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MANAGEMENT

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Letter to investors, Q3 2019

Performance

The model portfolio returned approximately 13.6% net year to date (approximately negative 4.1% including fees in Q3). As of September 30th, 2019, the top ten positions comprised approximately 75% of the portfolio, and the portfolio held approximately 11% in cash.

I am pleased to report that ACML has taken on its first "friends and family" client investment. I am honored by the trust put in me, and am optimistic about the opportunity both to compound capital and to grow the business.

Investment process

What I look for

My first two letters contained my reasons to own stocks for the long term and approach to volatility. Here I will discuss how I specifically assess individual companies. In summary, I look for great public companies that have the power to endure, with long runways to grow through reinvesting cash flows at high rates of return, run by talented and aligned operators. This unpacks as follows.

At its most fundamental level, investing is about paying an amount of money today with the expectation of receiving a future stream of cash flows who's present value, when discounted at an appropriate rate, exceeds the amount paid today. The greater the difference, the higher the Margin of Safety and the better the profit. Very basic, but I think the point frequently gets lost in unnecessary complexity, especially when prices react so vigorously to general economic news and quarterly results.

In his 2014 paper "What Does a Price-Earnings Multiple Mean? An Analytical Bridge between P/Es and Solid Economics"[1] Michael Mauboussin does a great job of building a valuation framework from first principals, disaggregating valuation into steady state and future value creation, linking the future part to returns on capital.

To summarize:

$$\text{Value} = \text{Steady State Value} + \text{Future Value Creation}$$

Where:

$$\text{Modified steady-state value} = \frac{\text{Net operating profit after tax } (1 + \text{growth})}{\text{Cost of capital - growth}}$$

And

$$\text{Future value creation} = \frac{\text{Investment} * (\text{return on capital} - \text{cost of capital}) * \text{competitive advantage period}}{\text{Cost of capital} * (1 + \text{cost of capital})}$$

The steady state value depends on an estimate of normalized operating profits (or cash flows). While, to quote Mauboussin again from the same paper, "Future value creation boils down to how much money a company invests, what spread that investment earns relative to the cost of capital, and for how long a company can find value-creating opportunities."

It follows that most of the subsequent work I do boils down to trying to assess normalized profits, returns on capital, and runways for reinvestment. I value steady state by applying a standard discount rate (typically 10%, or a 10x multiple) to an estimate of normalized operating profits or free cash flows, and then qualitatively assess the company's potential to reinvest at high rates of return. I learned about the futility of false precision in my first job at Deutsche Bank, where I was tasked with building complex integrated models in Microsoft Excel to support

[1] https://bit.ly/2M2bSkm

valuations for public company mergers or capital markets raises. I was required to develop multiple detailed scenarios with clusters of assumptions to present a range of potential valuations. However, a model could be made to spit out almost any valuation depending on the choice of assumptions (e.g. margins, growth rates), and was frequently less useful than a back of the envelope valuation done by an experienced senior banker. It is more effective to keep things simple, and base a valuation on a handful of well thought out key value drivers.

Mauboussin's steady state + future value has a nice parallel with one of my favorite case studies by Alice Schroeder, who wrote the book "Snowball" on Warren Buffet. She describes an investment Buffet made in Mid-Continent Tabulating Company in which he figures out the 1-2 factors that determine the success of an investment, and then looks for a "15% day one return [discount to steady state], an then it compounds from there [future value]."[2]

In order to estimate normalized operating profits or cash flows I develop a thorough understanding of the business, especially its value proposition to customers (how important its services or products are to customers), the nature of its revenue streams (how it gets paid, whether the revenues are recurring), and whether it has pricing power. Frameworks such as Porter's Five Forces (competitive rivals, potential new market entrants, suppliers, customers, and substitute products) prove helpful in this effort.

I also spend time assessing a company's economic moat, the presence of which gives me more confidence in the sustainability of cash flows. The major categories are a) cost advantages: such as unique assets/location, scale economics, dominant niche; b) intangible assets: such as brands, search costs, patents, licenses; c) switching costs: such as money, time, risk; and 4) network effects.

While moats are assessed qualitatively, they also have to be reflected in the numbers. For example, I want to see margins expand as revenues grow to justify the presence of economies of scale, and I want to see that a company holds onto customers for years to assert switching costs. Ultimately, I want to see extended periods of high returns on invested capital to believe in the presence of a moat.

