BY ANDREW LATTO

QUALITY INVESTOR

BLUE WHALE'S TOP TEN

Backed by Peter Hargreaves of Hargreaves Lansdown fame, the Blue Whale Growth Fund is a top-performing fund that focuses on high-quality conviction plays. Andrew Latto looks at the portfolio in more detail.

The Blue Whale Growth Fund was launched on 11 September 2017 and has returned 34.3% to April 2019. This puts it in fourth place out of 286 funds in the IA Global Sector. The fund's top ten positions merit a closer look.

At the end of April 2019, the Blue Whale Growth fund owned 30 stocks and aims to hold between 25-35 stocks. The ten largest positions make up 46.7% of the portfolio and are not listed in size order.

Blue Whale recently published the investment case for its ten largest holdings. The fund manager stated that:

> *They represent our highest conviction picks within the portfolio and offer, we believe, a significant upside to the current share price."*

Companies may, though, have become large positions due to recent share price momentum. This could make them relatively expensive and may result in the manager reducing its exposure.

Blue Whale's top ten

The market capitalisation of Blue Whale's top ten positions ranges from US$5.4 billion to US$981 billion. Eight are listed in the United States, one is listed in the UK and one is listed in Europe.

Five of the positions have been held since the fund's inception in September 2017 – Adidas, PayPal, Adobe,

Blue Whale top ten (most recently added first)

Company	Share price	Market cap	Listing	Founded
Anysys Inc	$187	$16bn	Nasdaq	1970
Smith & Nephew	£16.3	$16bn	LSE	1856
Veeva Systems	$142	$21bn	NYSE	2007
Wyndham Hotels	$55.4	$5.4bn	NYSE	1981
Salesforce	$155	$120bn	NYSE	1999
Microsoft	$128	$981bn	Nasdaq	1975
Alphabet*	$1,162	$809bn	Nasdaq	1998
Adobe	$280	$137bn	Nasdaq	1982
PayPal	$113	$132bn	Nasdaq	1998
Adidas	€256	$56bn	Frankfurt	1949

Source: Blue Whale, SharePad, share prices at close on 17 May 2019;
**Blue Whale owns the GOOGL class of shares, which have voting rights.*

"IMPROVING MARGINS ARE AN INDICATOR THAT A COMPANY IS ABLE TO HOLD OFF THE COMPETITION."

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Alphabet and Microsoft. The other five were added between March and November 2018.

The youngest company in the portfolio, **Veeva Systems (NYSE:VEEV)**, was founded in 2007. The oldest company in the portfolio, **Smith & Nephew (LON:SN.)**, was founded in 1856. The average age of the ten companies is 46 years.

Blue Whale's beauties

Blue Whale Capital states that:

> *"In picking our top 10, we employ what we internally call 'The Beautiful Companies Concept'. That is picking those companies which fulfil several important criteria that we believe makes them 'beautiful'."*

Companies that Blue Whale invests in must have 1) the ability to grow and improve profitability over the long term and 2) no structural or imminent cyclical issues.

The manager expects its holdings "to receive favourable revisions of medium-term consensus growth and profitability expectations." Improving margins are an indicator that a company is able to hold off the competition.

Nine of Blue Whale's ten largest positions are expected to see margins improve by 2021 – including four by over 10% (i.e. 1,000 basis points). Alphabet is the exception with margins expected to decline from 24.5% in 2018 to 22% in 2021.

Top ten share prices and forecast valuation ratios

Company	Added	Shares since*	Free cash-flow yield %		P/E 2020
			2020	2021	
Anysys Inc	Nov-18	20%	3.3	4.1	28X
Smith & Nephew	Aug-18	20%	4.6	5	19X
Veeva	June-18	70%	2	2.3	63X
Wyndham	June-18	-10%	7.1	1.2	15.4X
Salesforce	March-18	21%	3.4	4.2	45X
Alphabet	Sept-17	25%	4.2	4.9	21X
Adidas	Sept-17	29%	3.6	4	23X
Microsoft**	Sept-17	71%	4.1	4.6	25X
Adobe	Sept-17	81%	3.9	4.5	29X
PayPal	Sept-17	79%	3.4	4.5	32X

*Source: SharePad, Blue Whale; *change on mid-month price for date added; **Microsoft year-end June; share prices at close 17 May 2019.*

"THE FUND INVESTS IN BUSINESSES THAT IT BELIEVES REPRESENT 'THE BEST COMPANY COMPETING IN ITS RESPECTIVE FIELD'."

