Meggen, 9 August 2019

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	1.5%	-18.3%	19.8%
2019 H1	22.7%	17.4%	5.2%
Compounded Annual Gain 2008 – H1 2018	601.1%	112.6%	488.5%
Overall Gain Sep 2008 – H1 2018	19.9%	7.3%	12.6%

Dear Co-Investor,

The NAV of Business Owner was €695.62 as of 28 June 2019. The NAV increased 22.7% since the start of the year and 601.1% since inception on 30 September 2008. The DAX was up 17.4% and up 112.6% respectively. Please note that these percentage changes differ from the changes in NAV due to disbursements from the fund related to taxes.

Update on Business Owner Investees

The seven companies that we owned at the start of 2018 and continue to own today are Alphabet, Credit Acceptance, Grenke, Facebook, Ryman Healthcare, Trupanion, and TFF Group. We owned Shake Shack and BETT AG at the start of 2018, but I have since sold both, though we retain a non-material holding in BETT AG. In both cases, the businesses developed slightly less well than I hoped whilst the share prices increased substantially. When this happens, I prefer to reallocate funds to other opportunities, however, I remain a fan of both companies.

I am happy to report that our companies continued their positive trend in 2018. Alphabet grew its operating income at 8.7% excluding the European fines. Credit Acceptance grew its adjusted earnings per share at 38.9%. Facebook grew its operating income by 23.3%. Grenke grew its net income per share at 20.3%. Ryman grew its underlying profit in the year to 31 March 2019 at 11.5%. TFF Group grew its net income by 1.7% in the year to 30 April 2019. Trupanion grew its adjusted operating income per share by 28%. For each company, I highlighted the earnings measure which best reflects the companies' progress. GAAP earnings are conspicuous by their absence – accounting conventions seem to gain in complexity whilst losing explanatory power.

Our companies continue to outperform my expectations

As a group, it is self-evident that our companies did spectacularly well. Facebook, Credit Acceptance, Trupanion, and Grenke were the standout performers. TFF was the laggard, but it is investing aggressively in its bourbon business in the US. In a couple of years' time, I expect this will feed through to strong earnings growth. Ryman tracked modestly below its target of 15% growth in operating income, but it has built a large pipeline of new developments. When these come through, I expect its operating income to track

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above 15%. Alphabet's operating income growth lagged its revenue growth (22% at constant currencies). Additional compensation expense burdened operating income which was related to gains on equity securities in financial income, so operating income growth is understated by an unspecified amount.

What about when the economy is less favourable?

Given how well our companies are doing today, perhaps a more pressing question is how they will fare when the next recession comes along.

Recessions are inevitable from time to time. As neither I, nor anyone else, can predict them, I give a lot of thought to how our companies will perform in a cyclical downturn. To borrow Warren Buffett's analogy: when the tide goes out, we do not want to be caught swimming naked.

Recessions are nothing to fear

Most of our companies have a certain sensitivity to the economy – For Google and Facebook to advertising spend, for Ryman Healthcare to the New Zealand and Australian property markets, for Grenke to corporate bankruptcies, for Credit Acceptance to unemployment rates in the US, and for PSG to the South African economy (whereby as South Africa is in a deep recession, the question is somewhat moot). AddLife and Trupanion are probably the least cyclical as they are in the healthcare sector. For most companies, some earnings deterioration is inevitable, however I expect all our companies to remain profitable and well capitalised even in a deep recession.

Risks from a recession are perhaps perceived to be greatest for our retirement village operator, Ryman, and our two lending businesses, Grenke and Credit Acceptance. In each case, I believe the opportunity outweighs the risk.

Moving into a retirement village is a non-discretionary decision

The decision to move into a retirement village is generally not a discretionary one. It might be triggered by a life event such as the death of a spouse or a fall. As such, any drop in demand in the retirement village sector is likely to be shallow and short-lived. As Ryman has the best product at the lowest price, I expect weak demand to primarily impact competitors. At 20%, its deferred management fee ("DMF") is the lowest in the market. With average property prices approaching NZ$ 1 m in Auckland and Melbourne, a 10% lower DMF constitutes a saving of NZ$ 100K for incoming residents. Ryman's competitors are in the unenviable position of being the swing capacity.