And finally, I assess management's strategy to determine the company's runway for reinvestment. It is difficult to understate the importance of having the right people making both operating and capital allocation decisions at the company. For this I look to managements' long term paper record of performance, decisions they took, and investments they made.

The fact is, insiders know more about what is going on inside a company than public investors ever could, even with extensive due diligence and the proliferation of alternative data sets – these can be very helpful, but at best are clues to what is really happening. I learned this lesson a number of times while on the board of closely held family businesses where we exerted a large amount of control but later discovered that, despite receiving extensive monthly reports comprising financials and management commentary, the board only heard a sanitized summary of events. It was only when I attended weekly sales meetings with department heads, or became directly involved with an operational project, that I learned about real issues, roadblocks, customer opinions, or indeed opportunities. It follows that information has been significantly abstracted by the time it reaches public shareholders.

I therefore take a "trust but verify" approach. I want to see management articulate a clear and realistic plan, especially during times of distress, that goes beyond pandering to the market's need for quarterly guidance. More importantly, I want to see them execute against the plan. Time and again I have noticed that this has a significant impact on results. Seeing management make open market purchases can give clues as to their belief in the plan. Managements who exhibit a stunned "deer in headlights" behavior, and focus on excusing problems rather than fixing them, produce suboptimal outcomes. As Lee Kuan Yew[3] says "The acid test is in performance, not promises." Finally, I look to management's treatment of shareholders, and carefully read the proxy statements to understand financial incentives and alignment of interests.

[2] https://www.youtube.com/watch?v=PnTm2F6kiRQ

[3] Singapore's first Prime Minister, governing for three decades, and recognized as the nation's founding father

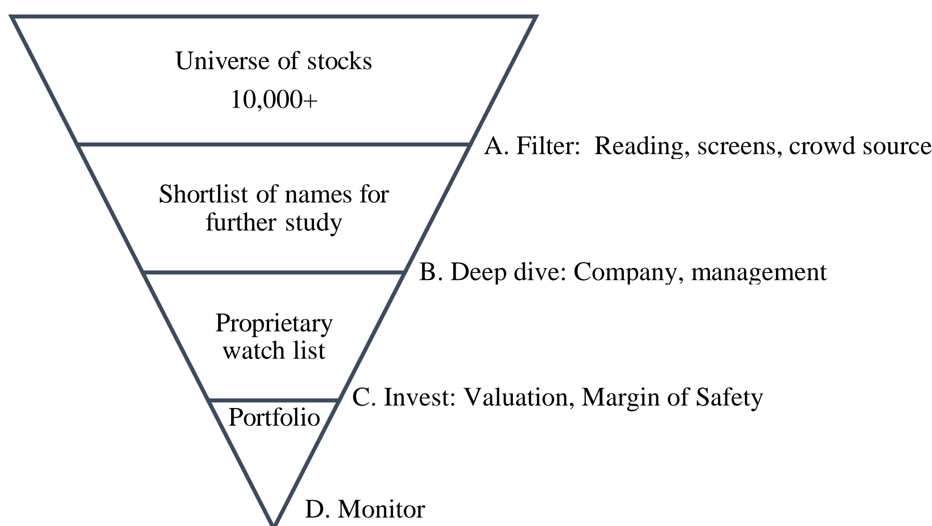
Finding high quality companies that are trading at discounts to their intrinsic value is not easy, especially for steady, predictable businesses, which are therefore easier to forecast. Expressed differently, markets are mostly efficient. However an area where they tend not to be quite so efficient is when there is some complexity in ownership structure. Holding companies and tracker stocks, for example, often trade at steep discounts to their holdings. I sometimes like these situations because they provide a way to own a good business with a greater Margin of Safety. One caveat: I believe it is risky to buy primarily with the expectation of a rapid narrowing of discounts, as they can persist for some time, and it is important to consider the capital allocation skills and motivations of managements or controlling shareholders in such situations.

As of the end of Q3, the portfolio held significant positions in companies trading at discount to their holdings – EXOR, GCI Liberty, Naspers/Prosus, Oaktree Specialty Lending, and Quarterhill. To re-use the Exor example, the share price is €61 while the Net Asset Value is €88.9[4] (of which approximately 2/3rds is publicly quoted and not subject to interpretation). This discount of 30% may take a while to close, but seems illogical to me when applied to a well run business that (in my opinion at least) has proven adept at creating shareholder value. Two other examples are discussed in the sections on GCI Liberty and Naspers later in this letter.

