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Brad's Musings

Breeding Rabbits

In this musing I hope to give you some insights into what I consider to be one of our most useful investing strategies at Waratah. It's a useful strategy because it still works and we continue to find opportunities despite an army of smart investors and even smarter computers that are competing against us. I will explain this strategy and provide two examples within our portfolios.

The strategy is a simple one: ***buy businesses that have essentially no ongoing requirement for capital expenditures***. Of course, any business meeting this requirement must still meet other hurdles to be a good investment. High barriers to entry, a strong brand, pricing power, good management, and a fair price for the shares are all important attributes. Most newspapers and radio stations have almost zero capital spending requirements but that's not enough to overcome the falling demand for their products. In addition to avoiding businesses in secular decline, the next most important attribute for any publicly traded business with no capital requirements is a demonstrated history and intention of returning the excess capital to shareholders through share buybacks or dividends. Alternatively, there are some special cases where the manager has demonstrated an ability to deploy the retained cash into similar businesses also with low capital requirements. These managers are rare and it is far more common to find situations where the managers are destroying value through acquisitions and would be better off giving it back to shareholders.

It shouldn't surprise anyone to learn that Warren Buffett and Charlie Munger have been employing this strategy with great success. If you have read Buffett's letters or attended any of Berkshire Hathaway's annual meetings you likely know the story of See's Candy. This manufacturer of premium boxed chocolates was acquired by Blue Chip Stamps (controlled by Munger and Buffett and later consolidated into Berkshire) in 1972 for $25 million. At the time See's was earning about $4 million before taxes. Now that may seem like a very modest multiple of earnings but according to Buffett the company only had about $8 million of net tangible assets. Up until this time Buffett had been a deep value investor and to pay more than 3x book value for a business was a real stretch for him. In fact, they came close to passing on the opportunity and Munger credits a friend for providing the final encouragement to complete the deal: "If See's had asked $100,000 more, Warren and I would have walked — that's how dumb we were. [Munger's friend] Ira Marshall said you guys are crazy — there are some things you should pay up for, like quality businesses and people. You are underestimating quality." Any business that can earn a 50% pre-tax return on tangible capital for any meaningful length of time is likely to be a quality business. The biggest drawback with See's is that almost none of the prodigious cash flow could be re-invested back into the business – there just wasn't anywhere to put it. That's not a problem for a firm like Berkshire Hathaway that can roll-up the cash flows and systematically allocate the capital to areas where it can generate high returns. In Buffetts's 2015 annual letter he writes, "To date, See's has earned $1.9 billion pre-tax, with its growth having required added investment of only $40 million. See's has thus been able to distribute huge sums that have helped Berkshire buy other businesses that, in turn, have themselves produced large distributable profits. (Envision rabbits breeding.)" When one considers the return on capital that Berkshire Hathaway has achieved since 1972 it is staggering to imagine what that $1.9 billion of pre-tax earnings has grown to today. How much of Berkshire Hathaway's $512 billion market cap is because of the re-invested cash flow from a small regional candy company purchased for only $25 million? Here's another mind-blowing question to end this paragraph with: what multiple of current earnings would have been too high to pay for See's in 1972 in order for Berkshire to have earned an unattractive return on investment?

Perhaps you are thinking to yourself, "that's amazing but opportunities like See's are one in a million". Such companies are indeed rare and they almost always look expensive at first glance using traditional analysis such as P/E ratios and EV/EBITDA. However, businesses like these can be found at surprisingly reasonable valuations when one considers free cash flow after all capital expenditures. I am going to highlight two examples that we hold in Waratah portfolios, one of which actually looks to be an un-discovered See's Candy.

