



Overview

- ❖ Outlook: Buying opportunity still persists for bottom-up pickers
- ❖ Switching costs: the most common moat
- ❖ The big money is not in the buying and selling...

July 7, 2016

Dear Starvine Capital Corporation Client:

In Q2 2016, accounts open and fully invested since the beginning of the quarter were relatively flat (-0.50% to -0.63%). During the quarter, the S&P TSX Total Return Index increased 4.74%, while the S&P 500 Total Return Index increased 2.46% (2.15% in Canadian dollars). The Starvine selection process is strictly bottom-up and therefore pays no attention to what is or isn't held in the indexes. As a reminder, "bottom-up" as used here means choosing companies based on their individual merits versus allowing big picture macro analysis to influence decisions. However, it is worth noting that the omission of gold stocks and REITs (real estate investment trusts) from the Starvine strategy accounts for much of the difference in performance relative to the Canadian indexes. Also, accounts dropped ~5% in the last five trading days of the quarter following the referendum that decided the U.K.'s fate in the EU. Several holdings generate a portion of sales in the U.K.; it is these companies whose stock prices were affected most, though I do not think the extent of the sell-off is at all warranted given the overall exposure of the portfolio to the U.K. (~7% using company sales as the basis). In fact, I am not averse to more volatility within the portfolio if it means being able to buy more of something at a discount that is only temporarily available.

Outlook

In hindsight, Brexit was more of a heart palpitation across a few trading days than a sustained sell-off. As recently stated in my memo on Brexit (which was quoted by [MarketWatch](#)), business will carry on just fine in the U.K. and Europe at large for most industries, regardless of uncertainties that may fester in headlines.

Value investors are primarily concerned with finding stocks priced sufficiently below their true weight. In other words, what is a company reasonably worth if we tune out all the noise? The Starvine strategy is trading below 10x cash flow (or at a 10% free cash flow yield); the indexes are certainly more expensive, but by being willing to own out-of-favor companies or those whose issues I deem temporary, I can find decent bargains in quality companies. If the market as a whole is expensive and at some point corrects (i.e. drops significantly), would the Starvine strategy be spared because it is more defensively valued than the indexes? It's hard to say, but as we are talking about equities here, it's likely that most stocks will temporarily fall to some degree.

The opportunities I'm seeing are pretty much the same as last quarter, with the exception of a few new spin-offs that are on the watch list. Companies with emerging markets exposure, healthcare, and/or those that grow via acquisition are still largely out-of-favor. Moreover, the share price performance of small- to mid-sized U.S. companies has significantly lagged large companies since early 2014, as can be seen by comparing the S&P 500 Index (larger companies) versus the Russell 2000 Index (smaller companies). These market trends may be headwinds in the near-term, but I am confident investors with a long time horizon will be rewarded from the strategy's moderate exposure to these areas. It goes without saying that ongoing demographic shifts (e.g. ageing, the rise of emerging market countries) will serve as long term tailwinds to the earnings growth of several companies in the portfolio. I estimate that accounts have 17% exposure to emerging markets, accomplished via U.S. companies whose management teams have excellent track records.

Switching Costs: The Little Man's Moat

Warren Buffett has spoken much of moats, or characteristics that allow a business to enjoy above average profits over a long time period despite the constant threat of competition. As investors, we can sleep better if assured that our companies have characteristics that give them immense sticking power with customers even in the worst of times. Pat Dorsey's 2008 publication, "The Little Book That Builds Wealth", is an excellent piece of work on moats – and accessible to the layman. Dorsey expands on four key moats:

- Intangible assets (things you can't touch like brand power, patents, and licenses)
- Cost advantages (process, scale, low-cost inputs)
- Switching costs (things that make it troublesome to switch to a competitor's product)
- Network effect (when a product's value-add grows in tandem with a growing user base)

Most companies do not have moats, and are thus likely to generate mediocre returns over the long haul. Without barriers to entry, competitors are free to copy or improve on the product and then lower prices to gain share. There is no systematic method I'm aware of to screen for moats, but their presence can be detected by finding companies with a consistently high ROIC, or Return on Invested Capital. ROIC is simply annual profit as a percentage of the money invested in a business – it's a crude gauge of how efficient each dollar of cash is at generating profit. The logic here is that if a business can earn an attractive return on its capital for a long period, it must possess something that is keeping competition at bay.