I will end this section by mentioning time horizons. When one's approach is based on assessing the present value of cash flows extending far into the future, the influence of quarterly earnings beats/misses and near term economic news is naturally diminished. Quarterly numbers have their place insofar as they provide more information to reinforce or disprove a long-term thesis. Later I discuss how quarterly fluctuations revealed flaws in my understanding of Calloway's Nurseries, following which I exited the position. But their short-term fluctuations are less important in and of themselves. The longer one owns a business, the more information one obtains, good or bad. Occasionally this will cause me to change my mind. As I weed out the disappointments and hold onto the gems, my expectation is the portfolio will be upgraded continually with a select few superior businesses that will be given time to compound.

Process

A question I have been asked a number of times is "how do you source proprietary investment ideas?" It is important to apply a pragmatic, repeatable, and disciplined process to investing that still has enough flexibility to adapt to opportunities. It starts with having a good idea of the type of company I am looking for, and then having a process to filtering rapidly the universe of 10,000+ stocks into a shortlist of higher potential prospects where I can efficiently focus my energies.



[4] As of June 30, 2019, from Exor Interim report 2019

A. Filter: I generate ideas through reading broadly and running my own screens on factors such as ROIC, insider ownership, margin stability, FCF generation and other factors. These are simply tools to help me come up with a shortlist for further study. I also speak with trusted and successful friends and exchange ideas.

Today there is an absolute plethora of ideas freely published by a large army of funds and sophisticated individuals across all market caps. One need only look at Manual of Ideas, Microcap Club, Value Investors Club, Value Investors Insight, Seeking Alpha, Sumzero, numerous blogs, a host of investor conferences held throughout the year, and quarterly hedge fund letters to understand the scope of this. This makes it much harder to discover an under-followed gem. I do not think this is a major problem, as different investors have different objectives, sources of alpha (e.g. Fuller's three sources of alpha: informational, analytical, behavioral),[5] and time horizons; which means one can still profit from a known story. So while there will always be weight given to sourcing proprietary deal flow, it also makes sense to leverage the aforementioned army of analysts on the internet to "crowd source" pre-vetted names to add to the shortlist.

B. Deep dive: I apply the methods discussed in the preceding section in my search for potential compounders. I read SEC filings (or equivalent for non-US companies), go through presentations, transcripts, and news articles on the company or its industry. Once I have built up an understanding of the business, I sometimes speak to management or at the very least the IR department to try and fill in any gaps in my understanding. At that point I also try and find other articles or reports on the company, paying special attention to disconfirming points of view that highlight problems I might not have been aware of that can prevent me from making a mistake. I also make liberal use the "too hard" bucket and pass on an idea if assessing it proves too difficult.

C. Invest: I often find companies that are cheap but unattractive, or companies that I really like but are too expensive. The former are discarded (but hopefully the increased knowledge from studying them remain), while the latter are added to my watchlist. When the price of one of the businesses in the watchlist becomes attractive, I am ready to move quickly to include it in the portfolio.

D. Monitor: I look continually to validate and justify a company's inclusion in the portfolio, updating my understanding as new information comes out. I also view the continba process of adding high quality companies to the watchlist as an integral focus of the process.

<u>Discussion on a selection of portfolio positions with an average weight over 1%:</u>

There was one exit this quarter and no additions. Positions with an average weight over 1% of the portfolio in the quarter were: Alliance Data Systems Corp., Burford Capital Ltd., Calloway's Nursery Inc., CarMax Inc., CRH Medical Corp., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., GCI Liberty Inc., Naspers Ltd., Oaktree Specialty Lending Co., Onesoft Solutions Inc., Prosus NV, Quarterhill Inc., Tencent Holding Ltd., Viemed Healthcare Inc., and Wandisco Plc.[6]

Calloway's Nursery Inc. - exit

I exited Calloway's in Q3 2019, largely because I became increasingly uncomfortable with the company's lack of detailed disclosure, especially following a period of significant swings in operating performance with no explanation.

