RV Capital

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Business Owner TGV vs. the DAX

Year	Annual % Change in Business Owner (1)	Annual % Change in the DAX (2)	Relative Results (1-2)
2008 (3 months)	-13.4%	-17.5%	4.1%
2009	31.1%	23.8%	7.3%
2010	27.0%	16.1%	10.9%
2011	6.5%	-14.7%	21.2%
2012	18.4%	29.1%	-10.7%
2013	31.9%	25.5%	6.4%
2014	24.9%	2.7%	22.2%
2015	46.7%	9.6%	37.1%
2016	-1.1%	6.9%	-8.0%
2017	28.5%	12.5%	16.0%
2018	1.6%	-18.3%	19.9%
Compounded Annual Gain 2008 – 2018	**18.5%**	**6.0%**	**12.6%**
Overall Gain Sep 2008 – 2018	**471.6%**	**81.1%**	**390.5%**

Dear Co-Investor,

The NAV of Business Owner was €567.14 as of 28 December 2018. The NAV increased 1.6% since the start of the year and 471.6% since inception on 30 September 2008. The DAX was down 18.3% and up 81.1% respectively. The percentage changes differ from the changes in NAV due to disbursements from the fund related to taxes.

Do Not Read Too Much into an Up-Year in a Down-Market

A positive annual return in a year when markets are negative across the board is the stuff that marketing dreams are made of. What salesperson does not dream of hawking a fund that appears to combine equity-like returns with cash-like risk?

Cash-like risk is not, however, what the Business Owner fund has to offer. As a long-only, concentrated equity portfolio, the fund can, has and will experience sharp and unexpected declines in market value.

Nothing can be read into a year's performance, but to the extent it can, I would point to the last 4 months of the year when the NAV fell 16%. This drop happened during a time when the global economy hummed along, our companies developed well, and there were no obvious macroeconomic risks beyond the usual noise. The mood music will not always be chillaxed when Mr Market turns fearful.

Helping Aligned Investors to Self-Select

My aim in pointing out the fund's potential volatility is not to unsettle anyone. It is to ensure that expectations are properly set. Correctly, investors desert in droves those funds that promise steady, upward returns when, inevitably, they have a drawdown. By setting expectations appropriately, I hope to earn a loyal investor base. If it means losing investors who are put off by the prospect of volatility, it is a price worth paying.

Drawdowns are a Feature, Not a Bug

In any case, drawdowns are no reason to be unsettled. To the contrary, if share prices never fell, there would be less opportunity to buy companies cheaply. Most of Business

RV Capital GmbH
Huobmattstr. 5, 6045 Meggen, Switzerland
Tel: +41 41 511 4687, www.rvcapital.ch

Owner's net purchases in 2018 happened in December. This is, of course, no guarantee that they were good decisions, but the performance in the coming years will be better than if the same purchases had been made and the market decline had not happened. Higher long-term value creation in return for some short-term discomfort at a price decline is a trade every business owner should be happy to make.

Update on Business Owner

The best way to track the development of the Business Owner fund is through the development of our companies. I will report on how they got on in 2018 in my half-year letter, however a continuation of the positive development of recent years looks likely.

Facebook Continues to Get Hammered

The drumbeat of negative news around Facebook continued in the second half of 2018. There is not much I have to add to what I wrote in my half-year letter. Given the general pessimism around the stock, you would think the business is in a tailspin. In fact, it is likely to have grown in excess of 30% in 2018, which would make it the strongest performer out of all our companies. Newspapers will no doubt continue to exhort people to delete the app in the coming year, but where on earth would they get their news then?

No New Companies

I did not add any new companies to the portfolio in the second half of the year (in the first half, I added PSG Group, as described in my half-year letter). I continue to track several new companies closely but, ultimately, preferred to increase our stakes in existing investments, especially those with the steepest declines in the fourth quarter.

Subscription Business Models

An increasingly frequent theme in my discussions with companies is the shift to subscription business models. This is most obviously at software businesses – think of the shift from a licence fee to use Microsoft Office to the annual subscription fee for Office 365. Increasingly, I see it elsewhere too. For example, last Autumn, I met with Karel Cornelissen, CEO of Energy Partners, an unlisted PSG business that provides energy solutions to industrial companies. Whereas in the past, Energy Partners received a one-time fee for an installation, increasingly customers prefer it to own the underlying asset and charge them based on delivery of the underlying service, e.g. cubic metre of steam or kWh of electricity.

Win-wins Drive the Shift to Recurring Revenue Models

A big driver of the shift to subscription-based services is a win-win for the customer and the company. The win from a company's perspective is obvious - a multi-year commitment to buy its products is preferable to starting each year with an empty order book. Though less obvious, there are multiple wins for the customer too. For starters, she can budget more reliably. Most importantly, she is more likely to receive a product that is reliable and up-to-date as the company is incentivised to do everything to minimize churn (cancellations). Incidentally, this is the logic of Ryman selling occupancy rights for its independent living units, not the units themselves. Ryman is more capable and better incentivised to maintain its villages than its residents, who have a shorter time horizon and deteriorating mental and physical faculties.

