Going Global: Moats & Macro

Introductions

- Pat Dorsey, CFA
  - Founder, Dorsey Asset Management
  - Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform.
  - Author of *The Five Rules for Successful Stock Investing*, and *The Little Book that Builds Wealth*.

- Dorsey Asset Management
  - Single strategy, separately managed accounts
  - Long-only, all-cap, global mandate
  - Concentrated in 10-15 stocks

What We Look For



We focus on moats, management, and compounding potential because all three are sources of perpetual inefficiency.

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Finding Inefficiency

"All of the information is in the past,
but all of the value is in the future."

<u>Quantitative data</u> is efficiently priced

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

<u>Qualitative insight</u> is less efficiently priced

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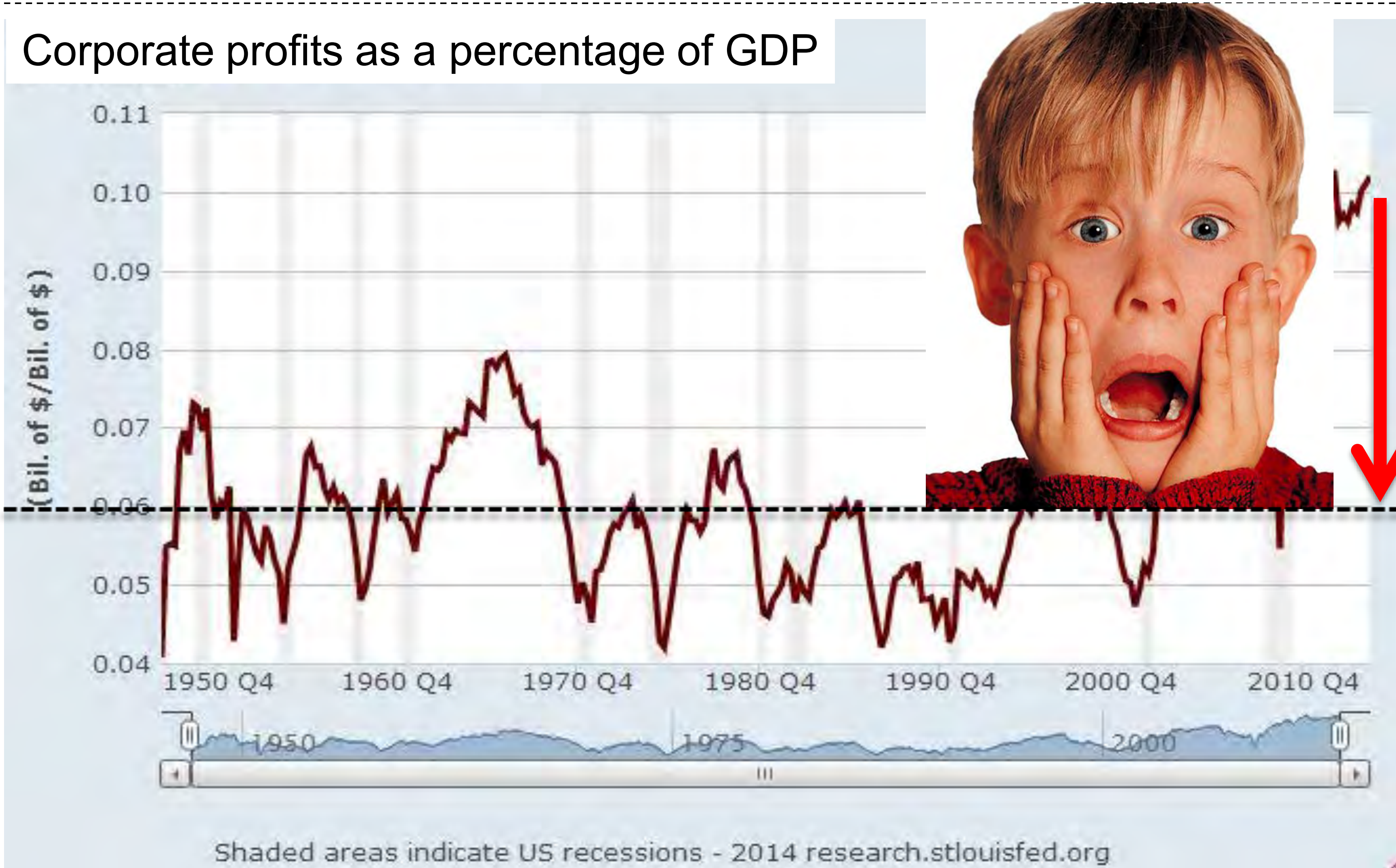
Agenda