Top ten valuations

The Blue Whale Growth Fund will be driven by the performance of its top ten holdings. All but one company has increased in price since being first added to the Blue Whale portfolio.

Eight of the top ten positions are forecast to have a free cash flow yield of at least 4% in 2021 (share prices on close 17 May 2019). Seven of the top ten positions are forecast to have a P/E ratio below 30X in 2020.

The "leaders in their field"

The fund invests in businesses that it believes represent "the best company competing in its respective field." Blue Whale states that: "we believe in investing only in the best."

There are no companies in the portfolio that directly compete against each other. It is clearly the case that **Alphabet (NASDAQ:GOOGL)**, **Microsoft (NASDAQ:MSFT)**, **Adobe (NASDAQ:ADBE)** and **PayPal (NASDAQ:PYPL)** are market leaders.

It is less clear if **Adidas (ETR:ADS)** is better than its rival Nike or if **Wyndham Hotels & Resorts (NYSE:WH)** is better than InterContinental Hotels. Smith & Nephew, meanwhile, competes with Stryker and Johnson & Johnson.

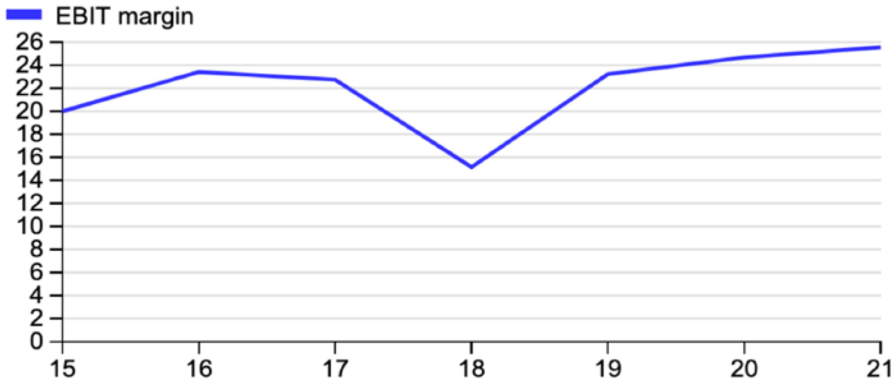
The following stocks are considered in order of the P/E forecasts for 2020 – least expensive first.

Blue Whale's top ten – margin progress

Company	Net cash/ (Net debt)	EBIT margin		Change (basis points)
		Last Annual	Forecast 2021	
Anysys Inc	$777.4m	37%	44%	700
Smith & Nephew	(£1.1bn)	20%	24%	400
Veeva Systems	$551m	26%	36.4%	1,040
Wyndham Hotels	($1.8bn)	15%	25.5%	1,050
Salesforce	($507m)	4.5%	21%	1,650
Microsoft*	($64bn)	31.7%	35%	330
Alphabet	$12.7bn	24.5%	22%	-250
Adobe	($2.5bn)	32.5%	43.4%	1,090
PayPal	$5.6bn	18%	24%	600
Adidas	$863m	11.2%	12.3%	110

*Source: SharePad; *Microsoft has a June year-end*

Wyndham's margins are forecast to improve



Source: SharePad

Revenue in the eight years to 2018 increased at an annualized pace of 2.7% – i.e. a 23.7% increase. Underlying revenue in Q1 2019 was up 4.4% and the company is confident that underlying revenue growth will approach 3.5% in the full year.

Blue Whale highlights the appointment of Namal Nawana as CEO in May 2018. His efforts to transform the group offer scope for "improved organic growth, operating profit margin expansion and improved returns from acquisitions."

Smith & Nephew is a profitable business, with a 20% EBIT profit margin; it just needs to deliver top-line growth. Ageing demographics, emerging market expansion and new product launches all drive increasing demand for health care.

Wyndham Hotels & Resorts (NYSE:WH) – hotel franchising

Wyndham Hotels & Resorts became a top ten position in March 2019 and is the smallest company in the portfolio. The company was spun-off from Wyndham Worldwide on 18 May 2018 and started trading at $65 per share.