Operating Earnings Paint a Distorted Picture of Earnings Power

I am a big fan of the shift to subscription-based services as I love to see alignment between companies and customers. However, the shift poses an analytical challenge. During the migration to a subscription business or in a growing subscription business, operating earnings paint a distorted picture of a company's earnings power. Revenue only comes in over years or even decades, but a substantial portion of the cost to generate it may be realised up front. Normally, operating losses are a bad sign, but in subscription businesses, they can be a good one if, for example, the company has high marketing costs to acquire new customers at attractive returns.

It's Not Just Marketing Expense that Distorts Operating Earnings

In the context of customer acquisition cost, I believe this dynamic – revenues being pushed out, marketing cost being brought forward – is well understood. I have discussed it in the past in the context of Trupanion. When you start to look for it though, you find it throughout a company's income statement.

Investment in New and Existing Services Fosters Customer Loyalty

High, upfront investment in product development can also burden earnings near-term but lead to greater revenue further out if the result is more products to cross-sell (leading to higher revenue per customer) and greater customer satisfaction (leading to lower customer churn).

Price Hikes Can Constitute a Withdrawal Against Future Earnings

Price is also an area where companies can trade short-term earnings against long-term value creation. If price hikes lead to a higher customer propensity to churn, the perverse situation could develop where a company's earnings skyrocket whilst its intrinsic value craters. In hindsight, this is perhaps what played out at Gillette and Novo Nordisk in their relentless pursuit of price increases for razorblades and insulin, respectively.

Conversely, companies can build up huge reserves of customer goodwill over time by pricing their product below what they could. Ryman is a great example of this. It caps the management fee of an independent living unit at 20% of the occupancy advance. Some competitors charge 30% or more. With the value of the average Auckland property approaching NZ$ 1 million, a 10% discount constitutes savings of NZ$ 100K AND Ryman provides a much better care experience. When there's a bust in the New Zealand property market, it won't be Ryman left sitting on unsold units.

Another Nail in the Coffin of Low-Multiple Investing

The leeway for management to time when it realises both revenues and costs makes me even more sceptical – to the extent that was possible – about the "low-multiple" brand of value investing. You can have great companies with negative operating earnings and deteriorating companies with high and even growing earnings, as the examples of Novo and Gillette demonstrate. An investment approach that forsakes the hard work of building an understanding of why a company's revenue and cost structure are the way they are is doomed to fail. In fact, the situation where a company appears "cheap" based on unsustainably high operating earnings could be a new incarnation of the "value trap".

If, however, valuing a subscription business by capitalising current or near-term earnings does not work, what approach to valuation should the value investor take?

For sure, book value is no alternative – investments in product can only be capitalised in the balance sheet to a limited extent, and investments in price or marketing cannot at all. Effectively, none of the good stuff makes it onto the balance sheet.

Two Possible Approaches to Valuing Companies

I see two possible approaches to valuation whereby one is vastly superior. The first – inferior – approach is to capitalise (or add back) the portion of spending on marketing, product development, or for that matter administration and any other cost line of the P&L that is of an investment nature. Yes, this involves a lot of judgement. Welcome to investing. Capitalising these investments results in adjusted earnings comparable to the reported earnings of a company that is forsaking the same investments.

The advantages of this approach are 1) the "investing" company is no longer penalised vs the "non-investing" company when the two companies' earnings are compared, and 2) the calculation is easy-to-do, transparent, and familiar to investors who like to compare companies' multiples.

It has one fatal flaw though – not all investments are created equal. Some companies destroy value through their investment choices, many barely make back their cost of capital, a minority make good returns, and an even smaller minority make spectacular returns. It does not make sense to treat investment equally in each of these four cases.

The Only Real Alternative

This leads me to the second and, in my view, only viable approach to valuation – the Discounted Cash Flow ("DCF") Model. DCF overcomes all the shortcomings discussed above by allowing for an investment phase of low or negative cash flows followed by a harvesting phase of positive cash flows after reinvestment opportunities have been exhausted. Discounting these cash flows back to the present yields an intrinsic value that can be used to ascertain which company has the lowest opportunity cost. It works equally well for companies with poor, average, good, and extraordinary reinvestment opportunities. Incidentally, there is no law of nature that the extraordinary business will be the cheapest. The only scenario where the extraordinary business will always be the cheapest is a world where everyone is myopically focussed on paying a low multiple of current year earnings and hence misses the long-term effects of compounding. This state of affairs would presumably not persist.

Junk-in, Junk-out?

There has never been any dispute amongst investors about the theoretical underpinnings of DCF models – everyone agrees that the intrinsic value of a business is the sum of the cash it generates between now and eternity, discounted at an appropriate rate. Value investors' beef is with their implementation. DCF models are associated with labyrinthine spreadsheets made up of multiple, interacting variables leading to an output that is opaque and, most likely, wrong. Put more succinctly: junk in, junk out.

Focus on a Handful of Key Metrics

It does not have to be this way. There are, of course, hundreds of figures that can be tracked at a business and by combining them into ratios, there are thousands more. The job of the investor is to cut through the noise and figure out which metrics really drive the business.

