Meggen, 23 January 2018

Business Owner TGV vs. the DAX

Year	Annual % Change in Business Owner (1)	Annual % Change in the DAX (2)	Relative Results (1-2)
2008 (3 months)	-13.4%	-17.5%	4.1%
2009	31.1%	23.8%	7.3%
2010	27.0%	16.1%	10.9%
2011	6.5%	-14.7%	21.2%
2012	18.4%	29.1%	-10.7%
2013	31.9%	25.5%	6.4%
2014	24.9%	2.7%	22.2%
2015	46.7%	9.6%	37.1%
2016	-1.1%	6.9%	-8.0%
2017	28.5%	12.5%	16.0%
Compounded Annual Gain 2008 – 2017	20.4%	9.0%	11.5%
Overall Gain Sep 2008 – 2017	458.6%	121.5%	337.1%

Dear Co-Investor,

The NAV of Business Owner was EUR 568.60 as of 29 December 2017. The NAV increased 28.5% since the start of the year and 458.6% since inception on 30 September 2008. The DAX was up 12.5% and 121.5% respectively.

Why the DAX?

We are roughly 30 words into this letter – "so far so uncontroversial," you may think. Wrong. I know from the occasional angry email that a minority of my readers – not my investors, I hasten to add - are already fuming. Why on earth should a fund with companies from all over the globe compare itself to the DAX?

I will tell the backstory in a moment, but first, you are probably wondering why an apparently minor detail elicits such a strong emotional response – I am guessing frustration and anger were not top of mind when you read about last year's results.

The fund management industry is characterised by intense competition. Crucially, this competition is to attract funds, not to generate the highest returns. When a new fund is launched, it generally has a theme that a marketing person thinks a customer segment could be amenable to. Exhibit 1 for the prosecution: A sustainable fund targeted at the environmentally concerned.

As soon as the fund starts to gain meaningful inflows, other players flood the market with similarly themed funds. The basis of competition then moves to performance relative to the benchmark.

As beating any benchmark is difficult and uncertain at the outset, a safer route to go down is to try to game it. Tricks of the trade include, but are by no means limited to, starting 10 small funds on day one and actively marketing the one five years later with the best performance, or using excess leverage, or investing outside of the universe. Imagine you start two funds, one for utilities and one for internet stocks, but crucially you put the utilities in the internet fund and the internet stocks in the utility fund. One of

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the two is going to have breath-taking performance – guess which one gets marketed to an unsuspecting public?

Understandably, people get upset when they think they see such jiggery-pokery.

The Backstory

So why do I refer to the DAX?

When I started Business Owner nearly ten years ago, it was domiciled in Germany, had mostly German investors and invested mainly in German companies. The DAX, the most well-known barometer for the German stock market, was the natural yardstick to compare progress against, comparable to the S&P 500 for US investors.

Whilst the composition of the investor base and domicile of the fund is unchanged, the capital allocation is more geographically diverse today. A global index is probably more relevant, but I have kept the DAX to date for two reasons.

Firstly, the decision to branch out beyond Germany was an active and – at the time – controversial one for a one captain ship – "Where on earth is your edge in Chinese Internet stocks?" I frequently heard in 2012. To the extent, it has brought a performance advantage, I believe it can be considered as part of the active track record.

Second, I think there is a lot to be said for not chopping and changing the benchmark every few years. Frequently changing the benchmark is another of the dark arts of performance manipulators. Given the fund's concentration, the sale of one company could completely change the geographic composition of the fund, necessitating constant changes of benchmark in theory.

Ultimately though, data on major indices such as the MSCI World is widely available. I encourage my investors to compare the development to whatever index they feel is most relevant. I believe the German market has been one of the better performing over the last ten years, so I doubt the picture would change much. Now I come to think of it, maybe it could be time to start marketing that Global fund filled with DAX companies…

Cryptocurrencies and Capitalism

One benchmark we can, for sure, agree Business Owner failed to beat last year was Bitcoin. The digital currency returned over 1'600%! For the uninitiated, Bitcoin is a digital currency that is created and held electronically.

I have been following Bitcoin for many years after a good friend drew my attention to it back in 2012 when it traded at just a few dollars per coin. Actually, he beseeched me to invest with the same vehemence you might expect someone to implore you to leave a building they knew to have a bomb in it. Needless to say, I did not otherwise you would not have suffered such a disastrous underperformance last year.

Bitcoin – a Ponzi Scheme?

