RV Capital

Meggen, 25 January 2017

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%
Compounded Annual Gain 2008 - 2016	19.5%	8.6%	10.9%
Overall Gain Sep 2008 – 2016	334.6%	96.9%	237.7%

A year behind the Dax

Dear Co-Investor,

The NAV of Business Owner was EUR 434.60 as of 30 December 2016. The change in NAV was -1.1% since the start of the year and +334.6% since inception on 30 September 2008. The Dax was up 6.9% and 96.9% respectively.

A single year's movement in the fund's NAV is an unreliable indicator of progress. Instead, I prefer to focus on the operational development of the underlying businesses. As always, I will report on how our businesses got on in 2016 in my half yearly letter, by which time they will have published their annual results.

Nevertheless, in a year when the fund lagged most major indices and is down in absolute terms, I understand if the question "how did they get on?" is more pressing than usual.

The development last year, whilst strong overall, was more mixed than in recent vintages. Our largest holdings, Alphabet, Grenke and Credit Acceptance, continued where they left off in 2015. They will most likely report that earnings grew by 20%+ in 2016. There will be plenty of time to celebrate their achievements in my next letter.

Novo Nordisk under pressure

One area of disappointment was Novo Nordisk. Novo reduced its five-year operating profit target twice in 2016, first from 15% to 10%, then later in the year from 10% to 5%. Whilst the first reduction had been anticipated by the market given Novo's increasing size, the second set alarm bells ringing. At the year-lows, the share price was down almost half from the start of the year.

What do I make of it?

Clearly, I am disappointed by the reduction in the long-term guidance. Clearly, a company which expects to grow at 5% over the next 5 years is worth less than one that expects to grow 15%. Clearly, some of the share price decline is justified.

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I do not though believe this is the disaster the market paints it to be. Novo will most likely report solid, if unspectacular, earnings progress in 2016 whilst at the same time it returned roughly 6% of its market value to shareholders in the form of dividends and share buybacks. This is not my definition of a crisis. The benchmark Novo should be judged against is not former expectations, but all alternative investment opportunities. Very few companies can grow faster than GDP, can return 6% to their investors, and have virtually no cyclicality.

The market's concerns are centred on insulin pricing in the US. It is worth flagging right from the get-go that the US constitutes roughly half of Novo's revenues. Of that, insulin is roughly half. It lost nearly half its value on uncertainty about a quarter of its business.

Some concern around US insulin pricing is justified. Lilly launched Basaglar, a biosimilar version of Lantus, the leading long-acting insulin, at the end of 2016. The arrival of a 3rd player broke the duopoly between Sanofi and Novo. It almost certainly means that the effortless price increases both players had enjoyed for Lantus and Levemir in prior years are history. I am not sure that is such a bad thing.

In other respects, the concern seems overdone. Novo may have even benefitted from the delisting of Lantus at some Pharmacy Benefit Managers (PBMs) as early data suggests more former Lantus patients switched to Tresiba than Basaglar. Although much has been made about the growing power of the PBMs, the reality is that they are no more consolidated this year than last. Furthermore, Novo currently finds itself in an unusually weak position as it is in the process of launching a slew of new products. Its priority is to gain good access for those products even if it means making price concessions. As these products become more established, its pricing power will improve.

Looking forward, pricing power will be determined by how innovative its new medicines are. Nobody wants the second-best insulin or GLP-1 for themselves or for their families. If its new products are genuinely differentiated, it will continue to command a price premium. Moreover, any premium will have been earnt on merit rather than with a me-too product in a benevolent duopoly. I far prefer this situation.

Based on the clinical studies that Novo has published, the experience in Japan (where Tresiba was launched far earlier), and anecdotal evidence from diabetics, my belief is that Novo's new generation medicines <u>are</u> differentiated. This is not a universally held view though. The PBMs either play down the improvements Novo has achieved or point to more cost-effective ways to achieve similar patient outcomes. They of course have their interests, as indeed does Novo. I know which camp I am in, but, as always, if I am wrong, I will change my mind.