In my experience, this is what the best company managers do. They distil their business into a handful of key figures – sometimes just one and rarely more than four. Warren Buffett apparently tracks the weight of candy sold at See's or new policies activated at

Geico on a weekly basis. Closer to home, AddLife tracks "P/WC" (EBIT divided by working capital), Credit Acceptance tracks economic value added, and Shake Shack tracks the number of Shacks and the payback on new Shacks.

Identifying and forecasting the key figures driving a business does not get you all the way to valuing it, but it takes you most of the way. If you can get the big picture approximately right, the residual uncertainty is taken care of by building in an adequate margin of safety in the initial purchase decision.

A DCF Model Should Fit on a Beermat

Tom Tryforos, a fellow value investor, once told me that every company should be valued through the DCF method, but you should be able to do the calculation in your head. If you need to build a spreadsheet, then the investment is probably not compelling enough. He is right. It is better to be approximately right than precisely wrong.

Connecting a Company's Economics and its Purpose

In my past letters, I have often discussed our companies' economics and their purpose. I have never explicitly connected the two though. This is an omission as if a direct line is not drawn between purpose and superior investment performance, purpose is unlikely to take up the prominent role in an investment process that I believe it should. A fund, after all, is not a charity. The nature of the subscription business potentially provides a framework to connect the two.

Purpose and Great Economics are Two Sides of the Same Coin

The best subscription businesses achieve great long-run economics by maximising the number of customers, the loyalty of customers and the revenue per customer. This means pricing their services compellingly, tailoring them to customer needs (including the needs she does not yet recognise) and acquiring new customers at attractive returns. These are the exact same priorities of a purpose-driven company – serving the widest possible customer base with the best possible service at the most compelling price. Purpose and great long-term economics can be two sides of the same coin.

Which Comes First - Purpose or Profits?

If a purpose-driven business model can act as a guidepost to great long-term economics and a deep understanding of a company's long-term financial interest leads to a purpose-driven business model, then in theory either route could be taken to end up at the same place. In practice, I strongly suspect that the best businesses figure out their purpose first and the financial returns are simply the result.

Jeff Bezos talks about optimising long-term cash flow, but frankly, I do not see him meticulously modelling the financial implications of, for example, free home delivery. Clearly, his lodestar is customer centricity. The talk about long-run cash flows is an attempt to translate his thinking into language that capital markets comprehend. Similarly, I asked Gordy, Ryman's CEO, how the company arrived at a 20% management fee. He responded simply that it was the right thing to do. It was clear he does not run financial simulations to see what would happen if it increased to 25%.

Subscription Benefits Shared

To be clear, I am not arguing all successful companies have a sense of purpose, nor all purpose-driven companies are successful. My point is financial success and purpose complement each other. In fact, they feed off each other. Value Investor Nick Sleep coined the concept "scale economies shared" to describe the virtuous circle of greater

scale feeding into lower prices leading to greater scale. Perhaps "subscription benefits shared" exist when, for example, product improvement feeds into increased loyalty, driving further investment in product improvement.

Are our Companies Managed with an Eye to the Long-Term?

A legitimate question is whether our companies are investing to fulfil their purpose or whether current earnings are juiced to provide a short-term hit of dopamine.

I firmly believe our companies are investing for the long-term – be it in price, customer acquisition, product development, or organisational capabilities. Randy frequently talks about pricing Shake Shack's burgers at "what it should as opposed to what it could". Grenke invests extensively in building out its distribution network and product offering. Google and Facebook invest extensively in R&D, and in the case of Facebook, it has in addition hired tens of thousands of employees to make its community safer. Trupanion pours every cent of operating earnings back into customer acquisition. These investments bode well for long-term value creation and imply that current operating earnings understate long-run earnings power.

Not All Companies Direct Investors to the Right Metrics

Although all our companies invest, one important difference is how they communicate their investments to investors. Whilst some are explicit about the reinvestment dynamics of their business and what drives long-term value creation, others focus investors' attention on operating earnings. No doubt, substance is more important than appearance, but the former may have greater freedom to make large investments in the business that burden current earnings. Trupanion, for example, has been explicit about its return on new customer acquisition. Presumably, its board and its investors would be delighted to see higher pet growth even if it meant higher losses resulting from marketing spend. I wonder whether all our companies have a similar licence.

The Importance of Building an Aligned Investor Base

Amazon's competitors often complain that they are at an unfair disadvantage as Amazon is under no obligation to earn money from a new business line for many years. What they miss is that Amazon's investor base was not the consequence of luck, but a conscious decision to allow investors to self-select who are aligned with its time horizon. Every company can make a similar choice. Yes, it will involve some short-term pain in the share price as non-aligned investors get off the bus and new, more aligned ones have yet to be found. But if the result is a shareholder structure that allows the company to maximise its long-run financial interest, the pain will be worth it.

2019 Investor Meeting in Engelberg

I look forward to welcoming you to my Investor and Emerging Manager Meeting in Engelberg on 19-20 January 2019. If you who cannot make it, do not despair! There will be a live stream on my YouTube channel.

Yours sincerely

Robert Vinall