When I was first introduced to Bitcoin, my initial reaction was "this is a Ponzi scheme" as there is no intrinsic value in bits of code on a computer and its price is driven by attracting new people to bid its value up. If you have had The Bitcoin Conversation with a believer, you will know the answer they shoot back is that this is no different from any paper currency. They have a point.

Money and Value

It got me thinking about the nature of capital and what gives money value. The definition of value that made the most sense to me is as labour saved. It is not a complete explanation of value, but a useful way to think about it, as the following analogy shows.

Imagine a closed community of farmers, each of whom tends to their fields manually. One day, a particularly inventive chap comes along and offers the farmers the use of a combine harvester. Thanks to this innovation, they save ten man-days of labour, time which can then be used to engage in another value creative activity, perhaps building a barn to store the grain over winter. Clearly, real value has been created by our inventor friend (in our example a barn). Clearly, all parties will happily agree to document this value creation. The inventor wants to get paid and the farmers want to pay him, so that he shows up next harvest.

The Role of Currency

The next step is to capture this exchange, which brings us to the role of currency. An I Owe You, a bank note, a seashell, and, yes, a Bitcoin could all be suited as media of exchange for this transaction. There are many desirable attributes in a currency (general acceptance, portability, scarcity, etc.), but the crucial one is a shared belief in the value it represents. All the above are potential stores of value for our transaction provided trust is a given.

Note that currency is necessarily an abstraction of value. Something that is intrinsically valuable, i.e. requires meaningful work to produce, is not well suited to be money. If the farmer is required to spend 10 days mining gold to pay the inventor for the ten days of labour saved, the whole exercise is a zero-sum gain, save for some jewellery for the missus. An abstract currency allows, in our example, the construction of a barn, which could be rented out to other farmers to store their grain, saving them the time of going hunting or gathering in the winter, effectively setting off a virtuous circle of productivity gains and new productivity-gaining innovations.

The Viability of Cryptocurrencies as Money

It is tempting to dismiss cryptocurrencies as a fad. It is uncanny how the current frenzy around initial coin offerings resembles the dot com bubble of the late 90s. Back then, the price of companies became completely untethered from any conceivable intrinsic value. Companies without a workable business model let alone revenues or, dare-I-say-it, earnings flooded onto stock exchanges with IPOs at astronomical valuations. People bought them simply because their share prices were going up, which for a time became a self-fulfilling prophecy (ring any bells?). The environment of easy money also attracted a lot of crooks with plainly fraudulent companies (ring any more bells?).

However, an important lesson from this period is that although almost all the dot com companies turned out to be worthless, they were not all worthless. Amazon, for one, emerged from this era.

Above all, the transformative impact of the internet was underestimated even by the most ardent Internet evangelists. From a late 1990s perspective, it was impossible to imagine how fundamentally virtually every segment of our economy was going to be transformed by the Internet.

If the analogy between the crypto boom and the dot com boom holds, there will be valuable cryptocurrencies in twenty years' time. Furthermore, they will transform our economy. In its essence, Bitcoin is a working demonstration of a distributed trust network, i.e. a network without any central authority. It offers both a means to agree on the contents of a database without anyone being responsible for the database and provides a financial incentive for the maintenance of the database in the form of new Bitcoins. It is easy to imagine how the distribution of trust could be profoundly disruptive to any business that is based on closed protocols and centralized control. This New York Times article provides a fascinating glimpse of how this might play out across various sectors such as ridesharing and social networks:

https://www.nytimes.com/2018/01/16/magazine/beyond-the-bitcoin-bubble.html

From today's perspective, none of the existing crop of coins are viable substitutes for dollars. They lack general acceptance and price stability, amongst other things. However, they could achieve this over time, or instead find a complementary role to fiat currency, as the New York Times article suggests. My conclusion is not to dismiss this space, but actively follow its development and potential impact on both current and future investments in the Business Owner Fund.

It is, however, beyond my ability to forecast which cryptocurrency will be amongst the winners (if indeed it has already been invented). As such, I have no regrets on passing on the investment opportunity in Bitcoin all those years ago. Over an investing lifetime, passing on things you do not understand is in aggregate the best policy, even if it is not always the best policy.

The No-Brainer Way to Play Cryptocurrencies

As we have already approached and most likely departed from the edges of my circle of competence, I would like to bring the discussion back to the obvious conclusion from a capital allocation perspective.

Imagine you are tasked with allocating the excess savings of our primitive farming community. You have the choice of buying a part share of the business of our inventor friend or taking a punt on one of the many types of seashell, which appear to be gaining traction as forms of currency in our early community.

