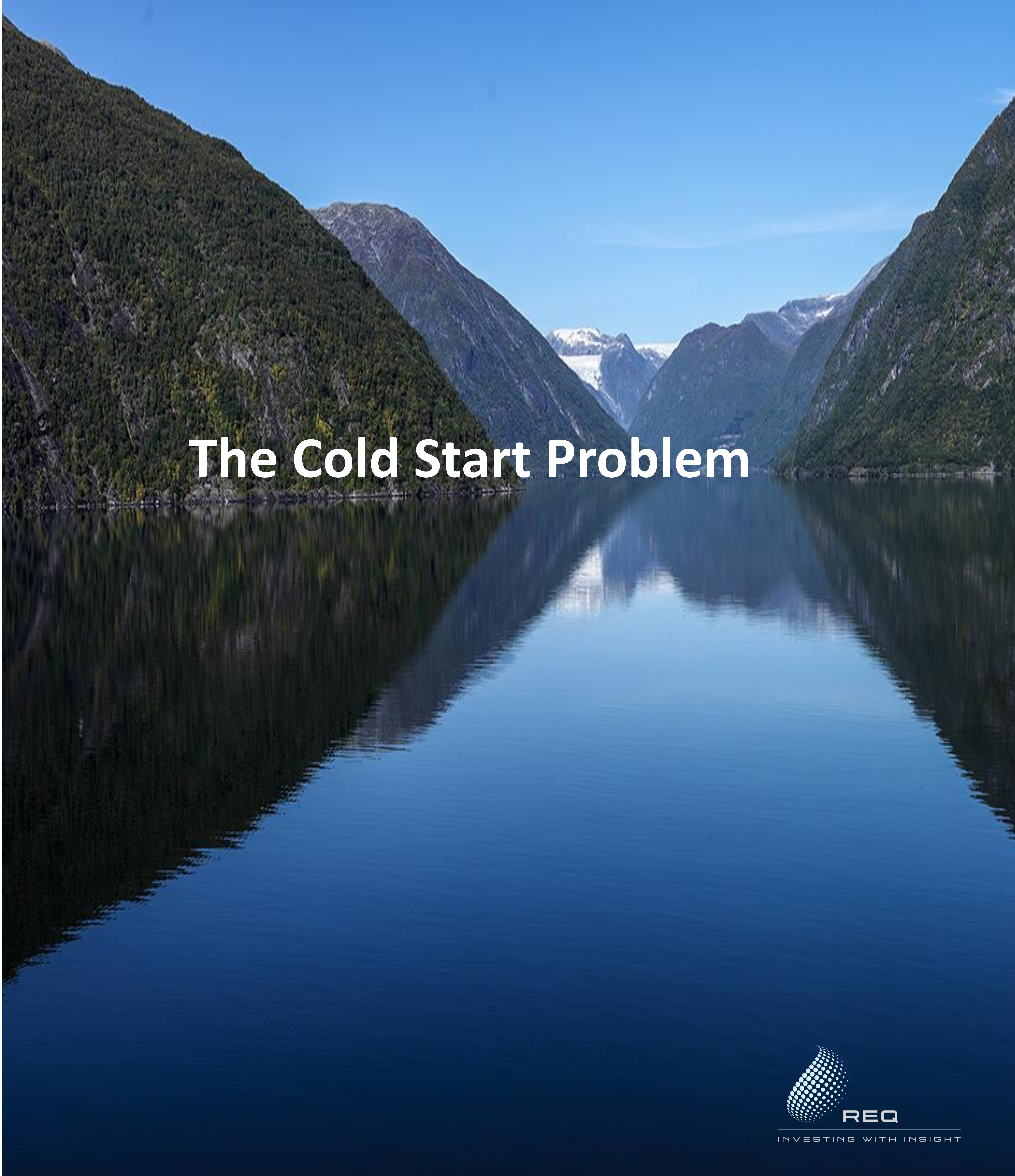
The Cold Start Problem



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INVESTING WITH INSIGHT

In a 2009 article (SFI Bulletin 2009, vol. 24*), scientist Ole Peters emphasized a common misconception in how investors evaluate businesses. They often envision a decision tree, with branches representing all possible futures, each assigned a probability—an approach rooted in Bernoulli's concept of expected return. However, as Peters explained, reality doesn't unfold this way. A company doesn't simultaneously explore every possible branch; instead, it follows a single, linear path, where each decision shapes the probabilities of what comes next. Out of infinite potential routes, only one can be taken, and while the past influences the future, each step down "reality" creates a new set of possible futures.