Calloway's Nursery is a small cap company that owns a chain of garden stores in Dallas and Texas. 3K, a family office owned by one of the former founders of ValueAct, won control of the company through a proxy battle or in 2016. My thesis was that Calloway's was undervalued for a company that generated strong and stable cash flows, rewarded shareholders with special dividends, and was under the control of a sophisticated shareholder who was focused on rationalizing the company's valuable real estate portfolio to maximize value (for example selling a store in a premium location and using the proceeds to purchase two locations and pay down debt). My belief is

[5] https://bit.ly/2owbMbJ

[6] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.

that stable companies, when purchased at undemanding valuations, can often produce good returns even though they operate in unsexy industries.

However, the company has fewer than 300 shareholders and so can avoid most of the SEC's reporting requirements. It limits disclosures to 3-page summary financial reports each quarter with no notes, discussion, further breakdown, or commentary. The problem with this became evident to me, albeit belatedly, when the company reported a 21% drop in year-over-year Q1 revenues, and a swing from 16% operating margins to a loss. This clearly busted my thesis that the company generated stable cash flows. Even though the company had a strong rebound in Q2 (this is a seasonal business), investors were left to guess as to the reasons. I can tolerate short term operating fluctuations provided I am able to develop a view as to whether difficulties are likely to be temporary. In this case, while I knew the company was opening new stores, and could see new line items for "Capital Leases" on the balance sheet, I had no idea if the deterioration in numbers was due to benign reasons, for example, new location start up dynamics, the temporary impact of weather/rain, or more serious reasons such as competition. Furthermore, I could not tell if the rebound was due to an improvement in the core business, or simply because the company had expanded stores, thereby adding new income streams which masked further deterioration on a same store basis. The company does not maintain investor relations and is unresponsive to shareholder questions.

This situation is not compatible with my goal of aligning with defensible businesses run by operators who also treat minority investors as partners.

Alliance Data Systems

ADS has two segments, the Card services division (85% of operating profit) and LoyaltyOne (air miles in Canada, 15% of operating profits). Card Services operates Private Label Credit Cards, which are store-issued cards that consumers can use only at the issuing store. While ADS manages its customers' card operations, such as receivable financing, bill processing, and delinquency management, its real strength is in driving customers' sales through targeted loyalty programs and marketing campaigns. It does this by signing long-term (5-15 year) contracts and integrating with and managing its clients' customer care and digital marketing activities, providing trained call center staff and data scientists who build detailed individual customer profiles to track shoppers' buying habit and preferences.

With its deep roots in the retail industry, ADS was formed in December 1996 through the merger of J.C. Penney's credit card processing unit and The Limited's credit card bank operation, the company has a large proprietary data set of consumer behavior, and is thus able to target highly relevant digital ads that drive additional consumer purchases. For example, when a consumer buys an item at a retail partner, they receive an email or are exposed to targeted display advertising suggesting a matching accessory or related item. This requires both SKU-level detailed data, and purchase behavior across different retailers. It would be financially prohibitive and operationally complex for customers to replicate these marketing activities, and few competitors possess equivalent data at the same level of granularity. ADS has a demonstrated ability to increase customer sales by 20-30%,[7] and a very sticky business (a "high switching cost" moat), as evidenced by retention rates of approximately 99% (excluding customer bankruptcies and sales), and multi-year Returns on Equity in the 30%+ range.

Card Services earns money like most other credit card companies, through interest and fees on credit card balances and late payments. A difference between it and general card companies is ADS is on a closed loop system, with no interchange fees to be paid by the customer (as charged by Visa and MasterCard). In fact ADS pays retailers a proportion of sales through a through a Revenue Share Agreement.

Sentiment on the company is currently quite negative for a plethora of reasons, most of it beginning in early 2016 when overall market sentiment turned against all things bricks and mortar, from traditional retailers to mall operators. ADS went from being a 20%+ per year growth story to a more pedestrian 8-10% as large legacy files were liquidated, such as Bon-Ton (liquidation, ~4.5% of receivables), Gander Mountain (bankruptcy), and Virgin

[7] Alliance Data Systems Q2 2019 earnings presentation

America (bought by Alaska Air).[8] A series of own goals did not help, including repeatedly missing earnings guidance, and a poorly managed plan in 2016 to let LoyaltyOne's air miles points expire that caused public outcry in Canada.[9]

More recently, in July 2019 ADS sold its underperforming Epsilon division to Publicis Groupe for $4.4bn in cash and $3.5bn after tax. Even though this was a decent price at approximately 10x operating profit, it was below the $5bn figure that had been circulated in the press. [10] Former CEO Ed Hefferin's repeated comments throughout the sale process of "a great deal of interest" did not help matters. [11] The proceeds have been used to pay down $2.4bn of debt with the remaining $1.1bn earmarked for share buybacks. In July/August 2019, ADS ran a modified Dutch Auction for the initial $750m portion of the buyback, and when they announced the tender had been oversubscribed at the lower end of the $144 - $162 price range,[12] arbitrageurs had to quickly unwind positions, further impacting the price and sentiment.