- One Thought on Macro
  - The Great Margin Debate

- More Than One Thought on Moats
  - What's a Moat?
  - Management & Moats
  - Building Moats with Capital Allocators
  - Moats in a Global Context
  - Valuing Moats
  - Some Moaty Ideas

The Great Margin Debate



*For illustrative purposes only

But Consider That…

- The U.S. has changed since the 1950s.
  - Mining & farming were 10% of GDP, now 1%.
  - Manufacturing was 27%, now 10%.
    - Lower-margin manufacturing is done offshore.
  - Professional Svcs & Info were 6%, now 17%.

- Non-U.S. profits up from 7% to 40% of total.

- When a dataset has changed so radically, <u>mean-reversion is meaningless.</u>

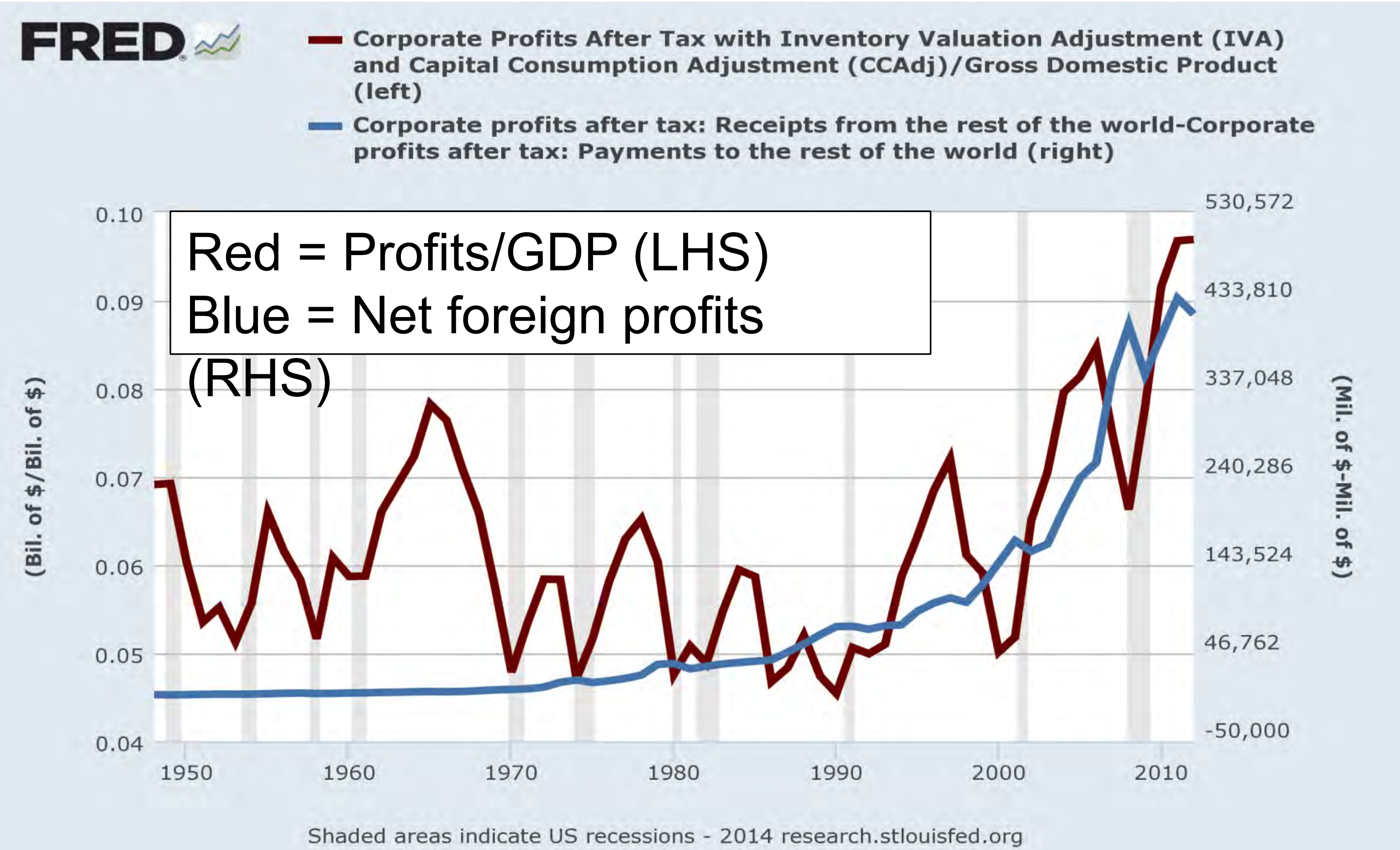
Not a Good Analytical Approach

See the Change, Do the Math

- <u>It is different this time</u>
  - Why shouldn't U.S. margins creep up over time as the economy changes composition, and as lower margin activities move offshore?
  - Who's predicting a renaissance in U.S steel?

- <u>Bad math</u>
  - Income earned abroad is in numerator (profits)
  - But costs are not in denominator (GDP)
  - Should we be shocked that the percentage rises?

Not A Coincidence