Credit Acceptance doubled earnings in the last recession

An increase in unemployment rates may dent Credit Acceptance's earnings for a quarter or two as its collections fall, however I expect the company to remain solidly profitable and well capitalised. Moreover, any earnings deterioration should prove short-lived as capital exits the subprime lending space and loan pricing improves. As Credit Acceptance's loan book turns over quite quickly, the latter effect should quickly outweigh the former. This was the experience in the great financial crisis. From 2007 and 2009, Credit Acceptance's adjusted earnings per share doubled from US$1.98 to US$3.95. Its shareholders should be praying the next recession comes sooner rather than later.

Grenke should benefit from its relative strength vs competitors

An increase in corporate insolvencies may dent Grenke's earnings, but as with Credit Acceptance, I expect it to remain well capitalised and solidly profitable. Here too, the opportunity should outweigh the risk. In the last recession, several of Grenke's largest competitors including GE and Siemens permanently exited the small ticket leasing market. In certain markets, competition has not returned, a full ten years after the recession ended. Furthermore, Grenke was able to make one excellent acquisition in the last recession (Grenke Bank). Grenke is far more valuable today than if the great recession had not happened. I expect more of the same next time around.

The proof is in the pudding

At some point, there will be a recession, so we will find out how prescient my analysis turns out to be (or not!). This is scrutiny I invite. However, the above analysis should not be mistaken for a forecast about the share price developments of our companies in a recession. I have no ability to forecast share prices in the short term. Sometimes even a modest deterioration in earnings can lead to a dramatic share price reaction as other market participants extrapolate it far into the future. For example, a non-material (in my view) increase in loan losses at Grenke in Q2 2019 triggered a dramatic share price decline, presumably because some investors think it is a foretaste of things to come. Such share price reactions are nothing to fear though. Periodic disconnects between economic reality and share prices are the rationale behind investing in an actively managed fund.

Is now a good time to invest?

With recession fears top of mind, the question of whether now is a good time to invest in the stock market is pertinent. I approached the question from a mathematical perspective in my 2014 letter, describing it as a function of your assumptions around the frequency of a market crash, its severity and your expected rate of compounding in the intervening years. If you are not familiar with that letter, I recommend looking it up.

I have come to realise though that there are two faulty assumptions underlying this question. It is perhaps more important to address these than the question itself.

A cardiograph?

The first assumption is that the stock market goes up and down over time but basically gyrates around the same level – think of a heart rate monitor. Accordingly, the smart money buys low and sells high; the dumb money does vice versa. People ask whether now is a good time to invest as, understandably, they want to be the former.

No, a ski lift

This heartrate monitor is the wrong metaphor though. A ski lift being buffeted by the wind is a more apt one as the stock market goes up over time. Developed markets should increase by around 6% p.a. over long periods of time, implying a double every 12 years, a quadruple every 24 years, and so on. If you have a 40 year plus time horizon and an investment opportunity that will go up 8-fold, how much is there to think about? The smart money is invested, not on the side-lines fretting about what to do.

Shooting fish in a barrel?

The second assumption is that investing is occasionally easy - like shooting fish in a barrel. Accordingly, the smart money waits patiently for the right moment to invest. Hence the question: "Is now a good time to invest?".

In my experience, investing is never easy. In fact, most of the time it feels a lot like today – many companies have had a good share price performance and are not obviously cheap. This is how it felt one year ago, three years ago, and most of the time over the last 20-odd years I have been investing.

Dislocations are rare and short-lived

Yes, there were precisely two short periods over the last 20 years that stocks were unambiguously cheap across the board – after 9/11 and the Lehman collapse. Even then though, investing was not easy. Immediately after 9/11, it was not unreasonable to assume that terrorists had gained the upper hand and the attack on the World Trade Centre was a mere foretaste of things to come. After Lehman, it was not unreasonable to assume that the financial system would collapse. Under both scenarios, how much could any company other than those providing the most essential of services be worth?

In both cases, I decided that if the world really was going to end, what was there to lose from owning a few stocks on the off chance the sun were to come up the following day. However, anyone who invested in this period will know that it was anything but easy.