The first company is Roper Technologies (known until 2015 as Roper Industries). At first glance, Roper looks like a typical industrial conglomerate not unlike Danaher or

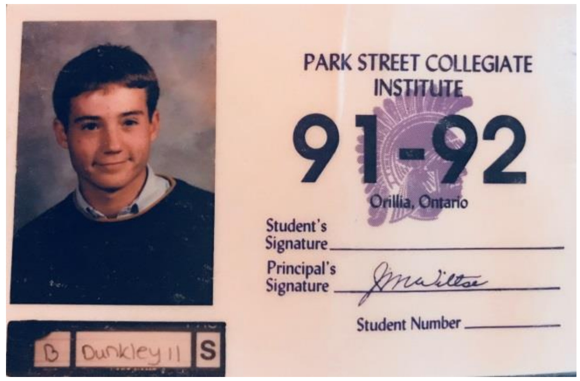
United Technologies. Roper is active in many different lines of business including tolling and traffic management systems (think toll highway transponders), engineered pumps, automated water meters, medical and scientific imaging, radio-frequency technology and many vertical market software businesses. What makes Roper special is its strict adherence to a very simple and successful strategy. Roper buys businesses that meet the following conditions:

1. Market leading companies with highly engineered products earning high gross margins on a recurring revenue base;
2. in industries with few competitors and low customer concentration (diverse customer base);
3. with low or preferably negative working capital requirements as sales grow;
4. that have high cash flow relative to gross property, plant and equipment (low tangible capital);
5. and low capital expenditures needed to sustain the earnings power of each business.

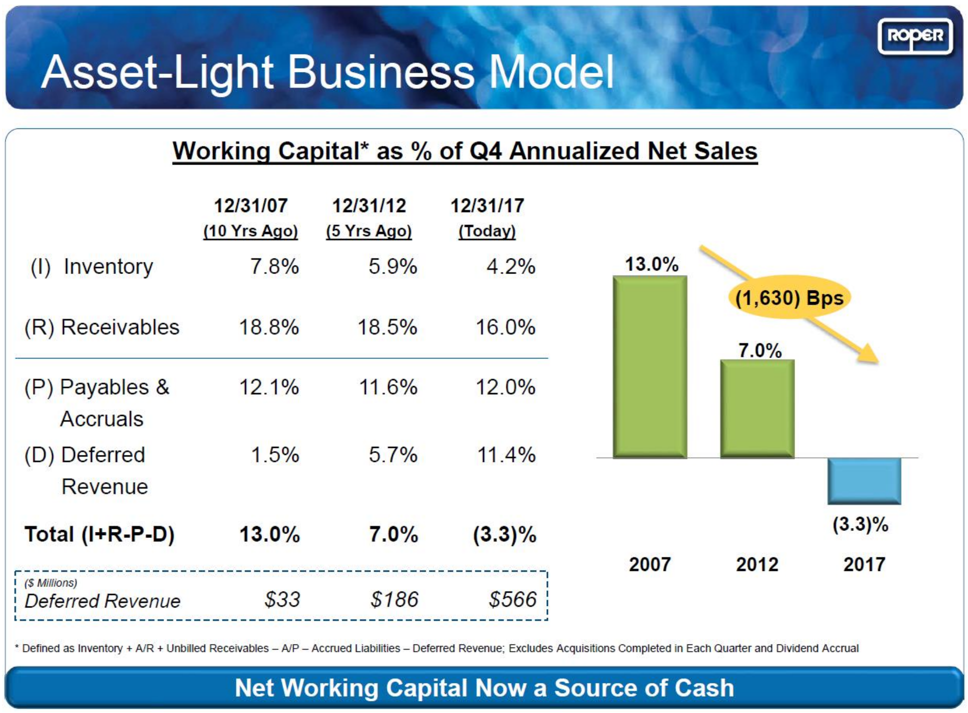
Roper is a collection of high quality businesses selected for their ability to generate cash so that said cash can be re-invested to acquire similar businesses. Under the continuous leadership of its CEO, Brian Jellison, Roper has been 'breeding rabbits' since its IPO in 1992. Over the last 25 years, Roper has seen its earnings per share rise from $0.0925 to $9.42 – a 20.3% compound annual growth rate (CAGR). Free cash flow per share (after taxes and all capital spending) has increased from $0.15 per share in 1992 to $11.35 in 2017 – a CAGR of 18.9%.