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From Macro to Moats

- An <u>economic moat</u> is a structural competitive advantage that helps insulate a company from competition.
- Absent a moat, competition pressures ROICs.
  - Capitalism is funny that way.

Intangible Assets

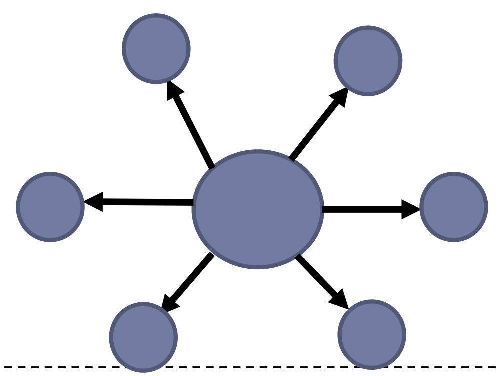
- Brands
  - Increase willingness to pay / lower search costs.
    - LVMH, Tiffany, Amazon, Coca Cola Içecek, Calbee
- Patents
  - Legal monopoly vs. expiry/challenge/piracy
    - Novo Nordisk, Chr. Hansen, ARM Holdings
- Licenses/Approvals
  - Legal oligopoly vs. regulatory fiat
    - Casinos, some financial exchanges, aircraft parts
    - Often highly dependent on local regulatory framework

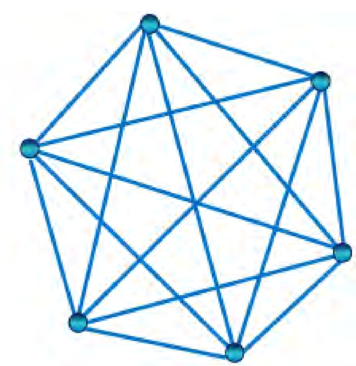
Switching Costs

- Does the cost of switching to a competing product or service outweigh the benefits?
  - Integrate with customer's business: Upfront costs of implementation = payback from renewals
    - Praxair, Silverlake Axis, MTU Aero
  - Sell ongoing service relationships
    - Rolls Royce, Oracle, Kone
  - Provide a product with a high benefit/cost ratio
    - Fastenal, Ecolab, Novozymes, Symrise, Fenner

