



Overview

- ❖ Introducing the Mid-Large Cap Value Strategy
- ❖ Switching Costs (pt. 2): Platform Specialty Products

April 12, 2017

Dear Starvine Capital Client:

In Q1 2017, accounts open and fully invested in the Starvine Strategy since the beginning of the quarter increased 8.1% to 8.2%. During the quarter, the S&P TSX Total Return Index increased 2.4%, while the S&P 500 Total Return Index increased 5.1% in Canadian dollars (6.1% in USD). Unlike last quarter, the US dollar weakened slightly versus the Canadian dollar, thereby serving as a minor detractor on performance. The strategy again benefitted from a general rise in equities. Also, a few of the larger holdings jumped on the back of positive earnings reports. There were no significant changes to the portfolio, except for the sale of CRH Medical. Over the past year, CRH's price increased from a conservative level (12% cash flow yield) to a point where I believe a lot of future growth was imputed in the valuation. I still believe CRH is an excellent company with an incredibly disciplined management team. Although in hindsight I sold out early, the price increased by more than 120% over a span of 15 months, whereas my expectation was that four years would be required to realize such a result. I look forward to owning it again when the earnings power catches up with the price, or if the price corrects meaningfully so as to restore the return potential.

Near the end of Q1, a new strategy was incepted within the Starvine platform in order to meet a broader range of investment objectives. I have decided to label this strategy (uncreatively for now) as the "Mid-Large Cap Value Strategy". Its characteristics are a little more defensive relative to the flagship Starvine strategy, given

- Higher Canadian content: 64% in Canadian listed companies vs. 37% in flagship
- Larger weighted-average market cap: \$17.9 billion vs. \$3.7 billion in flagship
- Higher number of holdings: 16 vs. 12 in flagship

Several holdings overlap between the two strategies. In fact, it is fair to view the new strategy as different "spin" of the flagship strategy for individuals who demand more diversification, a higher level of Canadian content, and a stronger preference for large cap companies. Few holdings in either strategy currently pay dividends. I do not eschew dividends, but I do favor management teams and businesses with excellent track records in reinvesting earnings. Unless you really need to siphon money out of your account regularly to spend, why not have the earnings reinvested by management teams with stellar track records of growing their companies? For example, with Brookfield's outstanding track record of reinvesting earnings, would you really want the company to dividend most of its cash flow?

Outlook

My view of the future continues to be positive. As companies in the strategy (now two strategies) follow through with their growth plans, real intrinsic value is being delivered. The flagship strategy is trading at 11.1x cash flow (or at a 9% free cash flow yield) on a weighted average basis, an increase versus the most recent quarter. The lift in the portfolio's trading multiple lagged the increase in market value due to rebalancing actions, namely the sell-down of CRH as it underwent rapid multiple expansion.

While my positivity is driven by thoughts anchored in a bottom-up view, I am not unaware of general market levels or the absence of a serious correction for several years. However, I have always thought it made concrete sense to invest in more ‘knowable’ things. As fuzzy as anyone’s assessment of valuation, earnings power and management quality can be, they are far more knowable than where the overall market is headed, in my opinion. Yes, interest rates will rise, which will in turn pressure valuations. But just remember that great capital allocators will (on average) grow their companies through macro headwinds over time, especially those who operate businesses with sound moats.

Switching Costs: The More the Better

A few quarters ago, the idea of [switching costs](#) was introduced in my investment commentary as a powerful type of moat. CRH Medical and Intuit (owner of Quickbooks), though very different from each other, were cited as specific examples of this phenomenon. Having captive customers, or those who would experience difficulty in switching suppliers, translates into pricing power and typically a high return on tangible capital. The more I reflect on switching costs, the more I desire to find companies embedded with them. It is just so beneficial for an investor’s quality of sleep to own revenue streams that are sticky as crazy glue.

About 50% of the Starvine flagship strategy is invested in B2B (business-to-business) firms, which tend to be a natural breeding ground for switching costs. It is not difficult to see why: most businesses must outsource functions because they involve skills in which the company has limited competency. It happens that these functions are often mission critical.

A key Starvine holding that is abundant in switching costs is Platform Specialty Products. Created by Martin Franklin (of Jarden fame) through a series of acquisitions, this company produces specialty chemicals for a wide range of industrial end-markets (automotive, energy, and consumer electronics) and crop protection.

| Attribute | Platform Specialty |
|--------------------------------|-------------------------------------|
| Mission critical | <input checked="" type="checkbox"/> |
| Low cost-to-benefit | <input checked="" type="checkbox"/> |
| Highly integrated with clients | <input checked="" type="checkbox"/> |
| Return on tangible capital | 33% |

On the industrial side, most products are mission critical for customers, to the point where production lines would shut down without the company’s specialized chemistry. Since the chemicals represent a minute portion of their customers’ overall cost base, there is little incentive to invest significant time to find alternative suppliers. For example, Platform’s products represent only ~\$0.90 per unit for a smartphone manufacturer’s costs. The same dynamic exists with its OEM (Original Equipment Manufacturer) clients in the auto industry, where Platform’s chemicals comprise only ~\$30-50 per unit for a higher end car. Completing the lock-in of business is the high level of integration with customers. I had the pleasure of speaking with Dan Leever, former Platform CEO, at the annual investor day in New York in September 2016. Leever intimated about the longevity of clients, some of which have remained with the company for decades. At the core of the bond are specifications that Platform must satisfy with the OEMs. These specifications – referred to as ‘the holy grail’ by management – require intense collaboration with clients, who then become dependent on the company’s technical service.

The combination of the dynamics above serves to entrench customers. In summary, switching to another supplier would (1) introduce the risk of production downtime if something goes wrong in the transition, (2) not cut overall costs in an impactful way, and (3) require a significant investment in time to ensure the new vendor meets the specifications. These realities are all conducive to deep sleep for the long term investor.

Sector Breakdown

As a result of exiting CRH, cash increased during the quarter and the representation of Healthcare decreased. The Specialty Chemicals category is comprised of one holding, the price of which increased significantly over the past two quarters and has yet to be meaningfully rebalanced.

| <u>Sector</u> | <u>Weight</u> |
|----------------------|----------------------|
| Specialty Chemicals | 15.9% |
| Food | 11.3% |
| Industrials | 10.6% |
| Media/Broadband | 10.4% |
| Technology | 10.3% |
| U.S. Real Estate | 9.8% |
| Energy | 9.7% |
| Business Services | 6.6% |
| Healthcare | 5.8% |
| Cash | 9.6% |

For a value investor who believes most of his holdings are undervalued on an absolute basis, the big question in this environment is whether undervalued stocks can become much more undervalued in the event of a market correction. With close to 10% in cash, the flagship strategy is better positioned to take advantage of a market dip this time around versus the sell-off in January/February 2016. Near-term rebalancing actions could raise the cash level higher. I think it's important to point out that the value of cash is two-pronged; not only does it provide dry powder for adding to existing holdings during times of uncertainty, but occasionally there are compelling, idiosyncratic opportunities that appear regardless of market levels.

Sincerely,

Steven Ko
Portfolio Manager

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