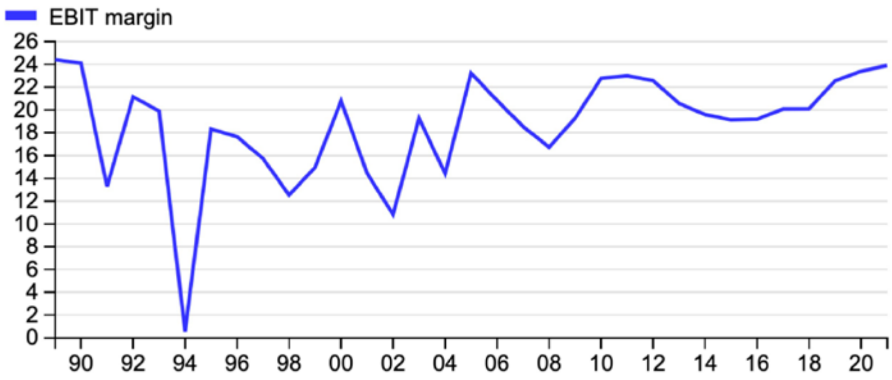
Wyndham Hotels & Resorts describes itself as "the largest hotel franchise company in the world." The group has an asset-light business model with its portfolio of brands licensed to hotel owners.

Wyndham's focus is on the mid-market and budget hotel segment, which is less economically cyclical than the upmarket segment. Most Wyndham franchisees only own one hotel and the typical agreement lasts for 10-20 years.

Smith & Nephew (LON:SN.) – Medical devices

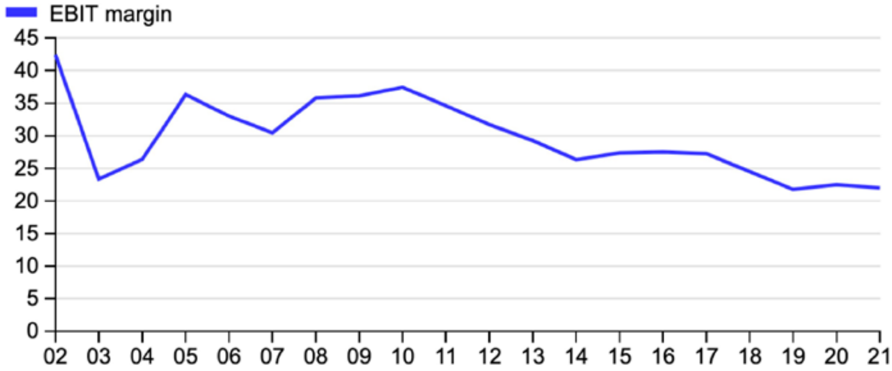
Smith & Nephew is a member of the FTSE 100 and became a top ten position in January 2019. The group has historically delivered a "lacklustre performance" but this appears to be changing.

Smith & Nephew's EBIT margin – forecast to hit 24% in 2021



Source: SharePad

Alphabet's margins have been declining



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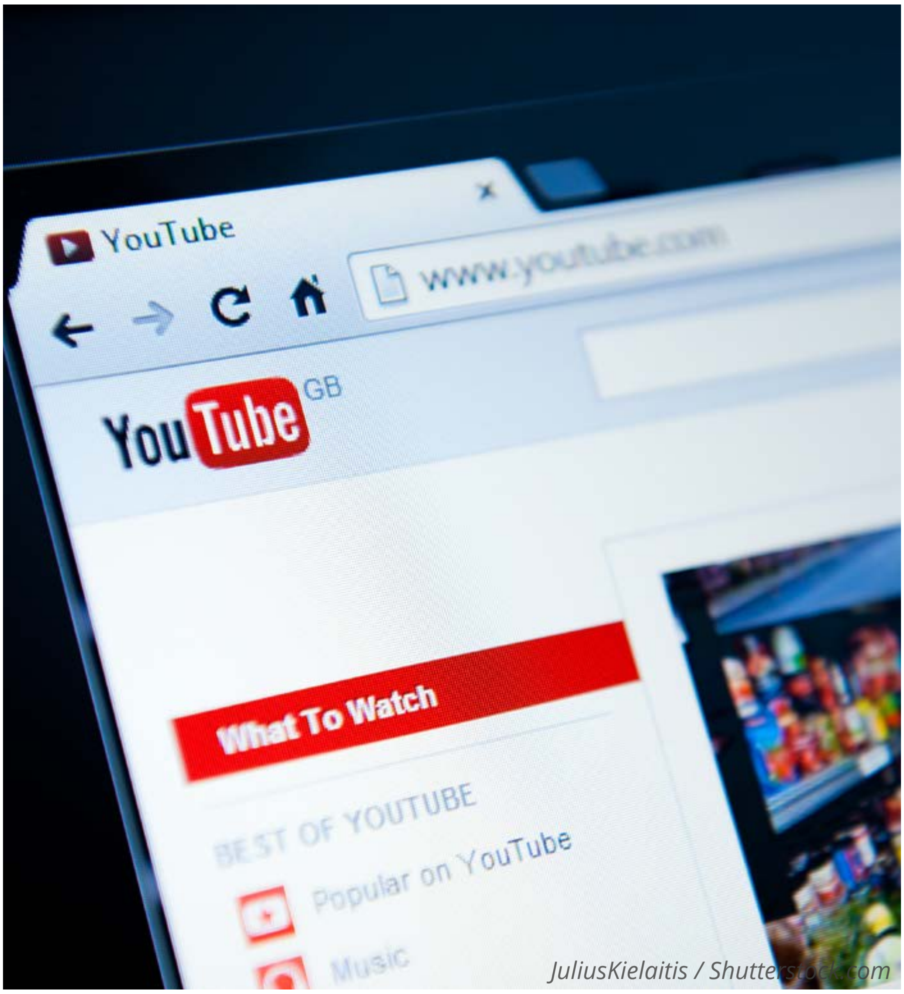

