

R/ Capital

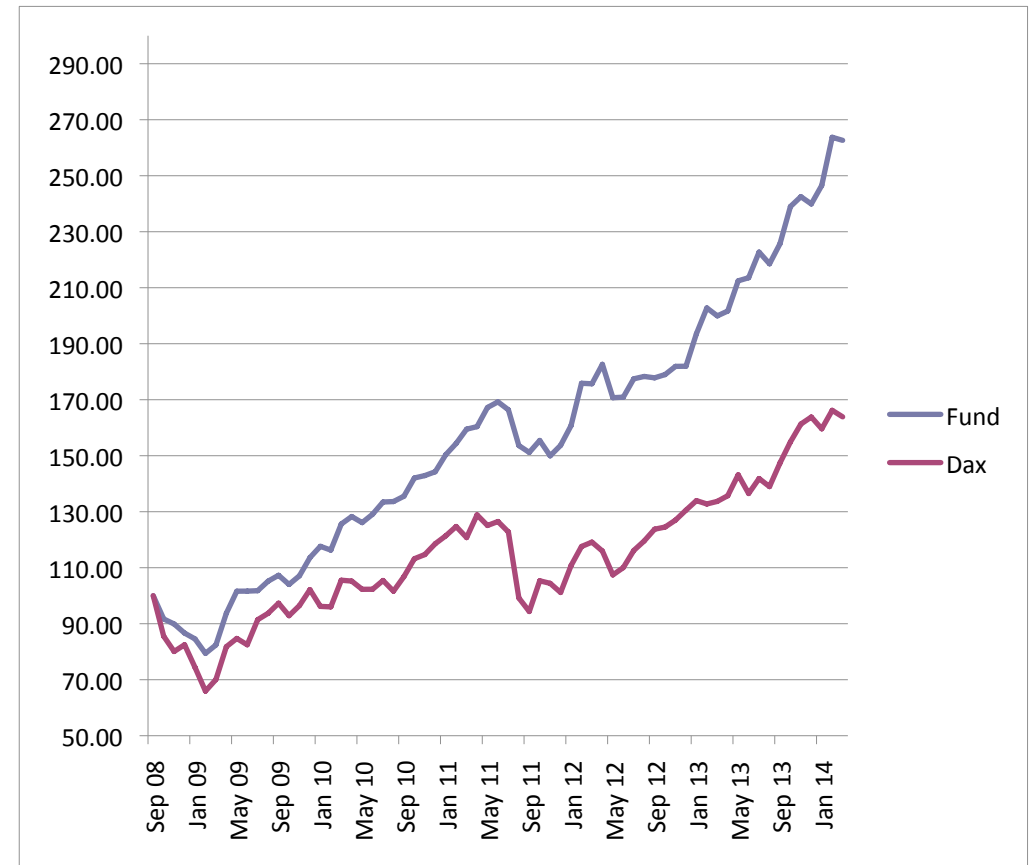
Mistakes of Omission

Robert Vinall

Omaha, 1 May 2014

About RV Capital

- RV Capital was founded in 2006.
- A one captain ship: Robert Vinall is the sole owner and employee
- AUM are US\$120 m
- Concentration is high. The fund has 10 holdings
- Turnover is low: <10% p.a.
- High concentration + low turnover permits a wide investment universe.



Why do we make mistakes of Omission?

- Behavioral Pressure
 - Losses hurt more than foregone profits
- Career Pressure
 - You do not get fired for missing a ten bagger
- Social Pressure
 - Rather fail conventionally
- Anchoring
 - On quantitative outputs
- Vanity
 - Value investors are proud of not paying up even for a great business

Why do mistakes of omission matter?

- Mistakes of commission are capped at 100%, whereas mistakes of omission are unlimited
- Mistakes of commission are rare in a concentrated portfolio, whereas mistakes of omission are more frequent
- It is well understood how to avoid mistakes of commission
 - No hidden leverage
 - Last man standing
 - Easy business to understand
 - Managers with integrity

Lots of ways to miss an opportunity

- Insufficient preparation
- An excess of opportunity
- Greed
- Lack of liquidity
- Too short a time horizon
- My Focus today is just one....

Fear of paying a high multiple (Valuation heuristics)

“Whether appropriate or not, the term ‘value investing’ is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics – a high ratio of price to book value, a high price-earnings ratio, a low dividend yield – are in no way inconsistent with a ‘value’ purchase.”

