Small Talk
Better, cheaper, faster…
by Marcus Burns, Senior Portfolio Manager, Australian Smaller Companies

To a man with a hammer everything looks like a nail.

Australia is a country blessed with a great climate, loads of natural resources, an abundance of land and the English legal System with the rule of law. You could stop there and logic alone would dictate these are conditions precedent for fostering a successful country. With these natural and cultural blessings in tow it would be unforgiveable, however, for us to become complacent. As the resources boom draws to an end and with it the vast investment in resources infrastructure, how well our country does will depend on our adaptability to new economic conditions. Conditions that will more likely favour companies whose managers are “fortunate because they are able” rather than those who are “fortunate and able”. By this I am referring to management teams whose capability to grow sales and profits faster than their industry average will likely become even more important as our economy subdues. Managers, in our opinion, likely to achieve this are those who can and have focused on innovation and who operate with lean and flexible work forces.

Innovation can take many forms. It can involve making something better, faster, cheaper, more convenient. It can involve making something new – I didn’t know I needed an iPad until Steve Jobs and Apple invented one. Ditto the iPhone. Someone invented ABS brakes, LED lighting and solar power. Many of the longest lasting and better companies to work for are the most innovative. They are more comfortable being uncomfortable – hustling in a tweak or a better way of doing things. We endeavour to do that at Schroders emulating the Japanese philosophy of Kaizen – continuous improvement - fully aware that if we can’t do something a little better, a little faster for our clients, they will eventually want to move on. So too, with some of our better smaller company investments the better management teams are hustling in new ways of operating and looking for new markets. In our investment universe we are always pleasantly surprised when we come across teams who think like this.

We have spoken of how Domino’s Pizza innovated to use the power of the internet to transform how pizza was ordered. Over 50% of Domino’s orders are now made online – and these orders are worth more to Domino’s. Since consumers can see the full menu offering, they typically upsell themselves by ordering more toppings or more from the menu. Domino’s went further and built in a clock to show consumers where their pizza was in the ordering cycle to build engagement, they launched a mobile iPhone and iPad app allowing pizza ordering. Each year Domino’s launches several new pizzas and other items. Why not give up your diet for a night and try the Belgian Choc lava cake!

In the telco space, the greatest innovations have been the digitization of voice, the greater use of data compression and vastly more powerful switching technologies. Once you digitize a voice you can compress literally millions of conversations down a single wire (or optic fibre cable to the cognoscenti). TPG Telecom has demonstrated forms of innovation by bundling VOIP calls with internet offerings. Consumers now don’t even realize they are using VOIP when they sign up with TPG but it allows the average person to call the US for 2cents a minute without plugging in a box or typing in endless numbers to access a call back feature. With their purchase of PIPE networks several years ago, TPG made in-roads into the corporate data markets. These markets had been dominated by Australia’s legacy telcos who charged extremely high rates for data transmission. TPG and others now offer customers “dark fibre” – not related to George Lucas’s Star Wars – it simply means customers can literally buy access to their own unlit fibre optic links to data centres and the internet. These are priced at significantly reduced rates to incumbent telco ISDN lines. TPG proudly communicates these new features, products and bundles at the end of their annual AGM presentations.

Innovation can be lucrative too. Just ask 26 year old David Karp (founder of Tumblr) how a hard 6 years of work felt when he pocketed US$1.1bn from Yahoo. Or Elon Musk how, after almost going bankrupt in the early years, felt when the market cap of his 10 year old electric car business, Tesla, exceeded venerable old Fiat’s two weeks ago. We aren’t asking every 20-something year old to drop out, find a garage and start building first generation computers but merely for CEO/leadership teams to take several days a month where they scrunch up balls of paper on the floor and seek to improve, unravel or astonish their customers both existing and new. Closer to home, there is a great example in New Zealand of a company called, of all things, Xero. Whilst accounting software doesn’t usually get people excited, Xero rents their easy to use software over the web to...
people who would normally turn up to their accountants with a box of receipts and a prayer. Rather than sending out a disk and charging customers each year for an upgrade, they simply charge a monthly fee to store, process and access their accounts. Better still, it allows their accountants to log on anytime to track cashflows and provide business or tax advice on the run.

Our smaller companies portfolio has owned many of these little innovation machines and we eagerly seek out more of them. Current examples in the portfolio include: Technology One, retail food group, Domino’s, TPG and Cash Converters. All of these businesses, to our minds, are examples of companies who seek to use innovation to expand their top line and their relative competitive advantage over their peers. They are building the moat so to speak and not only out pace their rivals but make it more difficult for them each year.

Outlook
Our cautious view on resources and mining services has been borne out over the past 12 months with stock valuations in these sectors now appearing to reflect more accurately their fundamentals. On the other side of the performance ledger we have seen a sharp re-rating of technology, telco and financials such that in many cases, valuations are much more difficult to justify. Our challenge is to carefully re-deploy capital in the better managed cyclical side of the small cap universe whilst preserving a core of the better managed innovation machines.

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