According to investor Nick Sleep, short-term investors spend their time handicapping the odds of each possible branch, trying to predict which outcome will materialize next. But this approach misses the bigger picture. Expanding on this idea, he states:

"We would propose that some businesses, once they have progressed down the first favorable branch, stand a much greater chance of progressing down the second favorable branch, and then the third, as a virtuous feedback loop builds. The process takes time, but a favorable result at any one stage increases the chances of success further down the line, as it were. Think of it as a business' culture."

This insight is crucial when evaluating businesses at different stages of maturity—particularly in the case of acquisition-driven compounders (ADCs).

Investor Dilemma

Investors frequently face a dilemma: should they bet on a smaller ADC with a shorter track record and an optically cheap valuation, or invest in a mature ADC that has already proven its ability to scale, but trades at a higher multiple? The choice between the two, easily sketched out in reversed DCF analysis, seems obvious to many.

The appeal of the first group is clear. Multiple expansion and significant earnings growth from a low base can lead to high returns if the business succeeds. But these companies often suffer from the cold start problem—lacking momentum, an established playbook, or the infrastructure to scale seamlessly.

By contrast, mature ADCs have already navigated key early hurdles and now benefit from a flywheel effect. Whether through geographic expansion or an ingrained cash culture, these businesses have already progressed through a first favorable branch. The result? Their odds of further success increase dramatically, as each step reinforces the next in a compounding loop.

Consider an ADC that has successfully built a business over many years, perhaps even expanded beyond its core markets or geographies. This company is now executing acquisitions internationally. The first milestone—proving it can scale acquisitions within a familiar region—has already been achieved. This reduces uncertainty around the second step: expanding the same model and playbook into new geographies.

At this point, the company has established a strong cultural foundation and refined its acquisition playbook, with each acquisition self-funded through cash flow. Additionally, acquisition responsibilities may have been decentralized throughout the organization. As a result, each subsequent acquisition becomes progressively easier, further increasing the likelihood of success. Some compelling examples of companies that managed to profitably expand beyond their core markets include the proven Swedish acquisition-driven compounders like Addtech, Indutrade, Lagercrantz and Lifco.

This creates a self-reinforcing cycle—the more successful acquisitions, the greater the confidence in the model, the smoother the integrations, and the stronger the long-term compounding. By contrast, an unproven ADC attempting its first few acquisitions must still de-risk its process. Execution missteps, cultural mismatches, or capital misallocations pose existential threats that a seasoned acquirer has already navigated past.

In Sweden, with a strong legacy of producing the most successful ADCs, in recent years, the low-interest environment of the last decade encouraged many new companies to follow paths of the proven companies. While some of these companies have succeeded through patience, discipline and smart capital allocation, many others—though they initially appeared promising with rapid growth and seemingly attractive valuations—have struggled with the cold-start problem.

The Illusion of Optical Cheapness

The human mind favors linear analysis, and investors are often drawn to optical cheapness. A small company, without a track record or an established cash culture, might seem tempting due to its potential for multi-decade earnings growth from a low base. But there's a flaw in this thinking.

The difference between a mature ADC which has successfully scaled beyond their core markets and developed a fully working cash culture, and an unproven one is not marginal—it is often exponential. This derisked approach has important implications for how one should think about value creation from a risk-adjusted perspective (and hence what price you would be willing to pay today).

Our experience from investing in these companies for almost two decades is that if a company has the potential to compound over decades, albeit missing out on the first years when trajectory is uncertain and risks high, it is still possible to achieve very attractive returns. Another key lesson for investors is that you typically tend to have time to evaluate the business model and management execution in order to avoid the cold start problem.

One example is Judges Scientific in the UK. It was floated in 2003, and the company had to spend several years getting the model and the execution right. If you watched the company from the sidelines for the first seven years to make up your mind about the quality of the business, you would still compound your capital more than 100x since 2010 including dividends.

Our experience shows that there are various ways to mitigate the cold start problem in an early phase. In our upcoming book, *The Compounders*, we will explore how some of the most successful Swedish and international ADCs have tackled this and many other challenges.

*This article first came to our attention via Nick Sleep. The full article can be found here.