I think it is correct to generalize that most "strong moat" businesses tend to be large companies. However, switching costs is the one moat that does not seem to discriminate on the size of the business. The beauty of switching costs is that they can be created through ingenuity, and perhaps that is why they are more abundant (in my view) across a wide spectrum of businesses relative to the other moat types. Most of the Starvine strategy is invested in small/mid size (i.e. less than \$5 billion market cap) and switching costs have a strong presence in more than half of the portfolio.

Unless you are a customer of a product or service that is tough to change out of, it can be difficult to identify switching costs from the outside. That's because the essence of this moat is psychological. For example, have you ever thought about changing your cable subscription to another provider? Your first thoughts about doing so will probably be the time and financial burden. The process will likely involve a good 30-45 minutes on the phone while being transferred from rep to rep, and the company will put up a fight by offering concessions. There is also the prospect of financial penalties attached to leaving a bundling package previously entered by agreeing to certain discounts on condition of purchasing broadband, wireless and cable services in one. Suffice it to say if these mechanisms weren't in place to discourage you, the cable business would be less profitable.

Where switching costs carry even more power is in certain business-to-business (BTB) situations. A great example from Dorsey's book that would resonate with business owners is Quickbooks, which is software that small businesses widely use for bookkeeping. Speaking from personal experience, once accustomed to using Quickbooks, the bonds are hard to break. By encouraging the automatic feeding of transaction data from business bank accounts into the software, the accounting of a small business becomes almost seamless. Little manual intervention is needed to balance the books and generate financial statements. Over time, a continuous record of all a business's transactions is formed in one place.

What does all this amount to? Pricing power. If I were to switch to another program, an investment of time would be required to learn how to use the new software. Also, my accounting system is mission critical, so why would I take the risk of changing providers unless absolutely necessary? The risk that something could go awry dampens the incentive to go with a cheaper offering. To top it off, the monthly subscription cost is a small percentage of my total overhead. Hence if Intuit (the owner of Quickbooks) were to raise the fee by 10% or 20%, there's a good chance I will stay a customer without too much thought. Intuit's ROIC is approximately 30%.

Another example is CRH Medical Corporation (a current Starvine holding), a provider of anesthesia services to ambulatory surgical centers (ASC) in the U.S. ASCs are typically owned by doctors, and the anesthesia practice within each ASC is also owned by the same individuals. By selling a partial or entire interest in the anesthesia practice to CRH, the doctors are able to monetize a part of their business. Moreover, having CRH administer the anesthesia practice translates into increased staffing and billing efficiency. Provided CRH performs well in its function, the ASC has no reason to switch providers. In fact, doing so poses operational risk given the high level of integration of CRH into the doctor's business. Furthering the difficulty of switching providers is the fact that CRH's anesthetists are bound by non-compete and non-solicitation agreements; the ASC would therefore need to swap out the entire team in order to change providers. In this scenario, the doctors would need to spend the time integrating the new personnel into the ASC's operations, which would be daunting especially if the current services are already satisfactory. CRH's adjusted ROIC is 20%

The businesses of the two above examples couldn't be more different in both products and size; Intuit is \$29 billion in market capitalization, versus \$245 million for CRH. However, what they share in common is a deep integration into their customers' businesses. The integration equates to being entrenched, which means not having to offer the lowest price possible at all times. In turn, having pricing power is conducive to high returns on capital.

Sector Breakdown

As previously mentioned, no new additions or complete deletions of companies were made during the quarter; changes in sector weights were therefore the result of price changes and trades made for rebalancing purposes.

<u>Sector</u>	<u>Weight</u>
Healthcare	15.9%
Media/broadband	15.3%
Industrials	15.2%
Energy	13.7%
Specialty chemicals	13.2%
U.S. real estate	11.4%
Technology	8.5%
Food	4.6%

In Closing

Relative to the market sell-off in January and February of 2016, Brexit has thus far been gentle on the stock prices in my watch list. The dislocation has not warranted any significant changes in portfolio positions. Many of the holdings are statistically cheap (i.e. trade at single-digit P/E multiples) and are also positioned to show strong earnings growth over the coming years.

As Charlie Munger once said, "The big money is not in the buying and selling...but in the waiting". And so I continue to sit, think, and wait.

Sincerely,

Steven Ko
Portfolio Manager

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