

DORSEY ASSET MANAGEMENT

Competitive Advantage & Capital Allocation

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Introduction

Pat Dorsey, CFA

- Founder, Dorsey Asset Management
- Former Director of Equity Research at Morningstar

Dorsey Asset Management

- Launched in 2014
- Concentrated (10-15 positions) global equity strategy
- Focused on owning competitively-advantaged businesses with reinvestment potential, managed by strong capital allocators
- ~\$250m AUM, four research professionals + CFO



ECONOMIC
MOATS



RUNWAYS FOR
REINVESTMENT



SUPERIOR CAPITAL
ALLOCATION

Today's Topic

Critically evaluating the durability of competitive advantage and how capital allocation affects shareholder value can create a variant perception when selecting equities for long holding periods.

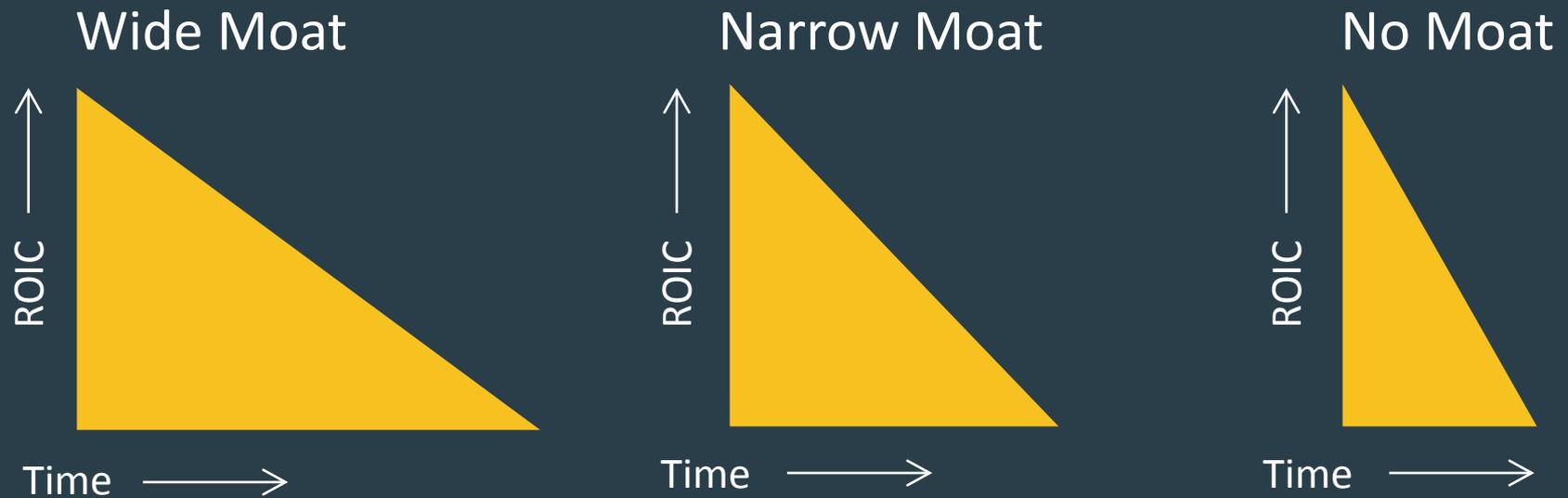
Beating the Odds

- Capitalism works: High profits attract competition.
- But, a small minority of companies enjoy many years of high returns on capital.
- How? By creating structural competitive advantages, or economic moats.



Why Moats Matter

- An extended period of excess ROIC increases business value by lengthening the period during which capital can be reinvested at a high NPV.



Types of Competitive Advantage

- Intangible Assets (Brands, Patents, Licenses)
- Switching Costs
- Network Effects
- Cost Advantages

Intangible Assets

Brands

- Lower search costs (Budweiser, Tide, Maggi)
- Create positional value (Rolex, Cartier)
- Confer legitimacy (Moody's, Nielsen, Gartner)

Patents

- Legal monopolies (ARM Holdings, pharma)

Licenses / Approvals

- Legal oligopoly vs. regulatory fiat

Note on Brand Vulnerability

Positional and legitimacy brands are based on strong social consensus. (TIF, MCO)

Low-search-cost brands are more vulnerable.