<u>Sale of Baidu</u>

Towards the end of 2016, I sold our stake in Baidu.

As a rule, I tend not to discuss past investments unless they lose money. Despite working out quite well financially – we bought most of our stock in late 2012 at around US$90 and sold in late 2016 at double this amount – Baidu nevertheless seems worthy of discussion. At the time of the investment, I had invested predominantly in medium sized German companies, known as the *Mittelstand*. A foray into China probably raised the question: "Had I gone off the reservation". Had I?

Many aspects of the investment in Baidu worked well. As you know, I look for four main qualities in an investment – a business I understand with an honest and talented manager, a sustainable competitive advantage, and an attractive price. The investment did well across all criteria.

At the time, I was impressed by Robin Li and felt I saw similarities between him and the best *Mittelstand* entrepreneurs. Given that the German market was racked with fraudulent Chinese IPOs at the time, this was a contrarian judgement to say the least. From today's perspective, he surpassed my high expectations. I found him to be passionate, committed and willing to make unpopular decisions in the long-term interests of the business.

The company's competitive advantage proved to be robust. There is a strong network effect in search and it transferred well to mobile. The company has a similar market share in mobile as it had on the PC.

Finally, the valuation was attractive. We paid 19x what we now know to be 2012 earnings. Given that revenues went on to compound at 44% p.a. over the subsequent three years, I think this can be safely considered a bargain.

However, in at least two important respects, I believe I misjudged the investment case.

First, I overestimated the quality of Baidu's search results, the lifeblood of the business. Subsequent to a medical scandal, Baidu delisted 25% of its medical advertisers. I understand this to mean that Baidu had been sending 25% of its customers to the wrong place for health-related searches. This is an unacceptable failure rate for searches which could, quite literally, be a matter of life or death.

Due to the inferior search experience, search is not nearly as ubiquitous in China as it is in the West. This means that whilst Baidu has a similar share of mobile search as it does of pc search, the pie is not nearly as big as it could have been. Had I been able to read Chinese, I would have spotted Baidu's low search quality in a heartbeat. Not speaking Chinese was a greater handicap than I thought, though to be fair there were no shortage of Chinese-speaking people in my network who flagged Baidu's search quality to me.

Second, I underestimated the importance of innovation. The moat in search is enormous, but it is not big enough to obviate the need to innovate. Baidu failed to anticipate the importance of mobile. As a result, its investments were for the most part reactive. To pick just two examples, Baidu had to spend large amounts on getting its search app pre-installed on smart phones and then later on building up proprietary O2O services in order to secure inventory for its local searches. Both investments made sense, but they would have been superfluous if, for example, Baidu had established the dominant operating system for smart phones, as Alphabet did. The failure to anticipate these and other trends resulted in far greater operating expense than I expected and, as a result, earnings did not compound nearly as fast as revenues.

Comparing Baidu and Alphabet's respective developments has given me a greater appreciation of just how good a job Alphabet has done.

<u>Final thoughts on Baidu</u>

Expanding your circle of competence whilst at the same time *staying within* your circle of competence is a delicate balancing act for all capital allocators. I will leave it to you to judge whether I struck the right balance. To me, it is not clear.

I would however highlight that whilst value investors have traditionally been sceptical of tech in general and China in particular, this is no longer a tenable standpoint in my opinion. A large part of the value creation in our society is coming from tech, and this will continue to be reflected in stock market valuations. Forgoing these returns will make the challenge of beating market indices even harder than it already is.

Furthermore, even if you decide to give tech a miss, it is still necessary to study it. Innovations from the tech sector are impacting and, yes, disrupting nearly all other sectors. I can make a plausible argument why virtually any company might be disrupted in the medium to long term. If you are not aware of these risks, you are not underwriting them. And if you are studying a sector, you may as well invest in it.