The assumption that investing is occasionally easy is wrong - most of the time because there are a lot of smart people scouring the markets for mispriced opportunities, and very occasionally because the world faces a threat which, at the time, feels existential.

Investing is hard, not impossible

Investing may not be easy, but it is not impossible. Every day over the last 20 years, there have been knowably excellent investment opportunities. This was certainly the case 2001/02 and 2008/09, but it was also the case a year ago, a time when nobody was shouting from the rooftops that investing was like shooting fish in a barrel. It pains me to think of at least one company I was studying intensely but failed to invest in even though my assessment was that the price was excellent relative to its prospects.

I strongly believe that when we look back in a year's time at today, there will almost certainly have been knowably great opportunities. In my experience, good investment opportunities are always plentiful. The limiting factors are the ability to identify them and, having identified them, the courage to act.

Visit to China

Last May, I spent a week in China. The trip was organised by my friend and fellow fund manager Dawid Krigge and his colleagues at Cederberg Capital for their investors and friends. Over the course of the week, we visited companies from the Internet, consumer services, and pharmaceutical sectors, travelled by high speed train to 3rd tier city called Shijiazhuang, and heard from local experts about China. We were in China the week that a ban was imposed on American companies selling to Huawei, so it was an interesting time to be there. Dawid and his team were wonderful hosts, and I am hugely grateful to them for inviting me to tag along.

It is the sixth trip that I have made to China since 2012 and this time, as with every time before, I came back exhilarated by how much I had learnt. What makes China so fascinating is that it is large (at 1.4bn, its population is nearly 5x that of the US), important (what happens in China increasingly impacts everywhere else too), and different (most dominant companies in China are non-Western). Above all, the combination of all three characteristics that make China so fascinating. India is also large and different but has not developed as fast as China to take on the same importance. The US is large and important, but familiar.

What follows are some reflections on what I learnt from the trip.

Developed and developing

It is difficult to overstate how developed China already is and how fast the country is developing. It would be inaccurate to describe the infrastructure of Beijing as first world as I struggle to think of a Western city whose infrastructure is comparable. To pick one example, the high-speed train to Shijiazhuang took roughly an hour to take us over 300 km. Furthermore, the country continues to develop at a rapid rate. When I first visited Beijing in 2012, the air was unbreathable, and the city was a sea of cranes. Though not perfect, the air is now vastly improved (we had blue skies the entire week), and the cranes have largely departed as the city is basically built. Instead, I saw a similar sea of cranes at Shijiazhuang. Presumably, in a few years' time, they will have moved on again. If the development model of Beijing can be replicated across the country, it is only a matter of time before Chinese GDP per capita catches up with and then overtakes Western levels.

Overlooked

It strikes me that the average person in the West underestimates how rapidly China has progressed and how much runway is ahead of it. News reports on China are infrequent (generally coinciding with a State visit) and tend to focus on human rights abuses and the lack of democracy. Whilst these issues are real and important, the near exclusive focus on them results in people missing the wider picture. It's rather like visiting San Francisco and only taking away that it has a serious problem with homelessness. Yes, the problem is big and important, but if it is all you take away from a trip to Silicon Valley, I would suggest you are missing the bigger picture of the extraordinary societal changes being catalysed by the companies there.

The Chinese government has done a great job

The Chinese government has done a great job of improving the lives of its people. According to the World Bank, more than 850 million people have lifted themselves out of extreme poverty as China's poverty rate fell from 88% in 1981 to 0.7% in 2015. If worldwide poverty has decreased over the last 30 years, it is largely thanks to China, not Bob Geldof throwing a concert in Wembley.

It is difficult to imagine that the country would have developed as rapidly had the pro-democracy protests 25 years ago been successful given the slower pace of development in a democracy due to the need to build a consensus amongst multiple stakeholders. India is a case in point. This is not to say that I am in favour of one-party-rule. To the contrary, I firmly believe that democracy is the best way to organise a society as it provides a correction mechanism if a leader develops destructive tendencies (which, absent democratic controls, has tended to be the norm rather than the exception historically). However, just because the facts on the ground do not accord with our political convictions does not mean they can be denied.