Network Effect

- Provide a service that increases in value as the number of users expands.
  - Aggregate demand b/t fragmented parties.
    - Edenred, Henry Schein, XPO Logistics
  - Benefit from non-linear relationship between network nodes and network connections.
    - Visa, Mastercard, Facebook
  - Radial vs. Interactive Networks





Cost Advantages

- Process: Invent a better way of delivering a good/service that rivals can't replicate.
  - CDW, Inditex, Southwest, Dell

- Scale: Spread fixed costs over a large revenue base. Relative size generally matters more than absolute size.
  - UPS, Aggreko, Howden, Stericycle

Management & Moats

- “Good jockeys will do well on good horses, but not on broken-down nags.” (Buffett)
- Curly wins this race

Jockeys & Horses

- Managers matter -- <u>in context of the moat.</u>
  - The required minimum level of managerial skill is inversely related to the quality of the business.
  - Bad business? Better have a great manager.
  - Great business? Genius not needed.

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Exceptional Jockeys

Of course, great capital allocators can <u>create</u> moats from humble beginnings – Buffett started with an ailing textile mill.

Moats & Capital Allocators

- Truly exceptional individuals can create moats via insanely great capital allocation.
  - John Malone, Bill Stiritz, the Rales brothers, Brian Joffe, Li Ka-Shing, Selim Bassoul, Brad Jacobs, Bruce Flatt, etc.

- Managers like these are rare enough that most investors doubt their success.
  - "He/she will run out of targets."
  - "We don't forecast acquisitions."
  - "Oh, that's just a roll-up."
  - "What if they mess up an acquisition?"

Moats & Capital Allocators

- The result is a rich and sustainable source of market inefficiency.
  - Unpredictable -- Impossible for the sell-side to model.
  - Unconventional -- Creating value via acquisitions when most companies destroy value.
  - Lumpy – Value creation is financially messy, and comes in spurts rather than a smooth line.
  - Patient – Not focused on meeting short-term projections.

- Structurally lowballed market expectations create enormous opportunity.

Moats & Capital Allocators

- What's the Catch?
  - The managers are hard to find.
  - You have to do a ton of work to gain comfort.
  - False positives abound.
  - The stocks <u>never</u> look cheap.
  - Clients will doubt your sanity and work ethic.

Moats & Capital Allocators

Moats in a Global Context

- Lots of opportunity
  - About 60% of global market cap is outside U.S.
  - Over 70% of stocks >$1b mkt cap are ex-U.S.
- Local differences create moats.
  - Canadian banks, Washtec, S.A. retailers
- Analysis is often geographically limited.
  - Non-local competitors often not considered.

Moats in a Global Context

- Same biases in U.S. exist globally.
  - Index constituents & i-banking clients get love.
  - Capital allocators and one-offs are ignored.
- Complexity creates opportunity.
  - Cross-border listings, mis-matches between domiciles & revenue sources, holdco structures, different share classes.

Valuing Moats

- The value of an economic moat is largely dependent on reinvestment opportunities.

- The ability to reinvest tons of cash at a high incremental ROIC = a <u>very</u> valuable moat.
  - Fastenal, Amazon, XPO, Curro

- If a firm has limited ability to reinvest, the moat adds little to intrinsic value.
  - McCormick, Microsoft, Oracle