Berkshire Hathaway 1992 Annual Report

Five Friends

- Mr. Value Trap
- Mr. Value Stock
- Mr. Growth Stock
- Mr. Good Business
- Mr. Great Business

Mr. Value Trap

No Growth, 2% cost inflation

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	100.0	100.0	100.0	100.0	100.0	100.0
COGS	60.0	61.2	62.4	63.7	64.9	66.2
Gross profit	40.0	38.8	37.6	36.3	35.1	33.8
Gross profit margin	40.0%	38.8%	37.6%	36.3%	35.1%	33.8%
Opex	30.0	30.6	31.2	31.8	32.5	33.1
EBIT	10.0	8.2	6.4	4.5	2.6	0.6
EBIT Margin	10.0%	8.2%	6.4%	4.5%	2.6%	0.6%
Revenue Growth		0%	0%	0%	0%	0%
EBIT Growth		-18%	-22%	-29%	-43%	-75%
EV	100	100	100	100	100	100
EV/EBIT	10.0	12.2	15.7	22.3	38.7	158.0

Mr. Value Stock

No Growth, no cost inflation

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	100.0	100.0	100.0	100.0	100.0	100.0
COGS	60.0	60.0	60.0	60.0	60.0	60.0
Gross profit	40.0	40.0	40.0	40.0	40.0	40.0
Gross profit margin	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%
Opex	30.0	30.0	30.0	30.0	30.0	30.0
EBIT	10.0	10.0	10.0	10.0	10.0	10.0
EBIT Margin	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Revenue Growth		0%	0%	0%	0%	0%
EBIT Growth		0%	0%	0%	0%	0%
EV	100.0	100.0	100.0	100.0	100.0	100.0
EV/EBIT	10.0	10.0	10.0	10.0	10.0	10.0

Mr. Growth Stock

5% growth, no operating leverage

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Sales	100.0	105.0	110.3	115.8	121.6	127.6
COGS	60.0	63.0	66.2	69.5	72.9	76.6
Gross profit	40.0	42.0	44.1	46.3	48.6	51.1
Gross profit margin	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%
Opex	30.0	31.5	33.1	34.7	36.5	38.3
EBIT	10.0	10.5	11.0	11.6	12.2	12.8
EBIT Margin	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Revenue Growth		5%	5%	5%	5%	5%
EBIT Growth		5%	5%	5%	5%	5%
EV	100	100	100	100	100	100
EV/EBIT	10.0	9.5	9.1	8.6	8.2	7.8