Though my small sample may not be representative, all the Chinese people and Western experts I met in China told me that there is broad satisfaction with the job the Chinese government is doing and zero appetite for systemic change. Given the daily coverage in the West of the protests in Hong Kong, this is presumably counterintuitive for many of my readers. Again, I emphasise this is not an endorsement of China's political system, just a recounting of what I learnt.

The implication is clear: people's allegiance is to the system that best delivers an improvement in their living standards, not an ideology (I suspect the root cause of the protests in Hong Kong is the decline in the former colony's relative position in China). This should be a wake-up call to the West that democracy is not an end but a means to an end – to improve the lives of its citizens. If our system of government does not deliver improving living standards to broad swathes of the population, it is not a given that our democratic system will persevere. It pains me to observe how Brexit has put government in the UK on hold for the last four years. Remainers and leavers should agree that this is a national tragedy. The Chinese economy has grown by almost a third whilst the UK's politicians have squabbled amongst themselves.

Dynamic

The Chinese economy is incredibly dynamic. I did my first road trip visiting Chinese Internet companies in August 2013. Back then JD ("the Amazon of China"), Baidu ("the Google of China"), and Ctrip ("the Booking.com of China") were all in the ascendancy. Today, they are shadows of their former selves, having been eclipsed by companies that in some cases did not even exist in 2013. In the West by contrast, Amazon, Google, Booking and most of the other Internet companies that were dominant six years ago remain dominant today.

From a societal perspective, the high level of creative destruction is fantastic. For an investor, it is humbling. Many of the companies that I thought had sustainable competitive advantages six years ago turned out not to have had. One of Business Owner's investment criteria is that a company should be around and flourishing ten or more years from now. I struggle to think of a Chinese Internet company that meets this criterion today with the possible exceptions of Alibaba and Tencent, whereby even here I am not 100% certain.

Competitive

The Chinese economy is incredibly competitive. There is perhaps a sense in the West that a gentler form of capitalism operates in China given the country's nominally communist roots. Nothing could be further from the truth. Competition is brutal. On the trip, one investor quipped: "The reason Western companies cannot compete with Chinese companies is because Chinese companies cannot compete with Chinese companies". His point was that all profits get competed away and then some.

Many moats in China are weaker than in the West and in some cases non-existent. For example, market shares in payment, rideshare, food delivery, and online travel agency have proven far more fluid in China than in the West despite these businesses supposedly being protected by network effects. In practice, new entrants have overcome network effects by subsidizing one or both sides of the network. Meituan was able to overtake Ctrip in hotel bookings. In the West, ByteDance is attempting to overcome the network effects in social media through massive investment in subscriber acquisition for its app TikTok.

In the rare instances where competition does not do the job of competing away extraordinary profits, the government is quick to regulate. For example, it introduced a central clearinghouse for online payments and raised the reserve fund ratio for 3rd party payment platforms to 100%, both with the explicit aim of reining in Tencent and Alibaba. To be clear, I think this is the right thing to do as it is great for society. The take rates on digital payments are many times higher in the West, a fact that benefits a handful of banks and payment networks, whilst penalising tens of millions of merchants. However, the proactive approach to regulation makes an already difficult task of finding great investment opportunities even more challenging.

The Google of China?

When I first started analysing Chinese companies, I was cognisant that I was at a disadvantage vs local investors but thought it may be partially offset by my greater familiarity with Western businesses, especially in the Internet sector. As such, my Baidu analysis leaned heavily on my knowledge of Google. With the benefit of hindsight, this was a mistake. The Chinese economy is sufficiently different that superficial similarities to the West are as likely to hinder as to help any analysis. Baidu was not "the Google of China". If by "the Google of China," you mean "the gateway to the Internet," Tencent is the better candidate, although its business (gaming and messaging) is completely different to Google's. Similarly, the "Amazon of China" – i.e. the dominant e-commerce player – turned out to be Alibaba, not JD, even though JD's large first party business and tight control of the supply chain bears greater resemblance to Amazon's business model. Interestingly, Amazon seems to be gravitating towards a marketplace and advertising business model in retail – just like Alibaba. It would be perhaps fairer to describe Amazon as the "Alibaba of the West".