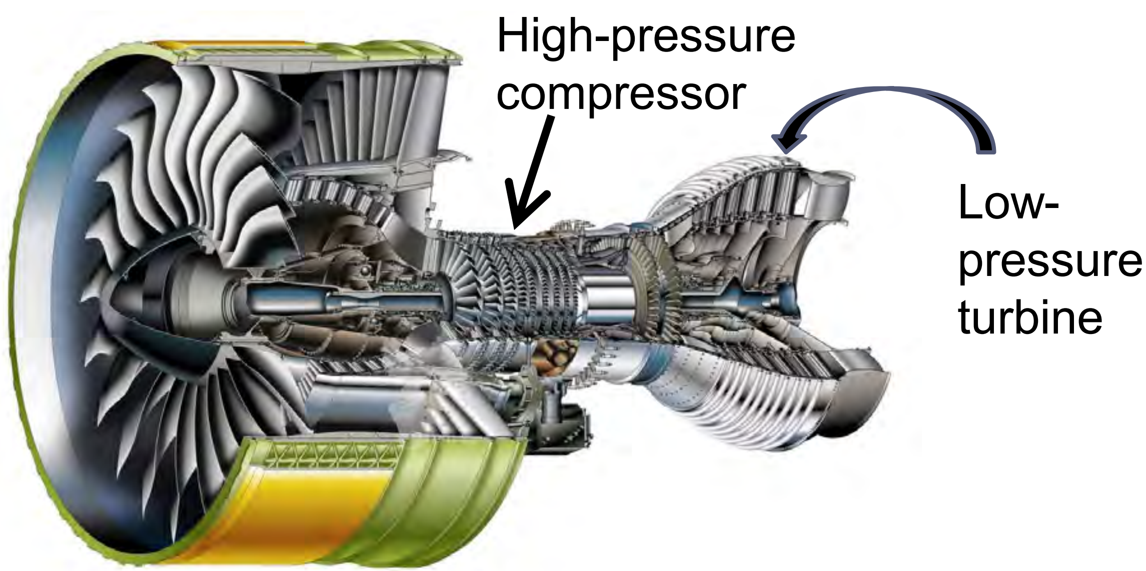
Valuing Moats

- In evaluating moats, <u>maximize</u> margin of safety while <u>minimizing</u> opportunity cost.
  - Most investors spend lots of time on margin of safety, and little on opportunity cost.

 *Past performance is not an indicative of future results.

Moaty Idea #1: MTU Aero

- Supplier of turbine (jet) engine modules, largest independent engine MRO provider.
  - 75% of EBIT from engines, 25% from MRO
  - EV=€3.9b, TTM EBIT=€320m, TTM FCF= (€35m)



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MTU Aero

- Business model: Secure "program share" on engine platform, sell modules @ negative margin, earn high margin on aftermarket.

- Moat: LT commercial agreements, onerous certifications, technical capacity.

- Opportunity: Strong new engine deliveries + declining spares sales = pressure on margins & working capital.