Roper's first day of trading was 13 February 1992 (I was in Grade 11 at time having just started a relationship with the young woman who was to become my wife, and so you will have to forgive me for missing this one). The stock closed after its first day of trading at a split-adjusted price of $1.71. During the summer of 1992 the stock hit a low of $1.21. I was a big hockey card collector at the time and I used my summer job savings to purchase 12 unopened boxes of Pro Set Platinum '91-'92 hockey cards. I had made a big score the previous year buying 3 boxes of O-Pee-Chee Premier cards so I really sized up on this next opportunity. It was an investment of about $400 at the time and the entirety of my investible net worth. With hindsight, this now seems more of a speculation and I can earnestly say that I wish I had bought Roper's stock instead. On 16 March 2018 the stock closed at $286.67 having delivered a compounded average total return of 21.7% for more than 26 years. Had I invested my $400 into Roper instead it would now be worth $67,089. As a comparison, an investment of $400 in the S&P500 would be worth $4,506. In case you are wondering, I still have my unopened boxes of hockey cards in my basement. It looks like I could sell them on-line for about $15 US per box, or about $225 CAD for the entire case, for a CAGR of -2.2%.

Not thinking about Roper Industries



There are very few businesses as good as Roper. Just consider some of these financial metrics for the most recently complete year: gross profit margins of 62.6%; EBITDA margins of 34.4%; operating cash flow equal to 26% of revenue; capital spending equal to 1% of revenue; free cash flow equal to 25% of revenue; free cash flow equal to 121% of adjusted net income; $32 of revenue generated for every $1 of net property, plant and equipment. One of the most significant of Roper's recent accomplishments has been the reduction of net working capital required to operate the business to a negative number. Net working capital is just as real as property, plant and equipment – just ask anyone owning a distribution business how important this is. Distributors have more money tied up in inventory and accounts receivable than they would ever need in physical plant and equipment. Likewise, construction companies often have to buy materials and pay sub-contractors and employees well before they receive progress payments from customers. Roper has been able to achieve negative working capital by purchasing businesses that are able to collect payment before they are required to pay their suppliers. Roughly 50% of Roper's cash flow is now derived from software and service businesses where customers pay up front, resulting in large deferred revenues for Roper. The following chart, from Roper's most recent corporate presentation, shows the net working capital progress made in the last 10 years:



Roper is special. The results speak for themselves and it has been achieving these results for over 25 years. So have investors bid up the value of Roper's shares up to the point where they are fairly valued? Well, if you do what most investors (and computers) do, you may very easily come to that conclusion. According to consensus estimates found on Bloomberg, Roper is trading at 23.8x 2019 estimated EPS and 18.4x estimated EBITDA. At a surface level, Roper appears to be an expensive stock, but it is not. To demonstrate this point, let's pick another industrial conglomerate that most analysts would say is a cheap stock, United Technologies. This stock trades at only 16.3x 2019 estimated EPS and 10.2x estimated EBITDA. United Technologies is a diversified manufacturer that owns the Otis Elevator Company, an aerospace engine manufacturer called Pratt & Whitney, and a collection of business supplying fire safety, security, and building automation solutions. In 2017, United Technologies generated EBITDA of $10.812 billion. After paying interest and taxes this amount falls to $7.763 billion. After non-cash items and changes in working capital, operating cash flow was only $5.631 billion. Finally we deduct capital spending of $2.394 billion to arrive at a free cash flow of $3.237 billion. So there you have it, $10.812 billion of EBITDA converted into $5.631 billion of operating cash flow (52% conversion) which converted into $3.327 billion of free cash flow (30% conversion). While the multiple on EBITDA was a mere 10.2x, you only got to put 30% of that EBITDA into your pocket. On a multiple basis, United Technologies is trading at 31.7x its 2017 actual free cash flow. Now, let's do the same analysis on Roper. In 2017, Roper generated EBITDA of $1.605 billion. After paying interest and taxes this amount falls to $1.146 billion. After non-cash items and changes in working capital, operating cash flow was $1.234 billion. Finally we deduct net capital spending of $59.5 million to arrive at a free cash flow of $1.174 billion. In 2017, Roper was able to convert 73% of its EBITDA into cash that you can put in your pocket, compared to only 30% for United Technologies. On a multiple basis, Roper is trading at 24.8x 2017 actual free cash flow compared to United at 31.7x. Now, you decide which of these stocks is the more expensive of the two. Just to hammer home the point, United Technologies free cash flow was 61% of its net income while Roper's free cash flow was 120% of its net income. After factoring in the reduction in corporate tax rates in 2018, Roper is trading at only 22.0x 2018 estimated free cash flow. **Investors often fail to make this distinction and instead rely on the dangerous short-cut of simply comparing P/E and EV/EBITDA multiples.** EV/EBITDA multiples are particularly misleading in isolation, given the complete disregard for a company's capital spending intensity. If you would like to continue utilizing this analysis, use the framework I outlined above to compare Sea World to Six Flags (theme park operators) and Lamar Advertising to Outfront Media (billboard advertising companies). In both case studies you will find the obviously cheap stock is actually the more expensive.