- Challenger brands do not require a change in social consensus to deliver full value to new users.
- Fragmentation of mass media has dramatically lowered the cost of reaching a mass market.
- Dollar Shave & craft beer vs. Moody's & Nielsen

Switching Costs

Costs more for user to switch to competitor than it does to remain with incumbent.

- Costs come in many forms — money, time, risk — and may be explicit or implicit.

Examples:

- Products that are tightly integrated with customer business processes (Oracle, SimCorp, Autodesk)
- Products with high benefit/cost ratios (Chr. Hansen, Amazon, Moody's, Abcam)

Network Effects

Provide a product or service that increases in value as number of users expands.

- (Visa, Rightmove, CME)

Network effects are maintained by:

- Subsidizing one side of the network (Adobe, Uber)
- Driving engagement (Facebook)

Network effects are at risk if:

- Pricing power is abused (Bloomberg)
- The user experience degrades (MySpace, Orkut)

Cost Advantages

Process: Create a cheaper way to deliver a product that can't be replicated easily.

- Inditex, GEICO, Dell, Southwest, Admiral PLC

Scale: Spread fixed costs over a large base. *Relative size matters more than absolute size.*

- RyanAir, Costco, Amazon, Cimpres

Niche: Dominate industries with high minimum efficient scale relative to TAM.

- Constellation Software, Wabtec, Spirax-Sarco

What's Not a Moat

Dominant Market Share

- High absolute market share. (GM, Dell)

Technology

- Commoditization & disruption are inevitable absent customer lock-in. (GoPro, Fitbit)

Hot Products

- Can generate high returns for a short period of time, but sustainable returns make a moat.

Moats & Management

What will widen the company's moat?

- *The answer should drive management's strategy.*
- Amazon: Improve the customer experience.
- Costco: Share scale economies.
- Uber: Increase vehicle liquidity.
- Howden Joinery: Solve a builder's problems.
- Facebook: Drive user engagement.

Capital Allocation

- Capital allocation is the link between business value and shareholder value
- If capital is deployed in ways that destroy value, shareholders do not fully benefit from increased business value. *Value is vaporized.*
- If capital is deployed in ways that amplify value, shareholders benefit from both increased business value and from value-accretive actions. *Value compounds.*

Capital Allocation: Basics

- Internal growth is not normatively good.
- Dividends can destroy value, if funded poorly or if paid out in lieu of investing at a high NPV.
- Repurchases are value destructive if executed above intrinsic value.
- M&A is usually a destructive use of capital...but there is a right tail of companies that have built huge value this way.

Growth: Invest if you can

If a company has high-ROIC internal opportunities, it should reinvest heavily.

- “When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we’ll take the latter.” (Jeff Bezos, 1997)



Growth: If you can't...don't try

Maturing companies usually continue to invest despite declining returns on capital.

- Aging is tough for companies as well as people.
- Cisco, MCD, Home Depot, Starbucks...

Phebe Novakovic's first earnings call at GD:

- Q: *"...I guess the question is about the parts of the business where you don't have growth? What do you do with those?"*
- A: *"Well, then you're going to drive earnings and cash, aren't you? There is no point in chasing revenue or pretending that you are in a growth market when you are not."*

Returning Capital

Dividends are not an admission of defeat...they are a declaration of victory!

- *“We’re a growth company.”*

Hoarding cash is pilloried in the U.S., but it has an evil twin in Europe & Oz: The Dividend Fetish

- Dividends are not normatively good if funded poorly or if they represent a large opportunity cost
- *“Because shareholders expect it.”*

Returning Capital

Buybacks are an active use of valuable capital, not a passive tool for mollifying shareholders.

- Buybacks should always be driven by an objective assessment of intrinsic value.
- *“We don’t have an opinion about the value of our shares.”*

What About M&A?