I would extend the same logic to the Chinese internet. To the uninitiated, it perhaps appears to be a cheap copy of the West's. Nothing could be further than the truth. It is at least as dynamic and innovative and maybe more so. Weixin, Tencent's messaging app, provides a glimpse of what WhatsApp, and even Facebook, could become. Alibaba shows how much better a business Amazon could have been if Jeff Bezos had integrated payment sooner into its formidable ecosystem (though to be fair, the mass adoption of credit cards in the West probably obscured the urgency of building a payment solution comparable to Alipay).

Even if you choose not to invest in Chinese Internet companies, it would be madness not to study them due to the insights they provide on the Western Internet. The Chinese Internet constitutes a unique opportunity to see how the Western Internet might have developed under different circumstances, and, by extension, what it might become. It is fascinating for the same reason that the Galapagos are for biologists. Again, if you are going to have to study a sector, you may as well invest in it.

Let me close by asking provocatively, does Baidu's marginalisation in the Chinese Internet foreshadow a bleaker future for Alphabet, or is Alphabet's situation different?

<u>Moat vs. Innovation</u>

A key tenet of value investing, and one of just four main criteria for selecting investments at Business Owner, is competitive advantage. The idea behind competitive advantage is that businesses need to be protected by barriers to entry to earn a return on capital above their cost of capital. Warren Buffett coined the term "moat" to describe this. Examples of moats are brands, switching costs and network effects.

The dilemma facing value investors today is that whilst moat continues to be a prerequisite to earning excess returns on capital, it no longer seems sufficient. The pace of change is too fast.

There is scarcely a single sector that either has not been disrupted already or might plausibly be disrupted soon. The disruption of newspapers by the Internet or taxi services by Uber are well known examples of the former. The threat to car insurers from self-driving cars is just one example of the latter. No company is safe.

The pace of change leaves value investors feeling increasingly disorientated. They traditionally spurn sectors that are subject to fast change such as biotech, fashion or technology, preferring to focus on sectors which are predictable and subject to slow, incremental change. However, what is to be done if the universe of unchanging businesses is continually shrinking and, moreover, all the economic growth, and hence value creation, is coming from elsewhere?

In my view, far greater attention needs to be paid to a company's ability and willingness to innovate. Value investors may prefer not to give too much consideration to innovation. However, no matter how wide a company's moat is, it is unlikely to be sustainable unless it goes hand in hand with innovation.

The centrality of innovation was brought home to me when I read through my investment thesis about Alphabet from my 2012 letter. I argued then that Alphabet had a sustainable competitive advantage due to the powerful network from search – the more searches you get, the better the quality of your results; and the better the quality of your results, the more searches you get.

There was nothing wrong with this analysis. The only problem is that Alphabet would not have much of a business left today if it had kicked back and stopped innovating. The network effect provided Alphabet with the funds to innovate. However, the innovations themselves – Android, predictive input, AI, etc. are the reasons the investment is so much more valuable today than back then.

This is a humbling thought. Whilst the scorecard I measure myself against is the fund's performance, I strongly believe that that performance needs to be driven by investment hypotheses playing out. Otherwise, it is the result of nothing more than pure luck.

It is probably not a controversial thought that innovation is important, but it is exceptionally difficult for companies to put innovation front and centre. Astro Teller, Alphabet's captain of moon shots, illustrates this with an interesting mental exercise. He offers a group the choice between "project A" - which is guaranteed to bring one million dollars of business value – "or project B" - which has a one in a hundred chance of creating a billion dollars of business value. Most people correctly opt for "B" given that it has a higher probabilistic payoff. However, when he asks which project their manager would most likely sign off on, they respond "A". Therein lies the dilemma. I thoroughly recommend the whole talk. The section I just described starts at around 27 minutes: https://www.youtube.com/watch?v=BwbkMV0Y9BM&t=1674s

What are the implications for Business Owner? In an ideal world, one would simply target companies that have sustainable competitive advantage and an ability to innovate. However, to a certain extent the one precludes the other. If one was so certain of the durability of the moat, what would be the point in paying attention to innovation? Giving proper weight to the issue of innovation involves recognizing the transience of competitive advantage. If innovation is indeed paramount, should then the whole concept of moat be relegated to the "nice to have" bucket? Or should one simply restrict oneself to a shrinking pool of opportunities where the moat looks sustainable?

