INVESTING STRATEGIES

Why Sheng Siong is good for long-term investors

BY GREGORY SEE

Our preferred type of investment is to purchase high-quality businesses with good growth potential and own them for a long time. To do that successfully, we pick our investments very carefully and only purchase at reasonable valuations.

First, we think that the best representation of business quality is a consistently high return on tangible equity — of more than 15% over five years — with a minimal level of debt. We then determine if the business possesses certain structural competitive advantages that can explain the good returns on capital (that would not erode over time due to competitive pressures). Strong competitive advantages include network economics effects, high switching costs, low pricing, favourable location, intangibles (for example, branding and patents), and regulatory barriers, among others.

Second, once we are convinced of the presence of certain structural competitive advantages, we seek to get a rough sense of whether the business can grow at a reasonable pace over the next 5–10 years.

Over many years of managing money, we have often made the mistake of prioritising growth over returns on capital. This has resulted in us owning subpar businesses that need to put up more and more capital to support sales growth (in other words, low capital efficiency), resulting in lesser free cash flows available for common shareholders.

While this approach may work for a while (assuming the starting valuation point is low enough), if our intention is to benefit from long-term capital appreciation, the result is often an unfavourable one. The outcome is often growing earnings but accompanying it with a lower valuation multiple, resulting in slow capital appreciation or even stagnant share prices.

This should not be surprising, as first, growth becomes value-destroying when return on capital is less than the cost of capital; and second, investors tend to adjust their expectations quickly and start pricing a business lower as it becomes clearer that management is chasing growth despite poor capital efficiency. After all, why grow if returns are going to be poor?

To further illustrate this point, take a typical savings account that pays 1% on deposits. On a deposit of $1 million, your returns at the end of the first year will be $10,000. You can easily double your interest (earnings) to $20,000 by increasing your deposits (capital) by an additional $1 million.

Nonetheless, it is still a bad investment as your rate of return is still only a meagre 1%. Focusing on returns on capital before considering growth is like performing a bench-press exercise. One should focus on getting the exercise form (return on capital) right first before considering adding more weights (growth) to the bar. Otherwise, injury (value destruction) is bound to happen sooner or later.

Third, we seek to understand and monitor the possible factors, such as an intensifying competitive landscape and government intervention, that may derail the business from reaching its full potential.

Finally, if we are confident of the above, and the business (stock) is selling at a reasonable valuation, we tend to purchase a meaningful amount.

We will now look at one business that has satisfied our above-mentioned investment criteria and explore the important factors that matter most for long-term investors.

SAMUEL ISAAC CHUA/THE EDGE SINGAPORE

Under CEO Lim Hock Chee and his family's management, Sheng Siong has delivered total returns of 650% to shareholders including AGT Partners

Sheng Siong Group

Being one of Singapore's largest retailers, with 68 stores in Singapore and four stores in Kunming, China, Sheng Siong is a founder-led company by the Lim brothers (Lim Hock Eng, Lim Hock Chee and Lim Hock Leng).

Having followed the company for many years and interacted with its management, we are of the opinion that the management possesses strong entrepreneurial attitudes and frugal values which are deeply rooted in the company and reflected in its business practices. At the same time, they have treated minority shareholders fairly and maintained a significant amount of equity ownership in the company.

For the past 12 years, the company's highly recurring free cash flows has allowed it to generate a consistent return on tangible equity of more than 25%, while maintaining a negligent amount of debt.

We believe there is still ample room for the business to grow, driven by new supply of HDB flats, the ongoing tailwind of customers switching away from shopping at wet markets and the company's expansion into China. These opportunities should allow the company to reinvest its surplus earnings at around the current rate of returns on capital.

We believe the business possesses two main structural competitive advantages that allow it to achieve such high returns on capital. They are: low prices, achieved by building a cost-conscious organisation; and favourable locations. By focusing its stores mainly in suburban HDB areas, this brings a huge amount of convenience and transportation cost savings to consumers who purchase groceries frequently.

Constantly delivering value

Since listing in 2011, the company has delivered shareholder returns of almost 17% per annum, including the 48-cent dividends received thus far. Put it another way, Sheng Siong was able to deliver a cumulative return of 650% over these past 12 years. What are the specific attributes of this company long-term investors need to understand in order to enjoy such returns? A key factor we deem powerful in the business world is the concept of economies of scale savings shared with customers.

Jeff Bezos, founder of Amazon, once said: "There are two ways to build a successful company. One is to work very hard to convince customers to pay high margins (Nike, Coca Cola, LVMH, Hermes). The other is to work very hard to be able to offer customers low margins (Amazon, Costco, Walmart). They both work. We are firmly in the second camp. It's difficult — you have to eliminate defects and be very efficient. But it's also a point of view. We would rather have a very large customer base and low margins than a small customer base with high margins."

The simple reality for firms like Sheng Siong that endeavour to constantly deliver value to its customers is the virtuous spiral established when companies keep costs down and margins low, and in so doing constantly increase their revenue and profits. As they expand (scale up), they enjoy stronger bargaining power with suppliers, leading to better credit terms and a wider selection of third-party products.

As the customer base increases, it is also able to: first, gradually develop and introduce more affordable house brands which in turn brings more value to its customers; and second, provide the resources and opportunities to expand into new locations that are nearer to its customers. Over time, these economies of scale savings continuously strengthen its relationship with its customers.

In other words, as the business grows bigger, the barriers to entry increase, widening its economic moat. In this case, it turns its size, usually an anchor for continued business performance, into an advantage. In the long run, this factor will be more important for long-term business success than the many other short- term distractions.

In deferring maximum profits today, the management extends the life of the franchise. This long-term focus and perseverance in adding value to customers make the company's future more predictable and less risky than the average business. The consensus view is that Sheng Siong operates in a matured grocery retailing industry and faces margin pressures.

However, we believe that the key long-term concerns, which may hinder the company from reaching its full potential, lies in the management's succession planning and the challenge in maintaining a strong cost-conscious corporate culture.

It is not difficult to identify the above. However, it is also not easy to hold on to that investing faith because there are just so many distractions: macroeconomics events, interest rates, currencies, politics, vagaries of stock market movements, sell-side analysts' reports, to name a few. All these tend to make things more complicated than they really are.

One important technique we believe long-term investors could use when interpreting any information is to ask these two questions: First, does any of this make a meaningful difference to the relationship between the company and its customers? Next, does any of this materially strengthen or weaken the company's long-term competitive advantages?

There are other important things as well, such as intelligent capital allocation of surplus earnings (share buybacks, dividends) and overall discipline in capital expenditure, but the two questions are vital for a business's long-term success.

Recognising and placing heavy weightage on these facts despite the latest news flow and media headlines is a matter of staying rational. It is this discipline that brings home the big reward in the end for long-term shareholders. E

Gregory Jonathan See is CEO and CIO of AGT Partners, an MAS-registered fund management company employing fundamentals-driven, active-trading and quantitative-driven strategies. In 2022, the fund managed by AGT returned a gross return of 14%, or 11.7% net of fees.

Disclaimer: Nothing mentioned in this article should be construed as investment advice nor of recommending the attractiveness of the fund managed by AGT, which is a long-term shareholder of Sheng Siong.