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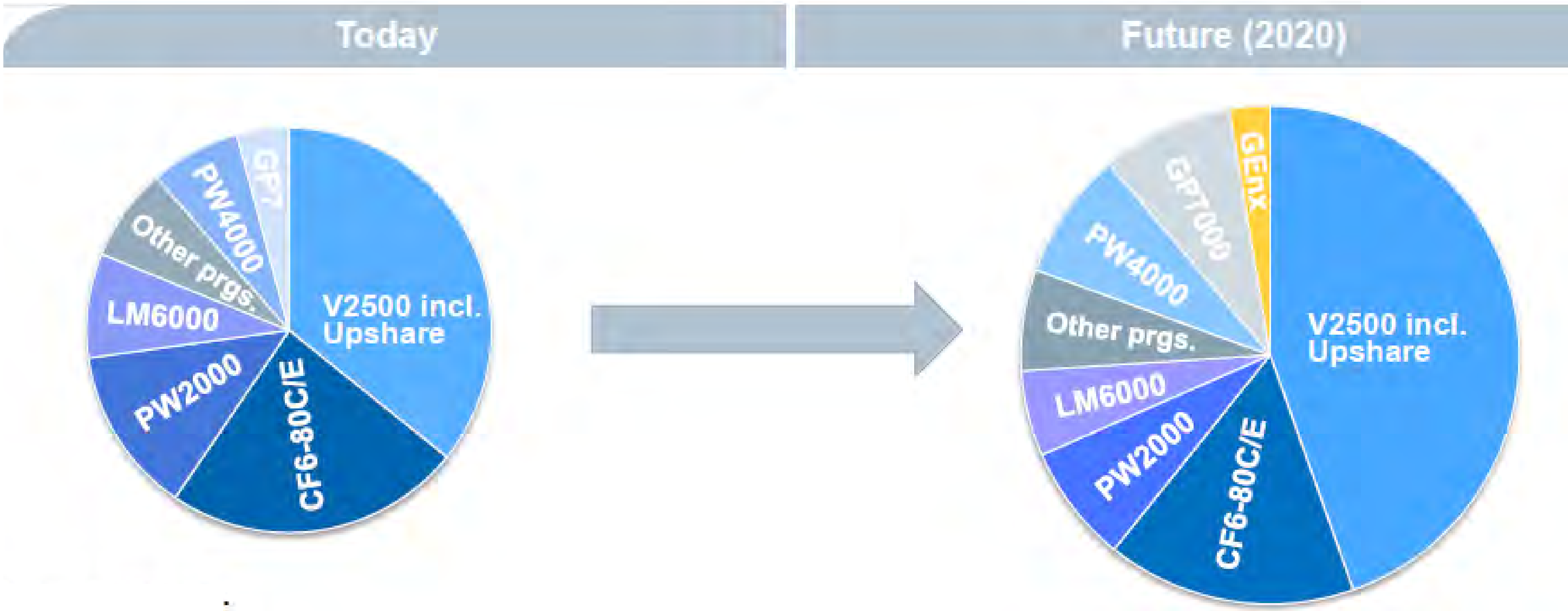
MTU Aero Engine Programs

Engine	Est. % of 2013 spares mix	Est. % of 2020 spares mix	MTU Program Share	Major Aircraft
V2500	40%	50%+	16%	A320
CF6	23%	15%	9.1%	B747, B767, A330
PW2000	16%	5%	21.2%	B757, C-17
PW4000	9%	6%	12.5%	B777
PW6000	4%	2%	18%	A318
GEnx	0%	3%	6.6%	B787
GP7000	0%	5%	22.5%	A380
PW1000	0%	0%	18%	A320neo, Bombardier C-series, Embraer E-jets

MTU Aero Spares Mix Shift



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MTU is Ready for Takeoff

- V2500 is entering "sweet spot" for shop visits, revenue should double by 2017.
  - Fleet average age = ~8 years
  - Huge installed base (4,800 engines)
- Lean program reducing capital needs.
- MRO gaining share from non-OEMs.
- LT opportunity from geared turbo fan.
- We estimate that by 2017-2018, FCF=€300m, EBIT=500m.
  - Fair value =~ €95/share

Moaty Idea #2: Aggreko

- Largest global supplier of temporary power.

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Aggreko Basics

- Moat: Size (4x fleet than closest competitor) and scope (200 locations in 47 countries).
  - Leads to capital cost/MW advantage of ~30%
  - Enables in-house design, manufacturing, R&D
  - Allows fleet to be deployed across geographies

- Opportunity: Weak power projects revenue + irrational competition + CEO departure = depressed share price.