Perhaps the concepts of moat and innovation can be reconciled. Warren Buffett often states that his CEOs' top priority is to widen their company's moat. The idea of widening a moat is key. It is worth quoting Buffett's precise words from the 2000 AGM:

We think in terms of that moat and the ability to keep its width and its impossibility of being crossed as the primary criterion of a great business. And we tell our managers we want the moat widened every year.

In my view, widening the moat is more important than the width of the moat. Everyone is attacking a company's moat, so the question is not how wide it is, but whether it is widening at a faster pace than competitors are filling it up. Innovation is central to the idea of widening a moat.

But how can an investor correctly identify innovation? It is hard. Within 60 seconds, I can see American Express enjoys a network effect, Gillette has a great brand, and SAP's customers have switching costs. But are these companies innovative? I don't know.

The question is further complicated by the halo that envelops companies that enjoy decades of uninterrupted success. There is a mental bias to attribute all kinds of positive qualities to them, including innovativeness. Whether they have been innovating only comes to light when the shoe drops, at which point it is too late.

When something is difficult <u>and</u> important, it is not a bad thing. To the contrary, it provides the thoughtful investor with an opportunity to beat the market through superior insight. Identifying management talent and integrity is also difficult. In fact, many thoughtful fund managers do not even bother trying as they consider it <u>too</u> difficult. That is great for capital allocators including myself who believe talent and integrity are important <u>and</u> occasionally observable.

So how might a capacity to innovate be identified?

Culture strikes me as key. It is essential that employees are given space to try new things and permission to fail. Alphabet is the best example of this I have come across. In this respect, at least, my analysis from 2012 was bang on the money.

A willingness to approach capital allocation opportunistically is also essential. At the 2016 AGM, Buffett highlighted Berkshire's ability to allocate its capital to new, more promising fields, as an antidote to the threats of disruption at some of its businesses. He pointed out that Berkshire Hathaway's original investments in its namesake textile mill as well as Blue Chip Stamps ultimately ended up worthless. However, the capital they generated provided the seeds which grew into today's Berkshire Hathaway. The ability to allocate capital free of any sense of historical obligation to an existing business is an important advantage of the conglomerate over the single product business.

A relentless focus on customer needs, rather than competitors, is also essential. Jeff Bezos often talks about focussing not on what is going to be different in 10 years' time, but what is going to be the same:

I very frequently get the question: 'what's going to change in the next 10 years?' And that is a very interesting question; it's a very common one. I almost never get the question: 'what's not going to change in the next 10 years?' And I submit to you that that second question is actually the more important of the two – because you can build a business strategy around the things that are stable in time….in our retail business, we know that customers want low prices and I know that's going to be true 10 years from now. They want fast delivery, they want vast selection. It's impossible to imagine a future 10 years from now where a customer comes up and says, 'Jeff I love Amazon, I just wish the prices were a little higher [or] I love Amazon, I just wish you'd deliver a little more slowly.

Working back from this insight led him to work on the Fire phone, which was an attempt to remove some of the friction from the ordering process. The sentiment was right even if the product ultimately failed. It did lead directly to the development of the more promising Amazon Echo, bearing out the adage "the harder you try, the luckier you get".

Henry Ford famously said:

If I had asked people what they wanted, they would have said faster horses.

But what if he had asked what the customer needs? The response would have been getting quicker from A to B. Bingo.

<u>A tweak in investment style</u>

How does this change how I allocate capital?

My intention is to pay far greater attention to innovation. Reflecting this, I am modifying the question on competitive advantage from:

"Does the company have a long term sustainable competitive advantage?"

to:

"Is the company building a long term sustainable competitive advantage?"

