# Blue Oceans Methodology

BLUE OCEANS
CAPITAL

# Methodology

**The Blue Oceans Capital Wholesale Strategy targets companies with rapidly-growing revenues and scalable-business-models, that have high performance across sustainability and ESG factors. We recognise that the transition to a more sustainable economy is a global mega-trend that is creating opportunities for companies delivering long-term positive-disruption.**

**One of the key characteristics of our approach is the depth of our analysis, which both facilitates and enables a portfolio that generally has less than 15 stocks. It's a highly concentrated strategy which provides for deeper insight into individual companies than is the industry norm.**

**The proprietary research process applies a high-level quantitative filter that feeds into fundamental analysis frameworks across both financial and non-financial ESG quality factors, right from the outset. This allows us to narrow our focus towards the best opportunities, from a global universe.**

# Quantitative Filter

Our quantitative filter is designed to find key opportunities of significant interest out of a data set of tens of thousands of companies. To achieve this we focus on two metrics we believe correlate to shareholder value creation (and that have shown to do so in the literature):

1) Growth in revenues, and 2) Return on invested capital (ROIC).

We set a high bar for these metrics, we aim for greater than 25% annual revenue growth, and greater than 20% ROIC.

(In some cases we consider early stage companies not currently meeting >20% ROIC, where we see significant potential to meet this criteria in the future. These companies are limited to 25% or less of the portfolio upon investment).

We also consider companies whose funds from operations have just turned positive, as we believe substantial risk is removed when companies begin to produce internal cash flows.

The quantitative filter delivers approximately 1,000 companies per quarter, and the IPO search produces 150 companies per month. They're all then assessed individually, through our fundamental analysis frameworks.

# Fundamental Analysis Frameworks

Our fundamental analysis process is designed to find the most compelling opportunities quickly, so we can narrow the field further and apply our deeper levels of analysis to only the most high-quality candidates.

## 1. HIGH LEVEL FUNDAMENTAL ANALYSIS

This first stage reduces our list of ~1,000 down to ~15-20 opportunities. The focus is on the business model and the financials, while also applying our negative exclusions filter. We assess the sustainability and overall responsibility of companies at every stage.

Our negative screening process excludes companies involved in the following industries:

- Fossil fuels (Mining, production and intensive usage)
- Animal Cruelty
- Ocean Exploitation
- Deforestation
- Alcohol and Gambling
- Any media harmful to psychological well-being
- Tobacco
- Controversial weapons.

We also won't invest in companies with material indirect exposure to these industries, which includes companies that provide services, transport, packaging or financing to the sectors. (Our materiality threshold for indirect exposure is 5% of revenue).

The strategy targets low-emissions companies. In terms of energy usage, we apply a fossil-fuel exposure threshold of 3%. This ensures we only invest in companies whose spending on fossil fuels, across the value chain, is less than 3% of total revenues.

This recognises the investment risks of material exposures to carbon emissions, whether it be through production or intensive usage of fossil fuels. It also recognises the environmental and social imperative of keeping the increase in global temperatures below 1.5 degrees, as recommended by the UN Paris Agreement and the IPCC.

**Put simply, we're looking for companies creating positive change.**

These are companies whose business models provide solutions to ESG issues. Examples of current investments include SolarEdge addressing the issue of sustainable power supply with solar power, Beyond Meat addressing the issue of environmental destruction by animal agriculture with pea protein and The Trade Desk addressing the issue of data privacy with data de-identification.

## 2. MODELLING EACH COMPANY'S ECOSYSTEM

Stage two involves the construction of a model ecosystem for each company, which offers us a much closer look at their specific business model, its interactions within its industry and flow of these influences into financial performance. It disaggregates individual components of industry trends, competition, customers, strategy, products and services, management, and financials.

For this, we use flow-charts. This graphical system allows us to visualise the entire business ecosystem and derive deeper insights, that allow us to see the core business model and the broader ESG issue it addresses.

* Based on total revenue exposure, assessed by Sustainable Platform.

Organising ideas in a traditional word document has significant disadvantages. Primarily, it is the inefficiency of tying together related concepts throughout the document. When reading a linear document, it becomes very difficult to draw meaningful conclusions between disconnected ideas.