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Alphabet (NASDAQ:GOOGL) – search engine and other bets

Alphabet's 17% annual revenue growth in the first quarter of 2019 was weaker than forecast. Two possible drivers include weak advertising demand and increasing competition from Amazon.

Amazon is charging companies to appear at the top of its search results, which potentially means less advertising money to be spent on Google. Consumers are also increasingly bypassing Google and searching for products on Amazon.

Alphabet is more than just Google search with key brands that include Google Maps, Gmail, YouTube, Android, Chrome and the Google Assistant. YouTube may be a key opportunity with 1 billion hours of content watched on the platform per day.

Blue Whale states that: "we believe investors continue to underestimate the growth of the digital advertising market. Many of the world's largest brands are moving spending from TV advertising."

Adidas (ETR:ADS) – Sportswear

Sportswear group Adidas has "enjoyed a renaissance" since CEO Kasper Rorsted took the helm in 2016. Sales have increased by 48% since 2016 and the operating profit margin has improved from 8.6% in 2016 to 11.2% in 2018.

Rorsted has invested in direct-to-consumer sales while bolstering the brand's position in "trend-setting" cit-

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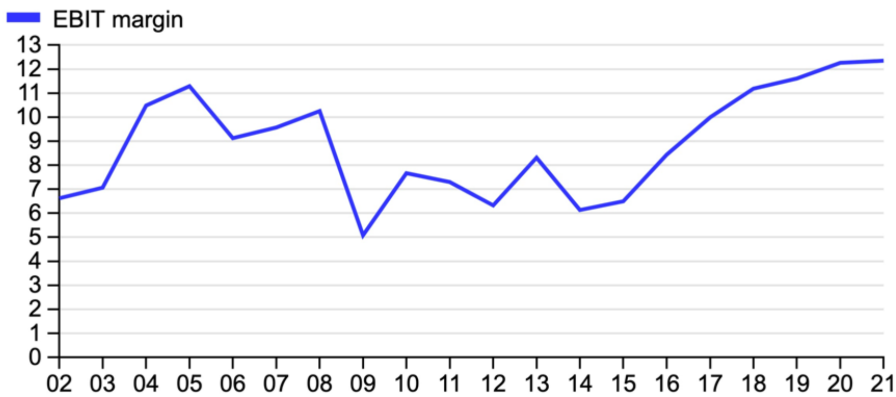
Adidas' margins rebound



Source: SharePad

ies. This has helped Adidas to improve its market position and increase profitability in the key North American market.

The group is also performing well in China and benefiting from the global trend towards casual sports wear. Blue Whale states that: "the potential for Adidas to continue delivering such strong performance is underestimated by the market."