So why am I still interested? ADS is still winning business at a rapid rate, its core business is still defensible and its services remain very much in demand. In 2018 and 2019 ADS signed agreements with Burlington Stores, Carter's, Houzz, Ikea, Interval International (vacation rentals), Sally Beauty Holdings, Sephora, The Children's Place, Ulta Beauty, and Wayfair amongst others. It is notable that many of these customers operate in more robust retail sectors, or are part of the new breed of e-tailers. The company is also proactively managing underperforming accounts, and has moved $2bn of credit card receivables to "held for sale." Throughout this more difficult period, total receivables, net of those held for sale, still grew from $13.5bn in December 2015 to $17.6bn in June's 2019.

The company has clear line of site to $20bn in receivables by end 2019, as new customers typically take 3 years from signing to fully ramp up as they sign on more consumer cardholders. Provided delinquencies remain in range, profits should scale in line. Longer term, the company sees a path to $35bn in potential receivables.[13]

The business continues to be very profitable, generating $1.3bn in Free Cash Flow[14] (a 20% yield on its $6.3bn market capitalization), and with reported EPS of $19, it trades a P/E ratio of only 6.5x. At these levels, provided the business is at least stable (an overly conservative viewpoint in my opinion) investors in ADS receive the entire market capitalization through cash flow in less than five years.

ValueAct Capital, the highly respected activist hedge fund that bought into ADS in 2016, installed a partner on the board and catalyzed the Epsilon sale,[15] remains a large shareholder and continues to make changes. CEO Ed Hefferin retired and Melissa Miller, President of Alliance Data Card Services since 2011 and widely credited with its success, has been promoted to CEO. Tim King, Card Services finance director has been promoted to group CFO.[16] The head of LoyaltyOne left and has not been replaced,[17] leaving the door open for its potential sale next, which would likely precipitate further buybacks which would be highly accretive at the current share price.

One of the things I do look out for in the medium term is ADS's competitive position in a rapidly changing fintech/payments competitive landscape. New companies such as Afterpay, an Australian consumer lending

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[8] Transcripts from Q3 2018 earnings presentation and Deutsche Bank Technology conference 09/12/2018
[9] https://www.theglobeandmail.com/report-on-business/industry-news/marketing/air-miles-parent-company-backs-off-from-points-expiration-plan/article33127263/
[10] https://www.ft.com/content/ffeaf816-54ad-11e9-a3db-1fe89bedc16e
[11] https://www.bizjournals.com/dallas/news/2019/04/03/publicis-groupe-epsilon-alliance-data.html
[12] Press release https://www.alliancedata.com/news/press-releases/press-release-details/2019/Alliance-Data-Announces-Preliminary-Results-of-Modified-Dutch-Auction-Tender-Offer-Including-Proration/default.aspx
[13] Wolfe research presentation March 2019, p20
https://s23.q4cdn.com/525801907/files/doc_presentations/2019/Wolfe_Investor_presentation_final.pdf
[14] Calculated as Operating Profits + deprecation & amortization – cash taxes – cash interest – capital expenditures, as per company methodology on page 14 of ADS Q3 2016 investor presentation
[15] https://www.thestreet.com/story/14051791/1/alliance-data-valueact-deal-could-signal-split.html
[16] https://d18rn0p25nwr6d.cloudfront.net/CIK-0001101215/66390c26-4ff8-4a7c-a966-6c328e3571a6.pdf
[17] 8K filing https://d18rn0p25nwr6d.cloudfront.net/CIK-0001101215/6cd3a538-48be-4601-885a-7e518f989222.pdf

company that lets shoppers pay for items in installments,[18] are rapidly gaining traction. These are only credit and not marketing solutions – they do not integrate with customers' inventory systems to obtain the SKU-level data, for example. Nevertheless, details of how ADS is adapting remains light, and the ultimate success of its digital initiatives, such as Frictionless Mobile Credit technology[19] are as yet unknown. It is hard to forecast these things, but should competitive threats actually prove to be more serious, I would not put it past ValueAct to arrange a sale of ADS as a more focused pure Card Services business, to a large competitor at some future date.