Innovative

Chinese companies are incredibly innovative. I think this point is worth emphasising as there is perhaps a misperception in the West that Chinese companies are less innovative and more imitative. In the Internet sector, which I am most familiar with, but most likely elsewhere too, nothing could be further from the truth. For example, mobile payments have been ubiquitous in China for some time. WhatsApp, by contrast, will offer mobile payments to "most of its users within a year" according to Mark Zuckerberg on Facebook's Q2 2019 earnings call.

In "AI Superpowers," Kai-Fu Lee explains that whilst many Chinese companies start out as clones of US Internet companies, the intense competition this engenders – he likens it to a "coliseum where hundreds of internet gladiators fight to the death" - fosters rapid innovation:

"But it was precisely this widespread cloning – the onslaught of thousands of mimicking competitors – that forced companies to innovate. Survival in the internet coliseum required relentlessly iterating products, controlling costs, executing flawlessly, generating positive PR, raising money at exaggerated valuations and seeking ways to build a robust business "moat" to keep the copycats out"

Meituan is highlighted in the book as an exemplar of this phenomenon. It started out as a Groupon clone and then branched out into all kinds of services including food delivery and travel bookings.

Chinese companies benefit from broad societal and governmental support for innovation. When I first started following tech companies in Silicon Valley, there was a similar sense of optimism about technology's ability to improve the world, but now it seems to have dissipated. Instead, the focus is almost exclusively on the potential downsides from any new technology. Facebook's announcement that it plans to launch Libra, a cryptocurrency, was met with near universal opprobrium even though payments are far from a solved problem in the West, especially for cross border money transfers.

The contrast in China could not be starker. I visited Sensetime, a Chinese leader in facial recognition. Its enthusiasm was almost endearing in its naivety given how problematic the technology is considered in the West. As we entered their offices, they proudly pointed out hundreds of cameras which were tracking us. One application claimed to be able to discern how happy you are. I did not score very highly, even though I was quite enjoying the tour, but, hey, who am I to know what I am feeling?

Facial recognition is a controversial subject where even techno-optimists in the West feel a certain queasiness. However, not all use cases are negative. Sensetime told us how its cameras helped locate a kidnapped child. I have no strong view on the technology. My point is that a society that dismisses technology *a priori* rather than carefully weighing the advantages against the disadvantages is destined to fall behind. Incidentally, the country where this risk is most acute is, in my opinion, Germany. New technologies are met with broad-based scepticism and the default regulatory response is to ban them.

A window into the future?

Chinese companies offer a window into the future given the faster pace of iteration and hence innovation. This alone makes them worthy of study.

When I first came across Tencent, I struggled to understand its business model as a large part of its revenues then (as now) came from in-game purchases of virtual items. It made no sense to me why anyone would pay real money for virtual jewellery. Fast forward five years and I observe my children enthusiastically purchasing "skins" and "dances" with their pocket money. The reason is now clear to me – they wish to signal credibility to other game participants in the same way that someone from my generation may want to walk into a party wearing a Rolex. I wish I had understood this better five years ago.

Insights can be gleaned from the study of Chinese companies with broader applicability beyond China. However, in the same way that not everything that happens in the West has applicability to China, I suspect the reverse is true also. As a Facebook shareholder, I hoped that WhatsApp would develop the multiple use cases of WeChat, but so far this has not materialised.

Variable Interest Entities

One aspect of investing in China that has bugged me since my first visit to China is Variable Interest Entities ("VIEs"). In industries that the Chinese government deems sensitive (which as far as I can judge is all industries), you do not invest directly in the Chinese company but in the ADRs of an offshore company that has a contract with it. Ownership of the onshore Chinese company remains with Chinese citizens (usually the founders), but contracts confer rights, including to the company's cash flow, to the offshore entity. The structure is elegant in that it squares the apparent circle of China's insistence on local ownership, Chinese companies' need for capital and foreign expertise, and overseas investors' desire to profit from the growth in Chinese companies' earnings.

The structure has always struck me as fragile, especially in a country where property rights are not particularly robust. Furthermore, it puzzles me that the Chinese government is seemingly unbothered that vast swathes of its economy (including all its Internet champions) are majority "owned" by foreigners when even a small acquisition by a Chinese company in Europe triggers handwringing and headlines in European capitals.