It is a subtle change, but, in my view, an important one. The new question better captures the idea of moat as a dynamic rather than a static concept.

The responsibility for creating and maintaining an innovative culture ultimately rests with management. As such, when underwriting management ability, I intend to focus more closely on what the leadership is doing to foster a culture where innovation can flourish.

An investment in Facebook

Facebook needs no introduction. You are most likely a user (the platform has 1.8 bn monthly average users, so I am not going too far out on a limb). If you are not a user, some of your friends certainly are. In addition, you may use two of its other properties – the messaging service, WhatsApp, and the photo sharing network, Instagram.

An investment in Facebook will earn no prizes for originality. However, the goal of Business Owner is not originality (I've given up trying to climb the career ladder at RV Capital). The goal is to buy the highest possible amount of long-run earnings power at the lowest possible price by buying part ownership stakes in great businesses run by honest and talented managers. By this criterion, Facebook presses all the right buttons.

Is the company building a long term sustainable competitive advantage?

I have been following Facebook since well before its IPO in May 2012. What held me back from investing were concerns about how durable its moat would ultimately be. There is, of course, a strong network effect in social networks – the more people on them, the more attractive they are to join; and the more attractive they are, the more people join. However, this network effect also works in reverse – if people leave, the value of a network deteriorates rapidly. During the short life of the Internet, I have observed both Friendster and Myspace (two early social networks) grow rapidly and then implode.

Over time, I have become more comfortable with the sustainability of Facebook's moat for at least four reasons. First, the decline of Friendster and Myspace was due to company-specific errors. Friendster failed to scale, which led to a poor user experience. Myspace failed to curate the user experience, which led to rampant bullying and pornography. Facebook seems unlikely to repeat either mistake.

Second, I have come to appreciate that whilst the network effect is core to Facebook's moat, its moat extends well beyond simply connecting users. Its platform contains not just people's connections but also their personal histories. The timeline feature creates switching cost as people will (mostly) prefer not to lose their memories by switching to a different network. With each passing day, the cost of switching gets higher.

Third, there is a vibrant ecosystem built around Facebook's platform including news, videos, services, and apps. The ecosystem increases the value of the network to users beyond the ability to connect to immediate friends and families. In fact, it is the content that drives the network's engagement rather than the connections per se. Most people have an account with Alphabet, and the ability to connect through Google+. The reason they do not is the almost complete absence of interesting content. Facebook's ecosystem grows every day and, with it, its moat.

Fourth, Facebook's dataset is a growing source of moat. Data has always been important, but progress in the field of artificial intelligence (AI) will make it even more so. The key thing to understand about AI is that more data leads to better results; and better results attract more users and hence more data. This virtuous circle constitutes a further network effect. It most likely ensures that Facebook, Alphabet and perhaps a handful of other companies will dominate the field of AI, the next big technological shift.

Facebook's moat is wide. More importantly, <u>it is growing</u>, as more people join, more content is added, more data is generated, and the ecosystem grows.

<u>Mark Zuckerberg</u>

Facebook is a purpose-driven company. The opening lines of Mark Zuckerberg's IPO letter read:

"Facebook was not originally created to be a company. It was built to accomplish a social mission — to make the world more open and connected."

Anyone who has followed Mark Zuckerberg over the years is left in no doubt that purpose – to make the world more open and connected - is more important than short term financial gain. A good example was the decision by Mark in the early years to restrict enrolment to college students as they could be unambiguously identified through their college email. This helped Facebook to keep anonymous users off the platform and create a superior user experience. Other networks that took a more laissez-faire to identity grew faster initially, but it led to an inferior user experience and, ultimately, failure.