GCI Liberty Inc.

In April 2017, Liberty Media acquired General Communication, the largest cable provider in Alaska, for $2.8bn and, in a complicated set of transactions, merged it with certain assets of its Liberty Interactive subsidiary. The combined GCI Liberty, owns approximately 8% of Charter Communications, the #2 cable company in the US with a $90bn market capitalization, as well as its Alaskan cable business and stakes in a few smaller businesses such as Evite (the online card company, private) and Lending Tree (a 27% stake worth approximately $1bn). The majority of the Charter holding is through yet another Liberty Media subsidiary, Liberty Broadband. Liberty Broadband is a tracking stock that owns 54 million shares of Charter plus some debt, and trades at a 12% discount to the value of its holding in Charter. GCI Liberty in turn trades at a "double discount" of approximately 19% to its assets (GCI Liberty has a market capitalization of approximately $6.4bn and owns net assets worth almost $8bn). GCI conducts opportunistic share buybacks, with a current repurchase authorization of approximately $494m. Given the discount, these repurchases are highly accretive.

Conceptually, this investment fits into my recurring theme of buying advantaged businesses, under the control of a skilled capital allocator, bought with a margin of safety - due to a "double discount" to Charter in this case.

The thesis on Charter is well understood by investors, and has been repeated publicly by management for years. It is based on three components: attractive and highly defensible cable assets, management's strategy to leverage these assets to drive both revenue and margin growth with a longer term mindset, and superior capital allocation that takes advantage of the predictable, recurring nature of subscription revenues to effect "leveraged buybacks."

Cable companies at scale have highly defensible positions as their substantial wire line networks deliver not only traditional video, but also high capacity two-way data connectivity for fast broadband internet, and would be prohibitively expensive for competitors to replicate. This has typically resulted in local monopoly and duopoly situations over each network's footprint (excluding Telco and satellite competitors with their relatively inferior offerings).

I view cable as a digital infrastructure play that is best positioned to deliver video and internet data to people's homes. An analogy is how the railroads are irreplaceable assets that transformed the delivery of goods across the US and are currently, by far, the most cost effective way to transport goods over long distances.[20] Whether the consumer wants traditional video, or is a cord cutter looking for over-the-top, or "skinny bundle" programming, content providers still need distribution to reach customers. On the subject of cord-cutting, evidence is that the mix of services needed to replace traditional pay-tv cost just as much in total, and that is before accounting for planned price increases by the streaming services.[21] Moreover, with the ever-increasing cost of programming, selling broadband services are much higher margin than video packages to the cable companies.

Cable is well positioned to satisfy the ever-increasing demand for data to enable for immersive, low latency, high compute applications directly to people's homes (think 8K video, gaming, virtual reality and Internet of Things). Cisco in its bi-annual forecast on global internet usage, predicted that Global IP traffic will increase nearly

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[18] https://www.forbes.com/sites/jeffkauflin/2018/07/03/how-a-28-year-old-turned-layaway-for-millennials-into-a-2-billion-business/#459888c659db

[19] https://knowmoresellmore.com/insights-news/alliance-data-announces-new-credit-acquisition-tools

[20] https://www.bts.gov/content/average-freight-revenue-ton-mile

[21] E.g. see https://www.consumerreports.org/tv-service/cord-cutting-decision-what-you-need-to-know/ and https://www.washingtonpost.com/business/2019/04/13/how-dream-cheap-streaming-television-became-pricey-complicated-mess/

threefold from 2016 to 2021.[22] Charter spent approximately $9 per home passed to upgrade to an all-digital 1Gbps speed network, and according to management the company has a relatively low-cost upgrade path to 10Gps symmetrical speeds. For comparison, Deloitte estimate it will cost mobile telephone companies $130bn-$150bn to roll out 5G.[23]

Recognizing that cable is a scale game, CEO Tom Rutledge has adopted the "Charter playbook." His goal has been to increase the overall number of customers by providing compelling, high-quality products combined in packages at prices that can't easily be replicated by competitors. "As you penetrate a fixed infrastructure, your average cost against that fixed infrastructure on a per-customer basis goes down, so your margins go up by higher penetrations in the fixed asset."[24]

The company is coming off a heavy investment cycle. In 2016, Charter acquired Bright House Network and Time Warner Cable; it launched into a massive multi-year integration effort, bringing the three companies into a singular network, pricing strategy, and product strategy. This included labor and capital intensive projects such as combining 11 billing systems and service environments into one, and in-shoring customer service calls from 30% to 92% (with associated costs to build call centers and hire people). Concurrently, the company upgraded the network to all-digital, which meant shipping digital set-top boxes out to millions of customers, and took data speeds to 1Gbps over 750,000 miles of infrastructure (their DOCSIS 3.1 project). Lastly they rolled out a mobile offering supported by a Verizon MVNO throughout the footprint.