The part share of the business is the right play for at least three reasons.

First, the business is creating real value in the form of labour saved. As such, it can be completely indifferent to which of the many types of seashell ultimately establishes itself as the primary medium of exchange. No matter what the currency is, people will be willing to exchange it for the services of our business. The seashell, by contrast, will only turn out to have value if it becomes the standard. Under all other scenarios, it is worthless.

Second, our business will produce profits in the form of seashells or whatever other form of currency is established for as long as it remains profitable. The single seashell which you purchase and hide under your bed will only ever be one seashell and once it is spent, broken or stolen, it is gone forever.

Third, our inventor business uses its retained earnings to invent more machines which generate more productivity gains, which result in new earnings streams, which are reinvested in new machines, and so on. This is the magic of compounding. It will continue as long as our inventor makes profits from his existing business and can reinvest those profits in new machines that provide new productivity gains to our community.

By now, you will have guessed the punchline. I view our companies in Business Owner as the inventor business, and Bitcoin as one of the many competing types of seashell.

Despite the modest underperformance vs Bitcoin over the past year (what's a thousand-odd percent amongst friends?), I feel comfortable about where our capital is.

The Role of Capitalism

Thinking about Bitcoin led me to think about capitalism in general. Even in my simple example of the farming community, it is easy to see how spectacularly well our economic system works. Each labour-saving innovation frees up time, which in turn catalyses new labour-saving innovations, setting off the most incredible virtuous circle. It has led us as a species from the savannah to the moon within the space of perhaps 200'000 years, not even a heartbeat on an evolutionary timescale.

It may seem a trivial point, but it strikes me that it needs to be emphasised more often how well our economy works. The alternative is to leave the field open to populist politicians describing how terrible everything is, and how they, uniquely, have the skills to fix things. Think: "Make America Great Again".

Yes, the system is imperfect. It requires the strong underpinning of law. The spoils need to be fairly shared amongst all participants so that they have a stake in the system's continuation. Neither of these two conditions is ever perfectly fulfilled. In some instances, they are not at all.

However, consider socialism as an alternative. It is a system that prohibits the flywheel of innovation as it objects to the outsized share of the spoils that accrue to our inventor friend. It is also a system that necessarily leads to dictatorship and violence. Given the obvious benefits to all parties concerned from the exchange between the farmer and the inventor, the only way to prevent it is through a ban enforced through the threat of violence.

A system that is based on violence and control can only appeal to one type of personality – the psychopath. Attempts to build socialist societies are not "spoiled" by the Stalins and the Chavezes. These are the only types of personality that are attracted to such a system and can thrive in it.

The Future of Capitalism

As great as our system is, I believe it is getting better. When Karl Marx visited England in the nineteenth century, he saw vast estates owned by the few with the land being toiled on by the many. He also saw new factories that the industrial revolution gave rise to. They too were owned by the few with the majority working under appalling conditions. He concluded that while technology might progress, the basic plight of the proletariat was unchanging. He was right to be disgusted by the lot of the workers, but wrong to diagnose ownership of capital as the root cause of the problem that effectively sealed the workers' fate in perpetuity.

He was wrong, as we now know, as mechanisation in agriculture would lead to farming becoming a progressively smaller part of the economy (and not a particularly profitable one at that for landowners). Furthermore, industrialisation was already leading to the emergence of a middle class made up of inventors, machine builders, distributors, lawyers, and an assortment of other professions. The tide was rising, and it was lifting many, if not all, boats.

He was also wrong as the role of capital was steadily diminishing, a process that has reached a zenith in the present day. Out of the five largest companies in the world at the end of 2017 (Apple, Alphabet, Microsoft, Amazon, Facebook), a grand total of zero required meaningful amounts of capital to get started. Still today, they can grow at virtually any rate they choose without raising external capital.

This is not to deny there are formidable challenges to become the next Jeff Bezos. Access to a decent education springs to mind as at least one. However, copious amounts of capital – inheriting a large estate, for example – is certainly not one of them.

It is time to reclaim the nomenclature for our wonderful system from the Marxists. They conceived "capitalism" as a pejorative term. It reflects just one aspect of our system and no longer the most salient one at that. The term "free market system" does not really do the job either as markets only work when there is an appropriate balance of freedom and regulation. If I had to distil our system into one defining quality, it would be Innovation. Our system unleashes the innovative capacity of human beings like no other. The outcomes are never perfect, but they are superior to all alternatives, certainly the ones propagated by populists. Perhaps "Innovationism" does the trick.