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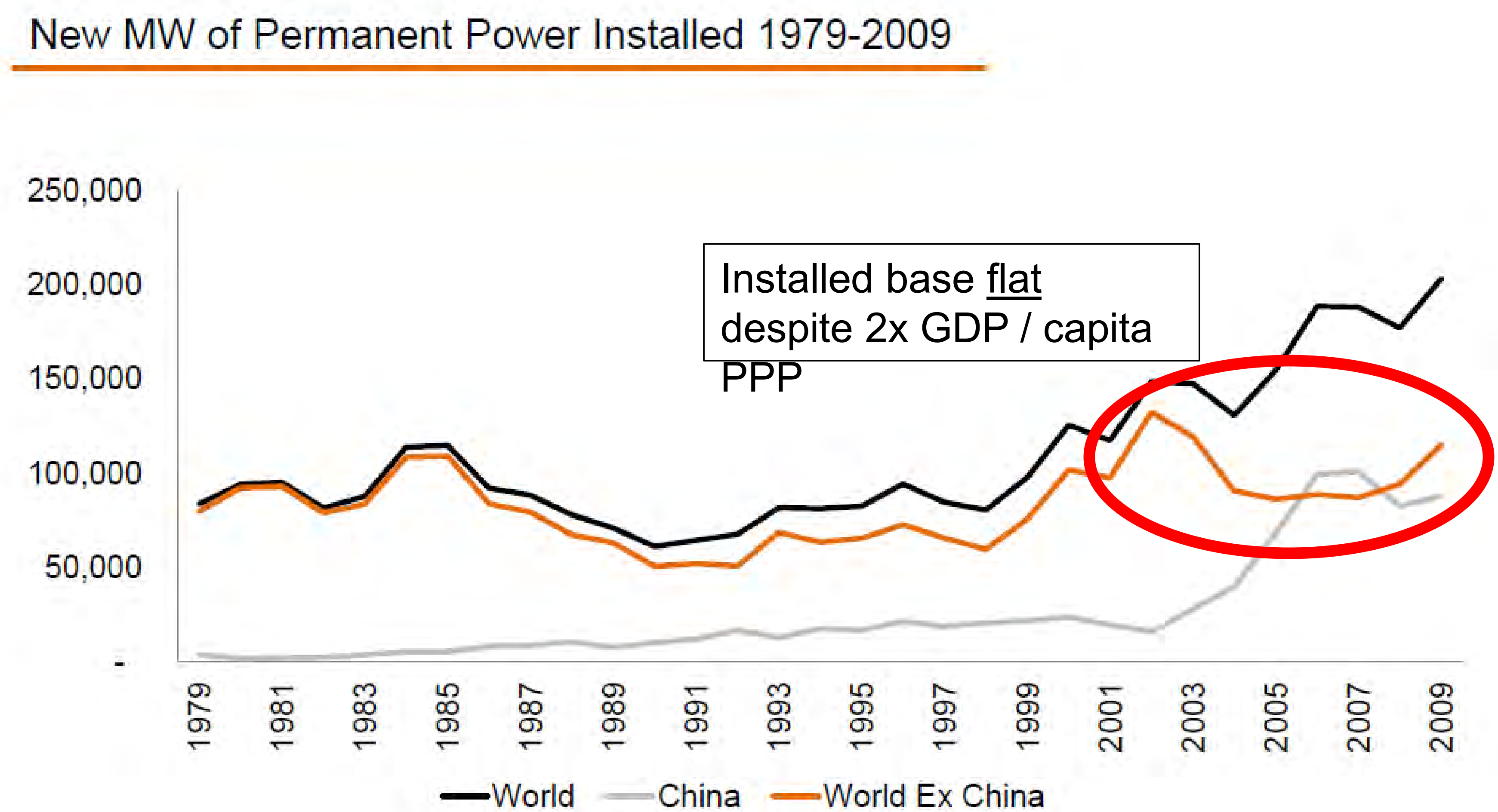
Supply & Demand



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Aggreko Shares Can Power Ahead

- Assumptions:
  - Local: 9% revenue growth @ 18% margin
    - (Local grew 15% CAGR past decade.)
  - Power Projects: 9% sales growth @ 30% margin
    - (PP grew 26% CAGR over past decade.)
  - Result = £525m EBIT in 2017, ~ £21 fair value.