Finally, it is always important to remember Munger's advice about inverting problems and questions and carefully considering the opposite case. As sure as Roper exists, its opposite exists as well. There are many businesses that generate very little or even negative free cash flow and yet keep borrowing and issuing shares to buy and build things simply to get bigger. We call these businesses 'capital pigs' or 'destroyers of capital' and it is where we search for short opportunities. Performance Sports Group, AGT Foods, SunOpta, Maxar Technologies, and Exchange Income Fund are all examples of capital pigs. Don't take my word for it, run the free cash flow conversion exercise yourself, and always be skeptical of working capital builds, rampant capital spending and increasing share counts.

So, I promised you I would share what I believe is an undiscovered See's Candy. I am going to drag this out a little bit and leave you guessing for a while as to what the company does. It's a small cap stock that, as far as I know, has no formal sell-side

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research coverage. It has a market capitalization of $260 million and its top 5 holders (1 insider and 4 institutions) own a combined 45% of the company. Given its limited liquidity, the only fund where we can have any meaningful weight in the stock is in the Waratah Special Opportunities Fund. I found it about 18 months ago when running a screen looking for stocks with low capital spending relative to EBITDA. I normally would never have stumbled onto this name, but this particular time I removed the market capitalization filter. Upon reading the output I instantly recognized the name of this business because I had purchased its products while visiting Orlando. So I downloaded a few 10-Ks and looked at its historical financial statements. In 2010 this business had net tangible capital (working capital and fixed assets) of only $6.1 million. In addition to this it had only $0.1 million of goodwill and $1.4 million of intangible assets. In that same year it produced sales of $50.9 million and pre-tax earnings of $8.3 million. I'll save you the math; that's a 134% pre-tax return on tangible capital and much higher than what See's Candy was doing when purchased by Buffett and Munger. So what has this company achieved since 2010? In the most recently completed fiscal year ended 30 June 2017, sales had grown to $96.7 million and EBIT to $26.3 million (a 3.2x increase in only 7 years). What is truly remarkable, however, is that this growth was achieved with zero acquisitions and total cumulative capital spending of only $8.3 million or about $1.2 million per year. And it gets better – over the 7 years from 2010 to 2017, this business was able to grow without requiring any additional working capital (it actually released $0.9 million). Over that same 7 year period, this company returned

$52.1 million of cash to shareholders via share buybacks, reducing the share count from 5.6 million in 2010 to 4.2 million at the end of 2017. If that wasn't enough to satisfy any owner, this company also paid cumulative dividends of $115.9 million over the same period. **This is the beautiful marriage of a company that does not need any capital to grow and a management team that recognizes that fact.**

Here's where the analog to See's Candy gets really interesting. Just like See's this business is also a food company that developed into a well-known regional brand. It's 7 years older than See's, having been established in 1916. Both were started by immigrants to America who brought family recipes with them to their new country. Both companies sell a premium priced product in an industry segment that has been flat for decades. There's one big difference however: Berkshire will never sell you See's, but shares in this business can still be purchased by anyone and at a reasonable valuation to boot.