A New Currency Mining Machine in the Portfolio

We have a new company in our portfolio, one which I am confident will earn a lot of dollars and - when the time comes - crypto-dollars long into the future. It is called Shake Shack and it's a modern day "roadside" burger stand that serves a classic American menu of premium burgers, hot dogs, crinkle-cut fries, shakes, ice cream, beer and wine.

About Shake Shack

Shake Shack was founded in 2004 by Danny Meyer. Danny is an American restaurant entrepreneur, who owns and operates a string of high-end restaurants in New York City through the Union Square Hospitality Group ("USHG"), his restaurant holding company. A great talk where he describes his philosophy is here: https://youtu.be/5HVdOExw8Dw

Shake Shake started out as a hot dog stand in Madison Square Park in 2001. It was part of a Public Art Fund project, the broader aim of which was to rejuvenate the urban area around the park. As such, the company was initially conceived as a community wealth project and to this day, a keen sense of purpose permeates the culture.

The hot dog stand was so popular that a permanent Shack was opened in the park in 2004. The next one did not open until 2008 (given the founder's roots in fine dining, it was not obvious to open a second one). The legendary lines at the first Shack became longer still after the second one opened, vindicating the decision. Today the company has 90 Shacks in the US and plans to open 32-35 more in 2018.

At an early stage in its life, Shake Shack went international. It opened its first overseas Shack in 2011 in the Middle East. Today, Shake Shack has 59 Shacks outside of the US, including Japan, South Korea, Russia, throughout the Middle East and the UK. In 2018, it will open its first Shack in China when it opens its doors in Hong Kong.

What makes Shake Shack special is the combination of fine dining with quick service, sometimes referred to as "fine casual". Randy describes it as "80% of the fine dining experience at 20% of the cost". Its restaurants keep the essential elements of a fine dining experience – great food, a beautiful location and warm hospitality – and dispense with the detritus – white table cloths, flowers, and table service. This allows it to sell a burger, fries, and drink combo at roughly $12, just a few dollars more than a fast food chain and a fraction of the cost of a fine dining restaurant. There are plenty of craft burger joints that make a good burger and there are plenty of fast food joints that make a cheap burger, but the magic of Shake Shack is combining the two.

How I heard about Shake Shack

I first came across Shake Shack in 2013 when I read Danny Meyer's book "Setting the Table". Danny's philosophy of treating employees well so that they take great care of their guests deeply resonated with me. On subsequent visits to New York, I made a point of trying out his various restaurants and always left impressed.

I had my first taste of Shake Shack (a Smoke Shack) on Broadway back in 2014. Rather like the death of JFK, everybody remembers where they were when they had their first Shake Shack! The queue was long, but it only served to heighten the sense of anticipation and in any case, I had fun chatting with some young people from China whilst waiting.

The company went on the stock exchange in 2015 and the share price shot straight up into the stratosphere. Since then, the share price has come back down to earth whilst the company has developed well both in terms of growing its footprint of company-owned restaurants in the US and establishing footholds overseas. In the 3rd quarter of 2017, I decided it was time to become a co-owner.

Why invest?

There are many potentially desirable characteristics in an investment, however if you speak with an experienced business person, they will always tell you that first and foremost it comes down to the people. This is my starting point too.

I could not be happier about the people we are associating ourselves with at Shake Shack.

Danny is the spiritual head of the company. He continues to play a key role as both board member and major shareholder.

The business is run by Randy Garutti. I was fortunate enough to have the opportunity to spend a morning with Randy last year. He is the epitome of a servant leader, who clearly cares deeply about his staff. Look at the final minutes of a talk he gave to the Conscious Capitalism CEO Summit in 2015: https://youtu.be/3IAv8yyjlZA?t=31m23s

Randy is exactly the type of person I had in mind when I talked in my last letter about partnering with leaders who "set the right example". He is also deeply experienced. He joined USHG in 2000 and oversaw the development of Shake Shack since the beginning. He became COO of the company in 2007 and CEO in 2011.

I also had the opportunity to meet with several restaurant managers through my research (trust me, my store checks were very extensive!). They each had their own management styles, but each of them exuded warmth and hospitality.

Is Shake Shack Building a Long-Term Competitive Advantage?

After the people, the next thing I look for in a company is strong and, most importantly, growing competitive advantages.