M&A is not a substitute for growth → “Defensive” deals are a recipe for disaster.

- Microsoft/aQuantive: \$7b set on fire
- Microsoft/Nokia: \$8b flushed down the toilet
- Cisco/Flip: \$600m destroyed
- Mattel/The Learning Company: \$2b kaput
- H-P/Autonomy: \$18b kissed goodbye

The bigger the deal & the less similarity between buyer and target → the more likely \$\$ will be torched

High ROI M&A

If M&A is to have even a faint hope of creating value, it must be a central part of strategy.

- Successful M&A requires a *disciplined process that is iterated and measured.*
 - Constellation Software
 - Lifco AB
 - Roper
 - Assa Abloy AB
 - DCC PLC
 - Danaher
 - Diploma PLC
 - Halma PLC

Assessing Capital Allocation

Look at the past 10-15 years of financials

- Has the share count increased or decreased? When did large changes happen? Why?
- Look at the CF statement for evidence of M&A.
 - *How much was paid?*
 - *What was the result?*
- Did the company simultaneously pay a dividend and tap capital markets?
- If ROIC has declined, is capital being returned?
- Does M&A serve strategic goals, or does it paper over strategic failures?

Assessing Capital Allocation

Read the current AR, MD&A, and the proxy.

- Is capital allocation discussed explicitly and rationally?
- Are words consistent with actions?
- Are actions & words consistent over time?
- What are the CEO's incentives? How does she get paid? Is there any ROI component?
- Is M&A included in compensation targets?
- Managers who are paid handsomely to misallocate capital will do so. *Incentives matter.*

Discussing Capital Allocation

- What is your process? Who is responsible for capital allocation? What is the hurdle rate? How is success or failure gauged? What's been your biggest error?
- How is the process measured? ROCE? ROIC? If ROI, what is included in the denominator? What was the ROI on past deployments of capital?
- What have you learned over time? What did you think would happen? What did happen? What did you learn? Should the process change?

Summing Up

- Competitive advantage drives the duration of excess ROIC, which increases long-term business value.
- Capital allocation links shareholder value and business value, amplifying or reducing equity returns.
- Superb capital allocation can compensate for a lack of competitive advantage. (Buffett's textile mill).
- A massive moat can compensate for poor capital allocation (Ballmer's blowtorch).

Summing Up

The outputs of capital allocation & competitive advantage may be quantitative, but the inputs require qualitative evaluation.

- You can't screen for switching costs – you have to talk to customers and understand the value proposition.
- You can't assume high market share equates to a cost advantage – you have to unpack the unit economics.
- You can't trust that management will allocate capital rationally – you have to gather supporting evidence.

Turn Off Your Laptops

*“All of the information is in the past,
but all of the value is in the future.”*

Quantitative data is often
priced efficiently

Qualitative insight is less
efficiently priced

$$\begin{aligned}
 \overline{\int_0^T f(x) dx} &= \lim_{n \rightarrow \infty} \overline{A(f, n)} = \lim_{n \rightarrow \infty} \frac{b-a}{n} \sum_{k=1}^n (\overline{f}_k) = \lim_{n \rightarrow \infty} \frac{1}{n} \sum_{k=1}^n x_{k+1} \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \sum_{k=1}^n \left(1 + \frac{k+1}{n} \right) = \lim_{n \rightarrow \infty} \frac{1}{n} \left[\sum_{k=1}^n 1 + \frac{1}{n} \sum_{k=1}^n (k+1) \right] \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[\sum_{k=1}^n 1 + \frac{1}{n} \left(\sum_{k=1}^n k + \sum_{k=1}^n 1 \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \frac{1}{n} \left(\frac{1}{2} n(n+1) + n \right) \right] \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \left(\frac{1}{2} (n+1) + 1 \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \left(\frac{n+1+2}{2} \right) \right] \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[\frac{2n}{2} + \left(\frac{n+1+2}{2} \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[\frac{3}{2} n \right] = \frac{3}{2}
 \end{aligned}$$



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Thank You

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