As such, I have taken every opportunity to ask Chinese officials and investors whether they think the VIE structure is sustainable. Oddly enough, my question is always met with a blank look. It struck me as odd that something I viewed as the elephant in the room was not even on their radar screens. During the last trip, it dawned on me why.

The VIE structure is incredibly favourable from a Chinese perspective. Control of the companies remains in China. The contractual right to cashflow is mainly theoretical as most companies reinvest most of their earnings (which makes sense given the opportunities for growth). Finally, it aligns with the government's legitimate aim to foster a competitive and vigorous economy that the costs of said competition are borne in part by foreign capital whilst the benefits accrue exclusively to its citizens. Why would China ever do anything to risk the VIE structure when anything that superseded it could only possibly be less favourable?

Hence the blank looks.

It will be interesting to see what happens when the economy matures, is less reliant on foreign expertise and capital, and companies enter capital return mode. What will China make of Tencent paying tens of billions of dollars to the South African Naspers when it runs out of places to put its cash? We will most likely not find out for a long time as it will be many years or decades before this happens.

By then, China will be a different place than today, where, if things go to plan, the legal system will be more robust, and China will have large interests in companies overseas and hence an interest in the reciprocal recognition of ownership rights. In the meantime, I can see no benefit to China from delegitimising the VIE structure. Foreign investors will certainly not. As such, the VIE structure strikes me as highly sustainable. It has persisted Sina's IPO in 2000, so this conclusion is perhaps not all that surprising.

<u>The humbling experience of investing in China so far</u>

To summarise, my investing experience in China so far has been humbling: I made one investment, which whilst working out well financially, was based on a faulty initial analysis. I overestimated the durability of the business models I encountered. Competition proved to be far more intense than I imagined, and, where it was not, there was sometimes government intervention. Finally, any informational advantage from my business experience in the West turned out to be illusory.

At this point, you are probably expecting me to announce a graceful retreat (ahem, capitulation) from China. In fact, it is my firm intention to plough on. Despite the above, I see several points that give me encouragement.

It is completely clear to me that the Chinese economy will catch up with and then overtake the US economy and become the largest in the world. The question is not if, but when. Furthermore, I believe the Business Owner fund's strategy of seeking out passionate and engaged business owners is as applicable to China as anywhere else. In fact, China should prove to be a particularly fertile hunting ground given the epidemic of entrepreneurship there. The combination of a large and expanding economy with first-class entrepreneurs should provide a forgiving backdrop for even the most mediocre of stock pickers.

Whilst I did not cover myself in glory with my Baidu investment, the decision to sell was a good one and was several years ahead of a broader recognition of the challenges that the company faces. Analysing Chinese companies is not an entirely hopeless endeavour for a generalist.

I have been able to build up a broad network of likeminded investors in China. The information I have received from my fellow investors has always been thoughtful and well-intended. As early as my first trip, the locals flagged to me the poor search quality at Baidu and a small but promising app by Tencent, called Weixin. Any mistakes I made have not been due to the quality of information I received, but my failure to act upon it.

Above all, what appeals to me about China is how <u>little</u> I understand it despite having made multiple visits. The prospect of a huge and profitable space to learn about is an appealing one.

Given all the above, it is appropriate that the fund's concentration in individual companies is lower in China than elsewhere. I am also keen to invest across several different industries to gain exposure to different sectors. Fundamentally though, I am optimistic about the opportunities and look forward to being able to report on a few investments in the coming years.

2020 Investor Meeting in Engelberg

I look forward to welcoming you to my Investor and Emerging Manager Meeting in Engelberg on 18-19 January 2020. I am happy to report that Piet Mouton, the CEO of PSG Group, our South African holding, will join us this year. Investors in the fund can register to attend at any time. Non-investors are also welcome, but as demand to attend tends to outstrip supply, tickets are allocated on a first-come, first-served basis. I will send out details of how to register in the coming weeks, so please do not reach out directly to me. If you who cannot make it to Engelberg, do not despair! There will be a live stream on my YouTube channel. I heard the criticism of the audio quality last year and promise an improvement next year.

I wish everyone a great rest of the year and look forward to reporting on the progress of our fund early next year.

Yours sincerely

Rob

Robert Vinall