The company I am enamoured with is called Nathan's Famous Inc., the owner of the Nathan's Famous hot dog brand. Nathan's impressive returns on capital result from licensing its brand under long-term contracts to a manufacturer in exchange for top-line royalties. Nathan's is a strong brand commanding a high price, allowing it to earn a 10.8% net royalty on sales of packaged products to 43,000 supermarkets, club stores and grocery stores found in all 50 states. The current license agreement with John Morrell & Co., a subsidiary of Smithfield Foods, stipulates minimum guarantees, and is in place until 2032. The second largest component of profitability comes from Nathan's

Branded Products Program, where Nathan's uses contract manufacturers (largely John Morrell & Co.) to supply products to foodservice distributors. Nathan's also earns franchise fees and royalties from 279 franchised restaurants located in 19 states and 12 foreign countries. The only business that uses any real capital at all are the 5 restaurants that Nathan's continues to own, including the original Coney Island location that started it all in 1916. These restaurants comprise about 10% of total EBIT but account for the vast majority of tangible capital employed. If Nathan's were to sell its 5 corporate restaurants its return on capital would approach infinity.

For many years Nathan's was a regional brand (New York, New Jersey & Florida), but over the last five years it has succeeded in moving towards becoming a national brand under the current licensing agreement. Nathan's has been named the official hot dog of Major League Baseball for the 2017 and 2018 seasons. The company also hosts 18 regional hot dog eating competitions to determine the athletes who will compete for the "Mustard Yellow Belt" at the Nathan's Hot Dog Competition held annually on the 4th of July at Coney Island. ESPN has broadcast the competition since 2004 and the event set records in 2012 with 1.95 million live viewers and nearly 9 million total viewers including re-broadcasts.

Nathan's stock closed on 16 March 2018 at $61.85 and, with 4.2 million fully-diluted shares outstanding, it has a market capitalization of $260 million. After accounting for a special dividend of $5.00 per share paid on 4 January 2018, we estimate that Nathan's will have cash on its balance sheet of approximately $50 million and long-term debt of $145 million, for an enterprise value of $355 million. For the current fiscal year ending 30 June 2018, we are estimating EBIT of approximately $28 million (up from $26 million the prior year); therefore, Nathan's is trading at only 12.7x EBIT. For a company that has no capital spending, this is a very low multiple. In the table below I have compared Nathan's EV/EBIT multiple to other asset-light food and royalty businesses, and also to capital intensive food manufacturers. As you can see Nathan's is cheaper than even the capital intensive food businesses:

2018 EBIT Multiple Comparison			
Asset Light Companies		**Capital Intensive Companies**	
McDonalds	17.1x	Premium Brands Holdings	19.1x
Restaurant Brands International	17.7x	Maple Leaf Foods	13.2x
Domino's Pizza	22.5x	Procter & Gamble	14.9x
Coca-Cola	20.8x	Nestle	17.4x
Average	**19.0x**	**Average**	**16.2x**
Nathan's Famous	**12.7x**		

As nearly all of Nathan's income is generated within the US, it is a big beneficiary of the new tax rates. We estimate Nathan's tax rate will fall to the mid-20% range, down from from 36.5% last year. After deducting interest expense and taxes, we estimate Nathan's will generate net income of $13.2 million or $3.15 per share. Dividing $61.85 by $3.15 gives us a P/E ratio of 19.6x; however, we can't forget about the $50 million of cash just sitting on the balance sheet. Nathan's could pay a dividend of $12 per share, effectively lowering the purchase price per share to $49.85 which would imply a P/E ratio of only 15.8x. With no capital requirements, Nathan's P/E ratio also approximates its free cash flow multiple. If we assume 3-5% revenue growth (pricing, geographic and product line expansion) and modest operating leverage on fixed costs, Nathan's should be able to continue growing earnings and free cash flow at about 8-10% per year. Adding this to Nathan's 6% free cash flow yield (inversion of P/E ratio) gets us a potential total return of 14-16% per year. This isn't a Netflix-type growth rate, but with a management team focused on flowing all of that cash back to shareholders, I can take my dividends and buy whichever stocks I want (maybe a little Roper?). And just like

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Berkshire Hathaway, imagine the stock portfolio I could have in 20 years, entirely paid for with cash coming from Nathan's.

Brad Dunkley

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