Mr. Good Business

5% Growth, operating leverage

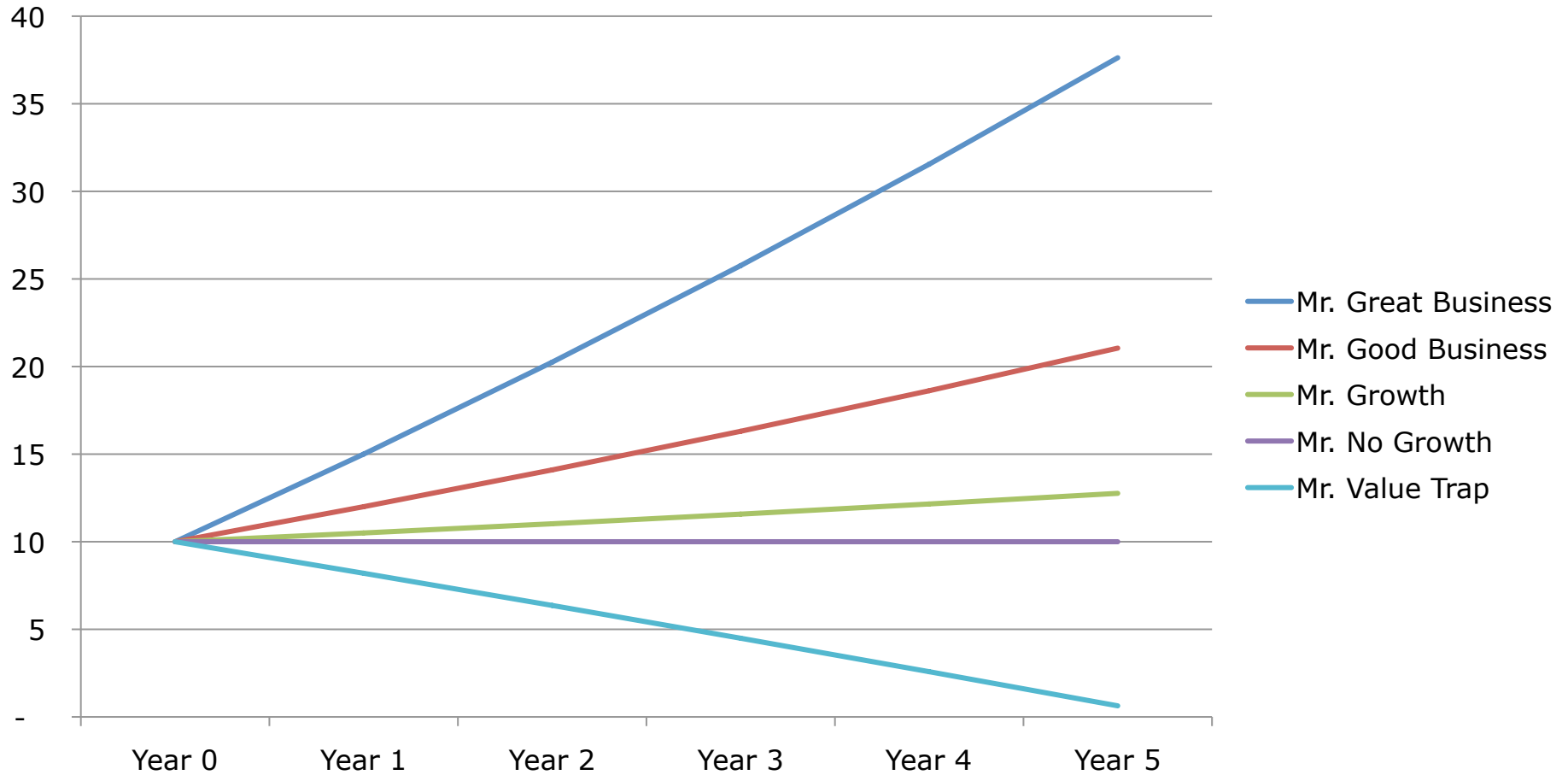
	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Sales	100.0	105.0	110.3	115.8	121.6
COGS	60.0	63.0	66.2	69.5	72.9
Gross profit	40.0	42.0	44.1	46.3	48.6
Gross profit margin	40.0%	40.0%	40.0%	40.0%	40.0%
Opex	30.0	30.0	30.0	30.0	30.0
EBIT	10.0	12.0	14.1	16.3	18.6
EBIT Margin	10.0%	11.4%	12.8%	14.1%	15.3%
Revenue Growth		5%	5%	5%	5%
EBIT Growth		20%	18%	16%	14%
EV	100	100	100	100	100
EV/EBIT	10.0	8.3	7.1	6.1	5.4

Mr. Great Business

5% Growth, Pricing Power

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Sales	100.0	105.0	110.3	115.8	121.6
COGS	60.0	60.0	60.0	60.0	60.0
Gross profit	40.0	45.0	50.3	55.8	61.6
Gross profit margin	40.0%	42.9%	45.6%	48.2%	50.6%
Opex	30.0	30.0	30.0	30.0	30.0
EBIT	10.0	15.0	20.3	25.8	31.6
EBIT Margin	10.0%	14.3%	18.4%	22.3%	26.0%
Revenue Growth		5%	5%	5%	5%
EBIT Growth		50%	35%	27%	22%
EV	100.0	100.0	100.0	100.0	100.0
EV/EBIT	10.0	6.7	4.9	3.9	3.2

An incredible dispersion of earnings power after 5 years



EV/EBIT Multiples at purchase to get identical return

Multiple Comparison	0% Return	10% Return	15% Return	20% Return
Mr. Great Business	38	22	17	12
Mr. Good Business	21	12	9	7
Mr. Growth	13	8	6	4
Mr. No Growth	10	6	4	3
Mr. Value Trap	1	0	0	0

Lessons

- Focus on the multiple relative to the business and not the absolute multiple
- At nearly all times, the great business will trade on a higher multiple than the value business
- For the truly long-term investor, the great business (properly analyzed) beats all other businesses at almost any price.
- There is a time horizon arbitrage in great businesses trading at high multiples
- It is perfectly valid to invest in non-great businesses, but be sure to pay a lower relative multiple
- Longevity of growth is far more important than the rate of growth

Someone put it more succinctly

“It is far better to buy a wonderful company at a fair price than a fair company at a wonderful price. I would rather be certain of a good result than hopeful of a great one.”

Warren Buffett

“Great” Businesses at “Good” Business Multiples in RV’s portfolios

- Google
- Novo Nordisk
- Fuchs Petrolub
- Baidu
- KWS Saat

“Good” Businesses at “Value” Business Multiples in RV’s portfolios

- Grenkeleasing
- Sto
- Tonnellerie Francois Frères
- BMW

Contact Info

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