The faster digital network and improved customer service reduce churn, resulting in fewer activity-intensive functions such as customer service calls and technician visits, which in turn reduce operating costs. 40% of new customers can now self-install digital set-top boxes that are shipped to them, again eliminating technician visits, and increasing numbers of customers consume media over their own devices (whether Roku or Apple TV), eliminating set-top box costs altogether. All told, capital expenditure will drop from $9bn to $7bn in 2019.

The results of all the above are beginning to be reflected in the numbers: in Q2 2019, Charter increased year-over-year total customers by 1m (4%), revenues by 4.5%, Net Income by 15%, and Free Cash Flow by 37% (due to the aforementioned reduction in capital expenditure). The company still has plenty of runway for growth, with 52% homes passed penetration and "a completely built, completely paid-for network in front of 48% of homes that we pass or 24 million homes that we have no relationship with, and that's our opportunity."[24]

To the third part of the thesis on capital allocation, in the words of John Malone, chairman of Liberty Media, Charter is a "clear, pure play, leveraged, free cash flow growth, buyback story." The company has taken advantage of its stable cash flows to lever up and buy back shares. Since September 2016, the company has bought back 21% of its shares outstanding for $21.7bn, at an average price of approximately $330 per share.

Finally, given Liberty Media's long term record of superior capital allocation and successful M&A, it is quite probable they will eventually find a way to collapse GCI Liberty into Charter, and possible they may look to sell Charter itself, provided they can obtain the right price; indeed both Sprint and Verizon were rumored to have been interested in 2018. With Liberty's inside knowledge of Charter and the media landscape, it is reasonable to expect they will make an intelligent decision that benefits shareholders.

Oaktree Specialty Lending Co.

In October 2017 Oaktree Capital, one of the most respected and successful alternative asset mangers with a well deserved reputation for integrity and prudence, purchased a 19% stake in Fifth Street Finance (FSC),[25] a troubled Business Development Company, [26] changed its name to Oaktree Specialty Lending (OCSL), and took over as its

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[22] Cisco: The Zettabyte Era: Trends and Analysis
[23] https://www2.deloitte.com/us/en/pages/consulting/articles/communications-infrastructure-upgrade-deep-fiber-imperative.html
[24] Charter CEO Tom Rutledge speaking at the Goldman Sachs media conference on September 18th, 2019
[25] July 2017 13-D filing, stake since slightly reduced to 16.8% (May 2019 filing)
[26] BDCs are closed-end investment companies, regulated by the Investment Company Act of 1940, that provide loans to smaller companies with limited access to public or syndicated capital markets

investment advisor. The previous manager had numerous conflicts of interest, charged excessive fees, made poor capital allocation decisions, and demonstrated weak underwriting standards on its investments. Unsurprisingly, the share price had languished and the company traded at a large discount to its Net Asset Value (as much as 50%).

Oaktree installed a team of highly experienced senior credit specialists who immediately set about making sweeping changes, from upgrading back office/accounting/compliance operations, to bolstering the balanced sheet with a new $600m credit facility. Most importantly, they took a deliberate approach to rebuilding the portfolio. At first, NAV per share dropped from $6.19 to $5.81 as they marked down non-performing assets that the previous manager had failed to do. They have since methodically built up NAV to $6.60, investing in $550m into core investments while reducing non-core investments by $620m. The portfolio now comprises $1.5 billion of investments diversified across 105 companies in 36 industries, with 80% invested in senior secured loans.

I will admit that OCSL does not have what I would consider a strong classical moat, and competes in a competitive space that is subject to credit cycles. One should therefore expect the position to be volatile at times. Nevertheless there are four things in particular that I appreciate.