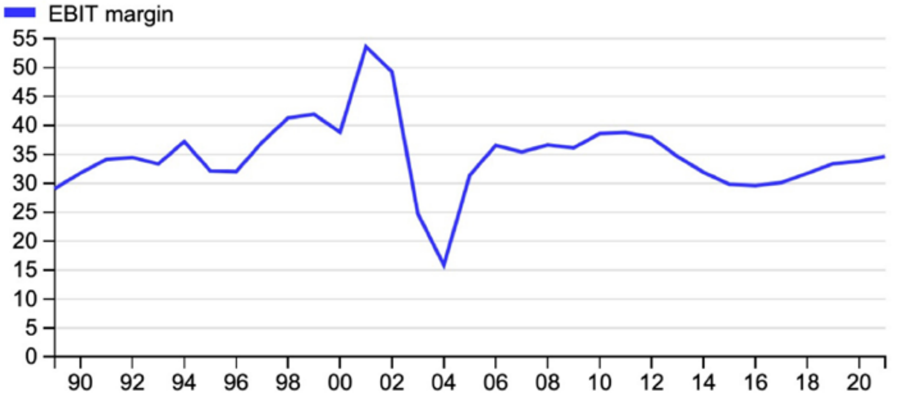
Microsoft (NASDAQ:MSFT) – enterprise software

Microsoft is the software group that rivals fear. Its Windows operating system for PCs has allowed it to remain steadfast in enterprise software. Other key products include Office, server operating systems and developer tools.

> **"MICROSOFT IS THE SOFTWARE GROUP THAT RIVALS FEAR."**

CEO Satya Nadella took the helm in 2014 and has "reinvigorated" Microsoft by overhauling the culture and making the software more "open." A shift towards the cloud has improved the group's earnings quality and provided a growth opportunity.

Microsoft's margins have been stable



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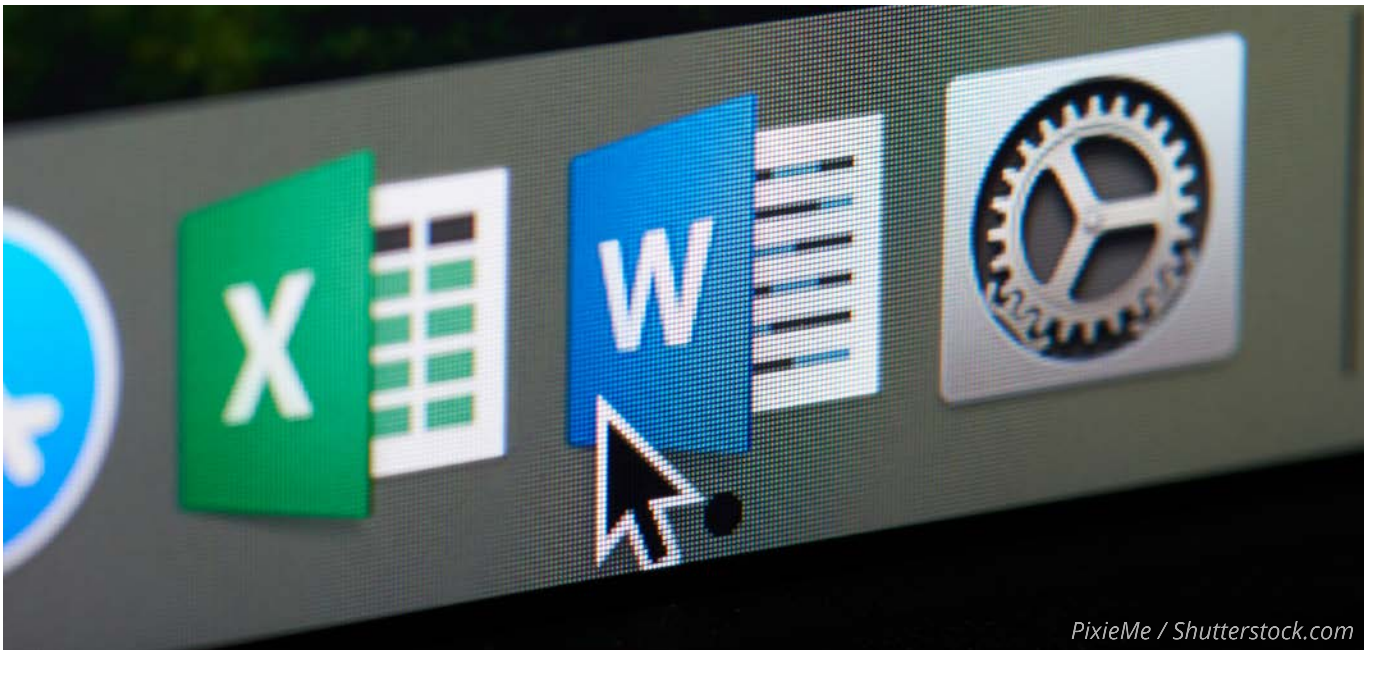

