Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Niches: Searching for roads less travelled

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One of the benefits of conducting fundamental research with a well-resourced investment team is the capacity to search far and wide for investment candidates. While many of the companies we own are large businesses with well established, familiar brands, in our experience, excellent companies and investment opportunities can also be found by looking at players focused on specialised niches—particularly those that play a critical role within a market and enjoy close customer relationships. Undeservedly—but perhaps not surprisingly—these companies often sit outside the market limelight, and can fall between the cracks of sell-side coverage.

The strengths of niche operators

By niche we mean a specialist market that is served by a modest number (preferably a handful!) of competitors. For a company, there are some clear benefits to successfully implementing a focused niche strategy. By virtue of a concentrated market structure, a niche operator should be able to enjoy excellent margins and therefore likely superior long-term returns. The fact that the markets they focus on tend to be fairly modest in absolute size can also reduce the risk of significant competition, as larger and seemingly juicer opportunities are to be found elsewhere. A further benefit of modest size is that there tends to be fewer anti-trust issues.

Arguably most important, however, is that a successful niche operator is likely to have a culture focused on profits and returns, and not on sales. It will often have a more focused investment strategy, crucially also for mergers and acquisitions (M&A). By their very nature, M&A deals will tend to be smaller and “bolt on”, rather than higher-risk jumbo or “transformational” acquisitions. Deal rationales will often be more focused on important questions such as “why is this an attractive market to operate in for the long term?” rather than the toxic “what is the EPS-accretion that a spreadsheet spits out?”

A criticism levied at niche operators is that they simply lack ways to grow, especially if they already dominate a market segment. However, the reality we typically observe is more nuanced. Niche operators often successfully outcompete less focused peers who are also busy operating in far larger but structurally less attractive end markets. Well-run companies can also be in a position to grow the overall market they operate in. They operate from a position of strength, with the management resources to innovate in new areas and expand the range of products available or the potential customer base.

Successful niche operators

Niches can form high quality pockets within larger, more mature and competitive sectors. From the perspective of an investment prospector, the securities exchanges form a rich vein of excellence within the financial industry. They operate essential and difficult to displace market infrastructure, typically enjoying very deep moats from a combination of branding and network effects. As a result, securities exchanges can deliver very attractive profitability and high returns—financial plumbing may not be particularly glamorous but it can be lucrative.

For a company, an appreciation of the benefits of being a niche operator can result in a deep-rooted culture of continuous improvement, even as the underlying business increases in size. A U.S. tech company we own has industrial roots, but today its revenues are split approximately 75% vertical software and 25% medical & water products.[1] The company is focused on operating "market-leading business in defensible niches" and has consistently become a higher quality business, as measured by returns on operating capital, profitability, cash generation and markedly reduced cyclicality.

By their very nature, niche operators can often play a vital but less visible role. One U.S. business services company we own plays a key position as the dominant proxy infrastructure provider. The company is deeply embedded in the U.S. financial markets, as can be seen by its very high and consistent recurring revenue retention rate, which has averaged 98% over the last 15 years.[2] We think this is a company that probably is "under-researched" by Wall Street, something almost certainly not helped by the fact that while it considers itself a fintech, and largely serves financial customers, it is classified as an industrial!

Recipe for compounding

Our investment philosophy focuses on high quality companies with a strong and resilient compounding outlook. By focusing on attractive niches, well-managed companies can carve out consistently profitable, high return businesses. In our experience, management teams with an appreciation for niches are often good custodians of shareholder capital. In any given year, the results are unlikely to blow the lights out, but a taste for niches is a good recipe for strong, consistent, long-term compounding.

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There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

[1] Source: Company reports and FactSet

[2] Source: Company reports and FactSet

DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Return On Capital (ROC) is a measure of a company's efficiency at allocating the capital under its control to profitable investments, calculated by dividing operating income by total capital.

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