way to reach customers with it.

Using technologies or ideas that are readily available... We often meet innovators and wonder at the simplicity of their idea. How come someone not think about it before? It is so simple! If you have not seen the movie yet, you may want to watch "A Flash of Genius". A good movie about the inventor of the intermittent wipers.

Many companies in our portfolio are using innovation to differentiate their products and solutions, generating faster growth and higher profitability.

We refer you to our comment of November 6, 2012 about a company, still in the portfolio, AptarGroup.  
[www.aptargroup.com](http://www.aptargroup.com)

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***Led the conversion from non-dispensing to dispensing***

Why would someone not think about putting a valve on that ketchup bottle so that it would not be messy anymore?

In 1908, Ford Motor Company revolutionised the car industry. Not by inventing the automobile or any new technology. The introduction of the assembly line dramatically reduced the cost of cars. Then in 1914, Ford brought another revolution, he more than doubled the daily salary of his workers to \$5 per day, effectively creating the new middle class in America.

People today have bid up the shares of Tesla Motors so much that it is worth more than twice Fiat which owns Chrysler, Jeep, Ferrari, Alfa Romeo, Maserati, but also, Case New Holland, one of the largest agricultural equipment company in the World, and also Iveco, one of the largest commercial vehicle company in the World. Tesla is certainly disrupting the automotive industry, but we would argue less so, than Toyota, who will launch this fall, its first commercially available Fuel Cell vehicle, a true disruptive innovation.

<https://www.youtube.com/watch?v=pUeodIxsSc0>



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### ***Innovation Matters: Innovative Companies Outperform***

Management consulting firm Arthur D. Little has found that "Top quartile innovation performers obtain on average 13% points more profit from new products and services..."

In addition, Arthur D. Little's study found that: "...the top quartile innovators enjoy more than twice the proportion of new sales for new products/services (based on sales in the last three years), nearly twice the EBIT<sup>9</sup> and a 30% shorter time-to-break-even than the rest. This is a good illustration of financial (or economic) benefits of excellent innovation performance."

A University of British Columbia study has compared innovation "leaders" and innovation "laggards" finding that innovation is "...strongly associated with firms' expected returns."<sup>13</sup> In particular they found "...that more innovative firms have lower exposure to systematic risk."

### ***How do we identify and invest in Innovative Companies***

It is not easy to identify innovative companies? We have a few good indicators however. Many were listed in the above section.

We like to use comparisons within an industry and not across industries.

Is the company growing sales faster than its industry? Is it spending more on R&D than its peers? Is its gross profit margin higher than its peers, indicating a more sought after product? Has that margin stayed stable or increased in the last few years? What is the percentage of sales coming from new products, introduced in the last 2 to 5 years? Is the return on capital employed steady or rising?

To find an innovative company is a first step, but when to buy is most important. A good company is not necessarily a good investment, valuation matters. We most often use a discounted cash flow model. It allows us to use our own assumptions for growth and our own discount rate to account for risk.

A majority of companies in our portfolio are innovators. You will find many profiled in our previous comments.

Have a good week,

The Global Alpha Team.

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