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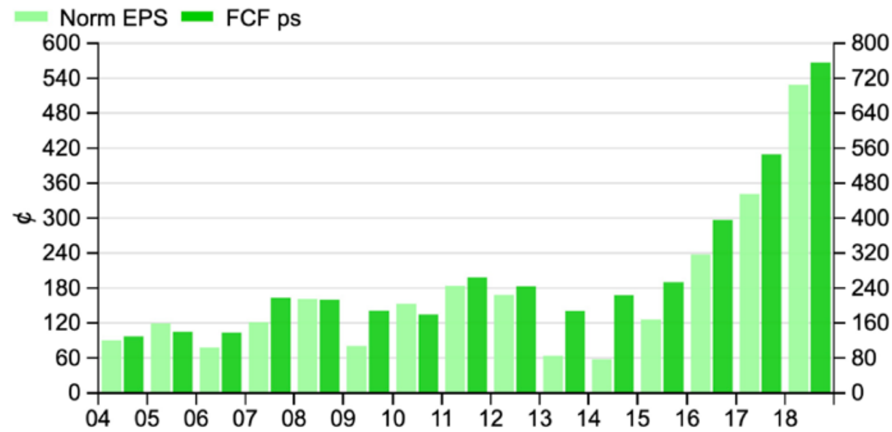
Adobe's margin picks up

Source: SharePad

Adobe's earnings per share take off



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Ansys' margins have been on a tear

Source: SharePad

Adobe (NASDAQ:ADBE) – digital content creation software

Adobe has over half the market for digital content creation software. Its products are used to create videos, websites, magazines and images. They are a must have for web developers, graphic designers and photo editors.

> **"THE GROUP'S EBIT MARGIN IS EXPECTED TO HIT 43.5% IN 2021 – A MULTI-DECADE HIGH."**

Adobe has moved towards a subscription model, which has reduced piracy and helped unlock global growth opportunities. The group's EBIT margin is expected to hit 43.5% in 2021 – a multi-decade high.

Blue Whale states that: "We believe Adobe will be a major beneficiary of continued explosive growth...as ever-richer digital content is consumed across devices."

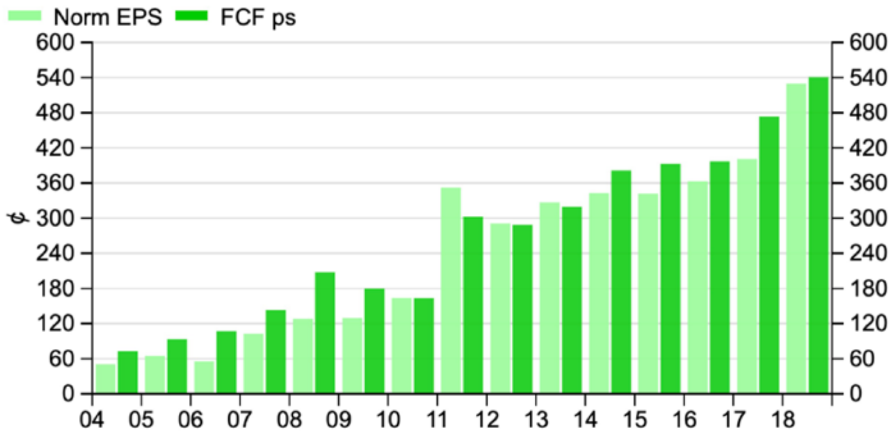
Ansys (NASDAQ:ANSS) – simulation software

Ansys describes itself as the global leader in engineering simulation. Its software predicts "how product designs will behave in real-world environments." This helps to save its customers – large industrial groups – time and money.

Increasing product complexity and new manufacturing techniques both underpin demand for Ansys' products. Recently appointed CEO Ajei Gopal has launched a number of growth initiatives.