Mark Zuckerberg and is wife spelt out their sense of purpose in a letter to their newly born daughter in 2015. I was deeply moved by the letter and can thoroughly recommend reading it. The letter contains not just words but actions - they articulate their plan to donate 99% of their Facebook stock to charity. This letter provides me with certainty about Mark Zuckerberg's character and motivation. Certainty about an important yet difficult-to-evaluate factor, is exceptionally scarce in financial markets. It would be madness to ignore it.

Mark Zuckerberg has created a culture of innovation at Facebook, which he terms "the hacker way". This concept also gives the name to its postal address. In this context hacking means testing the boundaries of what can be done, as opposed to the more negative connotation of breaking into computers. Openness, rapid iteration and a bias to action reflected in the words "done is better than perfect" are all features of the hacker way. Whilst Zuckerberg is still there – and given his young age this will hopefully be a long time – it seems unlikely that Facebook will drift into complacency and stagnation.

<u>Is the valuation cheap?</u>

In some respects, Facebook is a difficult company to put a value on. When a company is in a mature industry without too much cyclicality, it is easy to estimate a tight range for its earnings power and then apply an appropriately conservative multiple to it. Facebook offers no such certainty given its rapid growth and wide range of possible outcomes.

In other respects, Facebook is an easy company to value. Whilst there is a huge range of possible outcomes for its earnings power in the coming years, none of these outcomes involve the type of GDP-like growth of said hypothetical company. As such, there may be uncertainty about what Facebook earns but there is not risk, provided we are not paying too much more than we would for said hypothetical company.

What are we paying? Having hopefully convinced you that neither I, nor most likely anyone else, are going to be particularly proficient at forecasting Facebook's earnings power, I will embarrass myself and make a forecast for 2017: US$4.2 per share. Prepare to laugh in a year's time.

US$4.2 is after the cost of stock-based compensation but before the amortisation of intangibles from acquisitions. It is therefore likely to be a bit higher than GAAP earnings but lower than non-GAAP. At our cost price, this implies a multiple of around 25x (excluding the excess cash on its balance sheet). Even if this estimate proves wildly optimistic, Facebook will earn US$ 4.2 in the not too distant future given how rapidly it is growing. Any embarrassment is likely to be short-lived.

If I give the company some credit for both Instagram and WhatsApp (both of which are at the early stages of monetisation) as well as for its extensive investments in long-run R&D (which depress current year earnings power), it strikes me we are not paying a multiple that is all that different from what the wider market commands. The market cannot grow faster than nominal GDP. Facebook, by contrast, will most likely grow for the foreseeable future in a range of 20% and…. a lot.

Mea Culpa

A question that drives me to distraction is why I did not invest in Facebook earlier.

I looked on with amazement after the IPO when the stock price plunged on fears that the company would never earn money on mobile. Yes, that is how wrong the market gets things sometimes – the question was not what Facebook would earn, but if it would earn.

At the time, I had read David Kirkpatrick's "The Facebook Effect," a book I can highly recommend. Despite being published over a year prior to the IPO, it outlined in no uncertain terms the manifold ways Facebook could monetise its user base. I knew that Facebook would have huge earnings power. I just did not know how much. I mistook uncertainty for risk.

A further factor in my decision was that around this time I bought a very large position in Alphabet, and felt I had "exhausted" my allocation to tech stocks. Despite running a very concentrated portfolio, I seek some degree of company and sector diversification. This too was a mistake. Today, I see Facebook as highly complementary to Alphabet. For sure, there is one large correlated risk: Regulation. However, what competitive threats Alphabet does face invariably come from Facebook. Facebook's growth in video is just one example. Alphabet's loss will likely be Facebook's gain. Rather than fight this insight, it struck me as more prudent to exploit it by buying a part ownership stake in Facebook.

One final point: Facebook strikes me as an appropriate substitute for Baidu. It provides us with exposure to a social network (the other dominant platform for online advertising). I prefer this to having all our chips on search. I do though miss being invested in the Chinese Internet. Maybe there will be a new Chinese investment to report on in the future.

Yours sincerely,

Rob

Robert Vinall