First, the composition of their portfolio. They target fewer but larger investments ($30 million to $50 million in size), in more mature businesses that operate in less cyclical/more defensive industries, with lower amounts of leverage, with an emphasis on first and second lien secured loans. This was a marked difference to the old portfolio of smaller, tech heavy businesses that presented increased risk of credit impairments.

Second, their skillful execution. They proactively manage non-performing loans, for example restructuring Maverick Healthcare Group, a home health care products company that had been on non-accrual since Oaktree took over, and recouping their full principal balance plus accrued interest through the sale of the company.[27]

Third, their logical approach to investing. Instead of "pursuing riskier investments in order to generate loan volume or maintain portfolio yields… we are sticking to our core investment philosophy, which places a significant emphasis on protecting our investors' capital even if it requires sacrificing yield in the short term or moderating our pace of capital deployment. The current credit cycle is long by historical standards. And at some point in the future, the market will likely shift back to a more lender-friendly environment. In the event that a meaningful correction or disruption occurs, we believe that we will be able to take advantage of opportunities that arise given our demonstrated track record of investing across credit cycles."[28] They have reduced leverage to 0.58x with plenty of scope to increase size when more attractive conditions present themselves. [29]

Fourth, their access to parent company Oaktree Capital. This manifests in two ways. First is proprietary deal flow and extensive connections with banks and borrowers. This has already thrown up a number of co-investment opportunities, including a $30 million senior secured loan to U.S. Well Services (fracking), a $150 million first lien loan to Sorrento Therapeutics (biotech), and a $40m loan to Lightbox (real estate data and software). These loans were all done at rates of LIBOR +550 bps to +770 bps and backed by significant hard assets or equity cushions, speaking to Oaktree's robust underwriting standards. Second is management depth. When CEO and chief investment officer, Edgar Lee, resigned in August for personal reasons, the company concurrently announced his replacement, Armen Panossian, who possesses an equally impressive resume (Head of Performing Credit at Oaktree, Stanford Law, Harvard MBA etc.), with little apparent disruption.[30]

OCSL pays a healthy 7.3% dividend yield on a cleaned up balance sheet. As at September 30th, 2019 shares trade at a 22% discount to NAV, providing us with a margin of safety, and well below the 10% to 20% premium that well managed BDCs typically command.

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[27] Discussed in Q1 2019 earnings call
[28] Q2 2018 earnings presentation transcript
[29] The Small Business Credit Availability Act of March 2018 allows BDCs to employ a 2:1 debt to equity leverage ratio. OCSL's current ratio is 0.58x and their target ratio is 0.70x - 0.85x
[30] https://investors.oaktreespecialtylending.com/node/14266/html

Naspers Ltd. and Prosus NV
I outlined the thesis on Naspers in my Q1 letter and Naspers has indeed completed the spinout of its international internet properties. The new entity is called Prosus, and is listed on the Euronext stock exchange in Amsterdam, the Netherlands. Naspers now owns the group's South African media assets as well as 75% of Prosus, and Prosus in turn owns stakes in Tencent, Mail.Ru and a host of rapidly growing internet properties in classifieds, payments, food delivery, online travel and other sectors.

Following the spin, Naspers trades at an approximate 35% discount to its holdings, while the Prosus discount is smaller at approximately 17%.[31] I was pleased with management's efforts to communicate clearly and openly with shareholders regarding the spin, [32] and the combined company has many levers to pull to continue to close the discount and create value. For example, Prosus can distribute up to $120bn in tax-free dividends through a capital reduction, and has a more favorable tax domicile from which to effect further tax-free spins as different segments reach maturity. Whatever actions are taken, it is reasonable to assume management will do everything in their power to ensure Naspers benefits, given that their option grants are in Naspers' shares.

As I wrote in my first letter "While the discount receives a lot of attention, the bigger picture, in my view, is that the company's portfolio of assets is likely to continue to compound at attractive rates for the foreseeable future." Thus far I am encouraged by the company's progress, especially with their classifieds business which now has 105m average monthly app users, 70m monthly net new listings, is (slightly) profitable and has a clear path for continued revenue growth.

Closing thoughts

As I write this letter in early October, the market is starting to look like things might become volatile again. While that is never pleasant, the watchlist is full of a number of interesting companies just waiting to join the portfolio at the right price.

Samer Hakoura
Alphyn Capital Management, LLC
October 2019

[31] Bank of America Merrill Lynch report September 16th, 2019
[32] https://www.newglobaltechgroup.com/en/home/

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