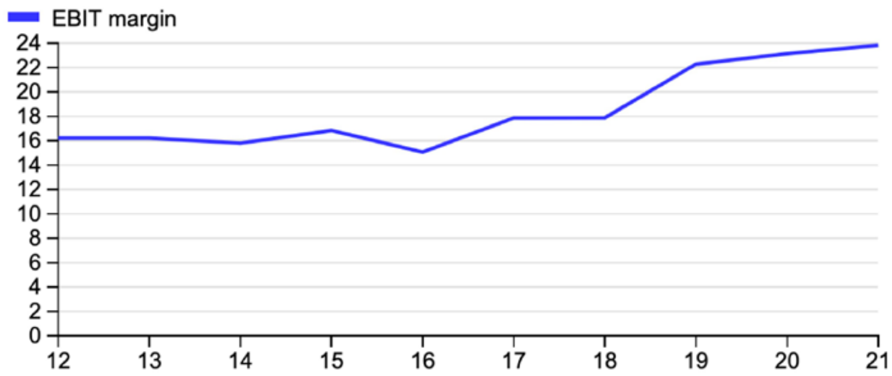
Organic revenue has increased 9% a year over the past seven years and margins have continued to improve. Blue Whale states that: "We are optimistic about an acceleration in Ansys' growth rate."

Ansys – Revenue growth with margin expansion drives earnings



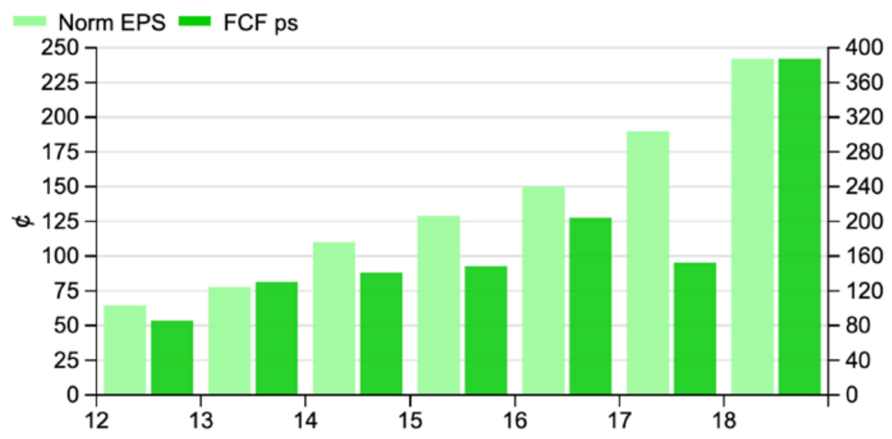
Source: SharePad

PayPal's margins are moving up



Source: SharePad

PayPal's EPS growth



Source: SharePad

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Paypal (NASDAQ:PYPL) – online payments

PayPal is the trusted brand when it comes to paying online – an area where trust is key. The company was the first mover in allowing consumers to pay online without having to fill in their card details.

Payment network effects have underpinned PayPal's growth and enabled it to keep the competition at bay. The more consumers that use PayPal the greater incentive there is for websites to offer the service and vice-versa.

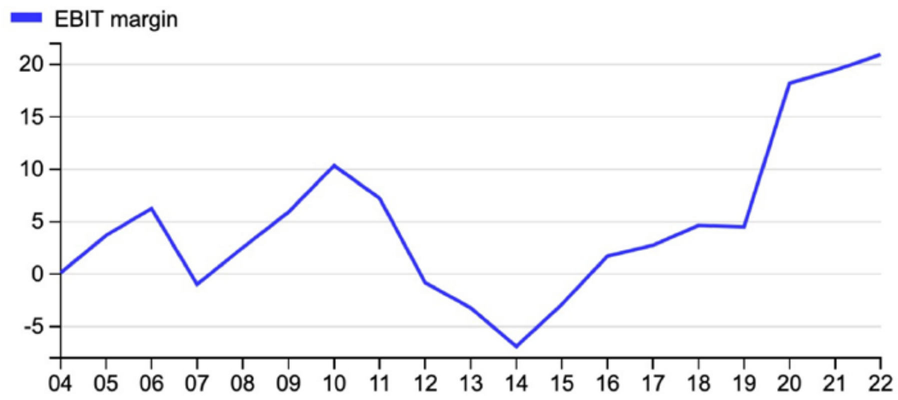
Salesforce (NYSE:CRM) – Customer relationship software

Salesforce's main focus is customer relationship management software. The company pioneered cloud-based CRM software in 1999 and 150,000 companies currently use its products.