- Risks:
  - Competitive threat larger than expected
  - Lower PP growth (mitigation or econ slump)

Thank You

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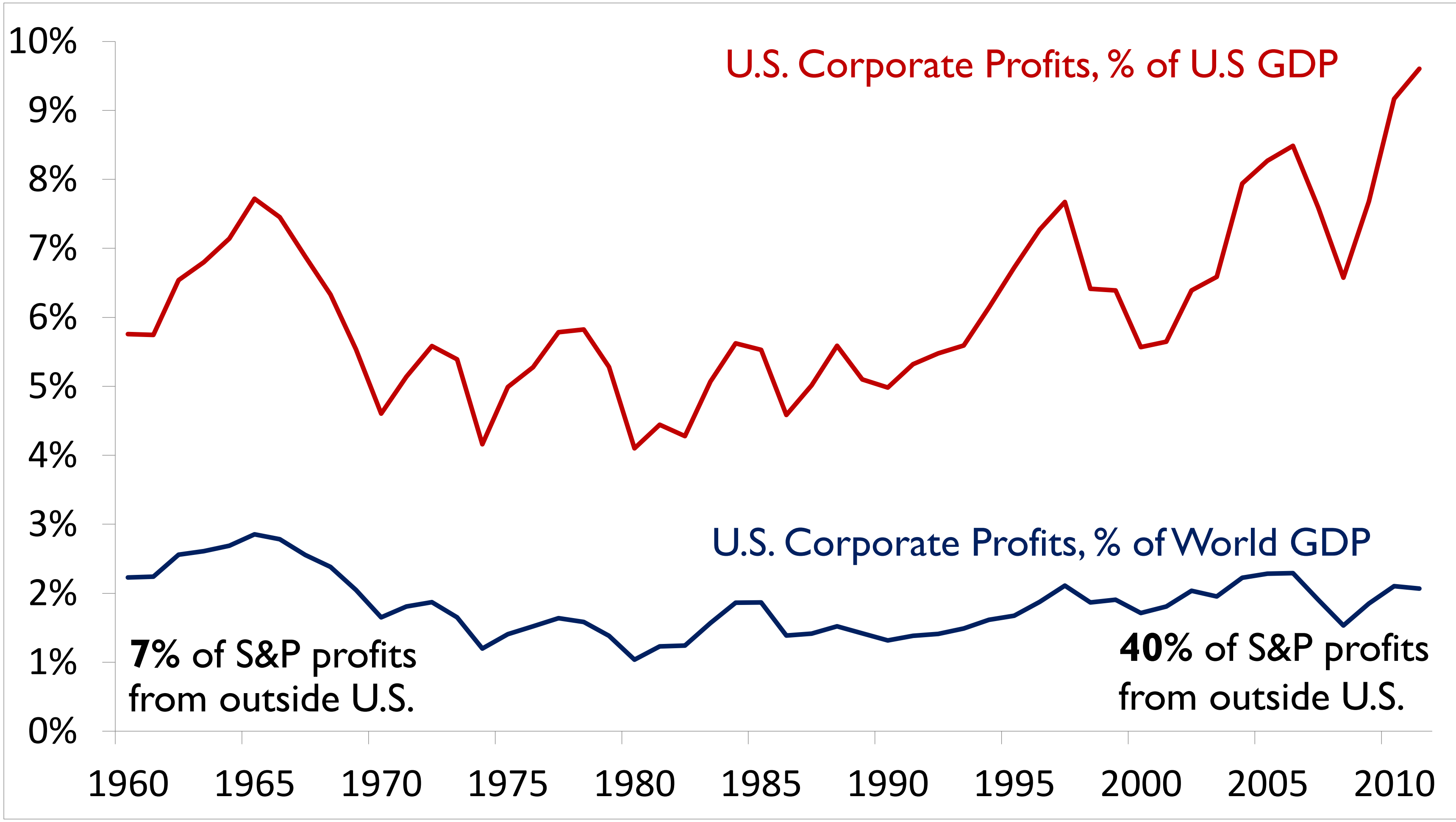
Globalization, Anyone?



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