REFOCUS

PORTFOLIO MANAGER MONTHLY - AUGUST 2018

Richard Court

This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

Scale: Bigger Isn't Always Better

Economy of scale definition: A proportionate saving in costs gained by an increased level in production

"Predictable income streams are much more valuable than volatile ones."
John Malone

A current theme in investing is the emphasis on buying "quality businesses". A quality business is generally defined as a business with a durable competitive advantage that allows the business to generate returns superior to its competitors and greater than its cost of capital.

But quality – like beauty - is in the eye of the beholder. A high point in the business cycle can dress up a poor or average business as a quality business due to returns being above what the business would normally be expected to generate over periods that include the worst of times along with the best of times.

So then, more specifically, what are the characteristics that convey a durable competitive advantage for a business? These qualitative characteristics include: network effects, intangibles that competitors or newcomers would struggle to replicate, switching costs, and cost advantages linked to size or scale. These different factors all deserve their own discussion. This article will only address one aspect however: Size or scale that conveys a cost advantage – a commonly quoted reason for a business being described as "quality".

The traditional definition of "economies of scale" is that as production increases, the per unit cost decreases. This happens due to part of the cost base of the business being fixed in nature. Hence, as volumes increase and fixed costs remain roughly the same, fixed cost per unit declines. This is also known as "operating leverage". This translates into cost advantages for businesses that are larger than their competitors. And therein lies the crux of the matter: Being bigger than the next guy only matters if it results in a cost advantage that is durable.

The above description typically conjures up visions of manufacturing businesses with factories producing widgets, but the cost advantage from size can also stem from bargaining power with suppliers. The qualitative factor here is that a larger business can have more bargaining power with suppliers than a smaller competitor. This effect is often found in grocery retailers, as was made obvious to us while researching Tesco Plc – currently our largest holding in the RECM Global Fund. Tesco is the dominant grocery retailer in the UK with just short of a 30% share of the grocery retail market. Smaller competitors readily acknowledged during our interviews with them that they could not compete with Tesco when it came to buying power, and that this phenomenon would persist as long as Tesco maintained its dominant position in the market place.

The problem is that the opposite effect can take place in reverse when production declines or sales fall. It is difficult for the business to reduce the fixed cost base. So when volumes decline, the cost per unit increases. In the event of declining production and revenue, diseconomies of scale takes place. This reduces profitability and may even lead to losses if the situation is severe enough.

There is another aspect integral to determining whether scale provides a business with an economic moat, which is often ignored because it has nothing to do with the cost base. Instead, it relates to the revenue generated by the business, and more specifically how stable revenue is. Stable revenue streams are generated from a customer base where the bargaining power in the relationship between the business and the customer resides with the business rather than the customer. This is sometimes referred to as "customer stickiness" – in other words, how likely the customer is to stick with the supplier even if faced with adverse influences such as price increases or falling standards of service. As you might expect, a high level of customer stickiness allows businesses with greater scale to consistently generate superior profits and allows these businesses to constantly reinvest in their businesses to further bolster and extend their competitive advantage.

Without customer stickiness, the risk of diseconomies of scale is high. A good example of this risk is an underground mining operation. These businesses have a high proportion of fixed costs meaning operating leverage kicks in when revenues increase. However, mines produce a commodity that customers can switch from and source from any other producers of the same commodity. By definition, customers are not sticky at all. The last 10 years of history in the mining sector have illustrated the ecstasy of economies of scale when revenues soar, and the agony of diseconomies of scale when they plummet.

Hence, in assessing whether scale indeed translates into a durable economic moat, the business should have both: 1) a fixed cost element to the cost base which allows for economies of scale and 2) a degree of customer stickiness which protects against diseconomies of scale.

The telecommunications sector contains businesses which potentially tick both boxes in the form of cable operators. These businesses provide video content to consumers via a physical infrastructure consisting initially of coaxial copper cable, but increasingly moving towards fibre. Many of these businesses are transitioning from simply providing content to providing connectivity and giving consumers the ability to select their own content.

This transition has been brought about by a change in the way people consume content. Gradually people are turning their backs on buying expensive bundled Pay-TV packages from cable operators and turning instead to flexible and better value for money Over-The-Top (OTT) streaming services that provide video on demand to consumers. The demand for these OTT services is driving an increase in demand for greater amounts of data at faster speeds. Cable operators are an attractive entry point to take advantage of this technological trend. This is because their existing physical infrastructure is well placed to provide consumers with the necessary connectivity at the required speed.

The largest businesses in this sector in the United States are household names such as Comcast, Charter and (before Charter acquired it) Time Warner Cable. These are indeed fantastic businesses run by good capital allocators, but the valuations unfortunately do not present a compelling opportunity for us as value investors at current prices. Their inherently strong characteristics have resulted in the market pricing them at fair to dear multiples. Similar businesses in different localities have thus drawn our attention, and as it turns out, provide far better investment opportunities at current prices.

Liberty Latin America is a cable operator that owns cable assets in the Caribbean, Chile and Puerto Rico. It provides Pay-TV and broadband to consumers in these geographic locations. The business was spun out of Liberty Global at the beginning of the year into a completely separate legal entity. Previously, it only had a tracking stock that reflected the economics of the Latin American assets.

The cost of providing either broadband or Pay-TV has a large fixed cost element. The cable company also holds the edge when it comes to bargaining power with the customer: The customer derives a great deal of utility from the products provided by this type of business and is prepared to keep on paying for these products and services as a result. Liberty Latin America is also able to enter into arrangements with mobile operators to provide mobile telephony to its customers. The ability to offer multiple products and services to a customer increases the likelihood that the customer will stick with the service provider and makes them less likely to shop around for alternatives. The result: a stable revenue stream from a sticky customer base flowing over a (largely fixed) cost base that lends itself to economies of scale. This has all the makings of a quality business model.

In Liberty Latin America, we've found a business with a durable competitive advantage that has the added bonus of being controlled by one of the world's best known capital allocators – Liberty Global founder, John Malone. It operates in a fragmented market ripe for consolidation. Currently trading at a significant discount to what we calculate to be the firm's fair value, it is a worthy and welcome addition to the RECM Global Fund.