T-Mobile CEO Jon Legere has stated that: "Salesforce connects us to...customers faster than ever before." Schneider Eclectic CMO Chris Leong has stated that: "Salesforce has completely transformed the way we manage our customer base."

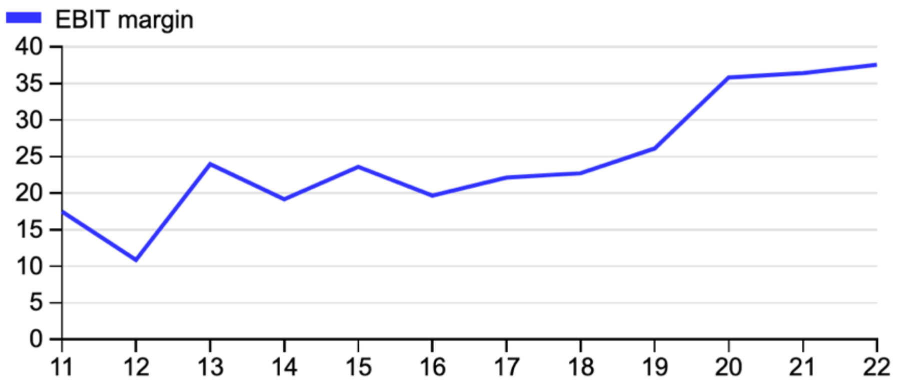
"THE GROUP HAS A 70% MARKET SHARE IN PHARMACEUTICAL CRM SOFTWARE AND HAS SCOPE TO EXPAND IN OTHER NICHES OF THE LIFE SCIENCES INDUSTRY."

Salesforce's margins are set to take off



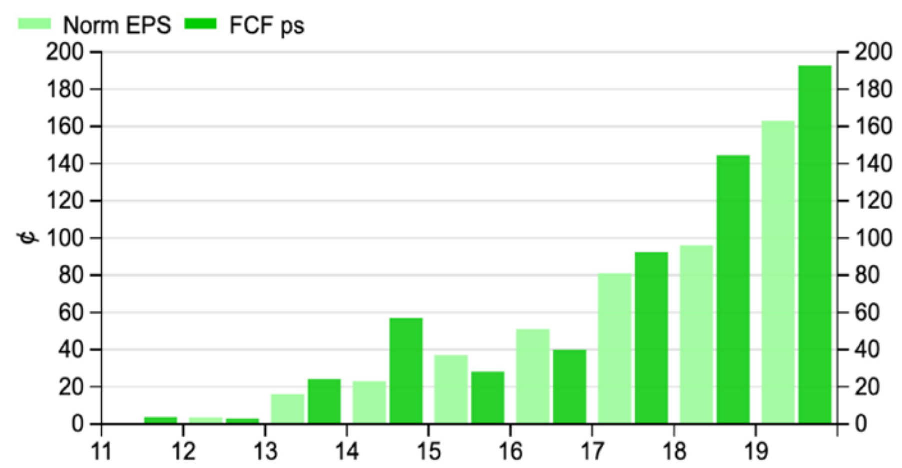
Source: SharePad

Margins approaching 40%



Source: SharePad

Veeva's earnings take-off



Source: SharePad

Veeva (NYSE:VEEV) – software for the life sciences industry

Veeva is the largest software vendor to the life sciences industry and was founded by current CEO Peter Gassner in 2007. Blue chip clients include GlaxoSmithKline, Pfizer, Syngenta and Coloplast.

The group has a 70% market share in pharmaceutical CRM software and has scope to expand in other niches of the life sciences industry. Veeva will also consider expansion in similar industries such as chemicals and cosmetics.

Summary

The top ten companies in the Blue Whale Growth Fund appear to be well placed. They are in growing markets and enjoy strong competitive positions. Nine of the ten are expected to see margins improve over the next couple of years.

The combination of revenue growth and margin strength will result in strong earnings growth. This will deliver strong share price momentum as long as current valuations are not excessive.

About Andrew

Andrew Latto, CFA, is an independent analyst and the founder of www.fundhunter.co. Fund Hunter's mission is to identify the best investment funds. The Fund Hunter model portfolio has meaningfully outperformed the All-Share index since inception. Andrew previously worked for an investment management company and a research company. He also contributes to www.cube.investments.