By using our ecosystem format we're able to dynamically draw linkages across relevant components and directly see influences in industry, products and services. But also, we can see the effectiveness, or not, of strategy, and how these dynamics affect financials and ultimately return on invested capital.

## 3. ESG ASSESSMENT OF COMPANY REPORTS

Our framework applies detailed analysis across more than 300 data points related to a variety of **ESG** quality factors. This is a qualitative process that analyses company reported data and insights.

Our **Environmental** analysis captures screening for controversial industries, and fossil fuel exposure, as explained previously, but it also assesses progress that companies are making in the transition to renewable energy, sustainable production process.

With recognition for the fact that some industries have a greater environmental footprint than others, it includes specific questions for industries such as manufacturing and construction, in areas of supply chain management, waste, pollution and water, for example.

Our **Social** analysis includes a standard layer of questions for all companies; which assesses factors such as community relations, employee relations, diversity and inclusion. There are also industry specific factors with particular emphasis on areas such as data privacy in technology companies.

Our **Governance** analysis is extensive, covering more than 250 data points. This aims to identify any evidence of manipulation in earnings, cash flows, key metrics and acquisitions. We look for alignment of incentives to underlying business performance, suitability and independence of directors, suitability of governance committees and management engagement with stakeholders.

## 4. HIGH-LEVEL REVIEW

In this section we zoom back-out, to consider what we must predict in order for our assessment of future cash flows in our valuation to be accurate. We question whether our predictions are indeed predictable. These factors can be very specific. The value gained in this framework is in determining:

1. Which specific factors will contribute most to future cash flows?
2. Can we predict the outcome of those factors into the future?
3. What probability would we assign to those factors continuing into the future?
4. What evidence do we have to support that prediction and success probability?

Often this process will result in new perspectives that lead to new questions and further analysis to answer those questions.

Once we are satisfied that all relevant questions have been properly answered and there is strong evidence to support our predictions, we are ready to move on to valuation, now having all the data necessary to assign future cash flows.

### 5. VALUATION

With all necessary data collated we are now in a position to value the business. We complete valuations in three parts;

1. **Cost to replicate:** Here we consider what it would cost for a competitor to replicate this business and go into direct competition. This includes balance sheet items required for operations but also considers relevant marketing and R&D expenses too.
2. **Cash flows from operations:** In this part we rebuild the income statement to find underlying cash flows from the business. Examples of considerations here include:
   a. Amounts allocated to reserve accounts versus actual cash flow movements.
   b. Capitalised software development expenses versus those expensed.
   c. Asset replacement cost versus depreciation and amortisation.
   d. Stock awards as remuneration for services.
3. **Future cash flows:** Here we use the figure obtained in cash flows from operations above to calculate future cash flows discounted to today. A conservative growth rate is assigned based on the accumulation of all analysis.

## Accept or Reject Decision

It's only a rare few companies that make it this far through our filters and analysis. Upon completion of the valuation we're in a position to make the final decision, to either accept, reject or add to the watchlist.

We don't sell out of one great opportunity just to chase another. Turnover costs and capital gains tax are key considerations in our investment decision making, and so even if an opportunity is found, we may not open a position in that company right away.

Factors that lead us towards making a purchase include: having made a recent sale, or a single position becoming overweight in the portfolio.

## Portfolio Maintenance

Companies in the portfolio are reviewed in accordance with our responsible investment framework. Each week news relating to every company in the portfolio is checked for any material ESG concerns, or deviations from our initial threshold assessments. And every year we analyse each company again using the ESG analysis framework as described in point 3 above.

Any ESG matters of significance are raised with the company. If responses are not adequate we may pursue the matter through a shareholder resolution or divestment. We complete voting for each company in the lead up to its annual general meeting.

## Who is Blue Oceans Capital?

Fundamental, value-based investment research.

At Blue Oceans Capital, we think differently. Our unique analysis unearths growth companies with defensible revenues, driven by innovation.

We only invest in companies having a positive impact, because building a better world can offer the best long-term performance.


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