Shake Shack clearly has a moat based on the fantastic unit economics of its restaurants. On average, it domestic, company-operated restaurants had average unit volumes ("AUVs") of US$ 5 m with an EBITDA margin of 28.3% in 2016. Given an average build cost of around US$1.9 m, this implies a return on capital of 74%. For newer shacks, it expects a return on capital in a still impressive range of 30-33%.

In my view, the main source of its moat is its brand. If pricing power is the litmus test for a brand, then it is most evident in the licencing business. Shake Shack commands royalty rates far above the industry average. Domestically, it makes a conscious decision not to fully exercise its pricing power and prices at a similar level to Five Guys, for example. This drives higher customer footfall and enhances the value of the brand. It is a win-win for Shake Shack and the customer.

Shake Shack's brand also results in cost advantages. It spends very little on building awareness when it enters a new region in the US or for that matter a new country as its brand is already so well known. Most successful restaurant concepts tend to start in one region, gain a loyal following, then struggle to export the concept elsewhere. The arrival of a Shake Shack, by contrast, is generally greeted by huge queues irrespective of whether it is the East Coast or West, or even overseas. The brand benefits from coming to prominence around the same time as social media was taking off, as well as being born in New York given the high numbers of tourists there.

Its culture is also a source of competitive advantage. At the heart of its culture is Danny's philosophy of "enlightened hospitality," the idea of taking great care of employees, guests, suppliers and the wider community. It creates alignment between all these constituencies and ultimately shareholders. This creates a virtuous circle of happy guests, which feeds into economic success, which in turn creates opportunity for employees and growth for suppliers. It is very tough to get such a virtuous circle going but once it is in place, it becomes self-replicating as people naturally continue doing what made them successful in the first place.

In my view, Shake Shack is growing its moat. By thoughtfully expanding its restaurant footprint in the US and overseas, it helps to spread the brand whilst at the same time capitalises on the demand for Shake Shack. It also creates opportunities for staff to grow within their roles reinforcing the culture.

Is the Price Attractive?

The final thing I look for in an investment is an attractive price. Through a traditional value investing lens, Shake Shack probably does not make much sense as an investment. GAAP earnings are small relative to the company's market value due to the early stage of its development. Its revenue base is still small and, whilst the existing restaurants are exceptionally profitable, these profits are reinvested through the P&L into building a bigger company, which burdens operating margins at the group level.

My investment case is not based this year's earnings or next's, but on where the company can be five or more years in the future. In an equity market where opportunities are scarce, I believe the best opportunities involve looking a little further ahead into the future than the crowd. Yes, the future is uncertain and Shake Shack's success is not guaranteed either at home or abroad but given how profitable its restaurants are on a stand-alone basis as well as the enormous runway that lies ahead, it strikes me that you get start-up like growth rates without start-up risk.

So where do I see the company five or ten years from now? I believe its domestic restaurant base can be many times bigger than it is today. The company targeted 450 domestic restaurants at the time of the IPO, which is five times today's levels. It still maintains this target but has pointed out that it has generally been positively surprised when it has tested new types of format or location. This bodes well.

In addition, there is the licencing opportunity overseas. The brand seems to work equally well or better overseas as at home. Its launch in Japan was a sensation, only to be topped by the subsequent launch in South Korea. The success in South Korea is particularly pertinent as the country is a trendsetter for the entire region. Shake Shack will open its first restaurant in Hong Kong this year with Shanghai to follow shortly afterwards. If South Korea is anything to go by, Shake Shack has an enormous opportunity in China. As far as I can judge, capital market participants are focussed mainly on Shake Shack's domestic opportunity, but over time I am hopeful this royalty stream alone could justify the price we paid for the entire company.

Taking company-operated restaurant and licence revenues together, I believe Shake Shack's revenue could reach US$ 1.7 bn at scale. Assuming an operating margin of 18% (remember that licencing revenue is almost pure profit), this implies operating earnings of US$306m or roughly 3.5x what we paid for the company. I have no idea how long it will take to get to scale, but if it were 10 years and an appropriate multiple were 12x, this would get us to a 15% CAGR including a little bit of cash generation along the way.

It is by no means guaranteed that the company will get to scale and, for sure, there will be setbacks en route if it does, however I believe it has the people, the culture and the business to get there.

2018 Investor Meeting in Engelberg

I look forward to welcoming many of you at my investor meeting in Engelberg in a few days. For those of you who cannot make it, I am planning a live stream on my YouTube channel. For those of you who can, I wish you safe travels!

Yours sincerely

Rob

Robert Vinall