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Editors

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MBA 2012

Joseph Jaspan
MBA 2012

Mike DeBartolo, CFA
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Robert Luciano
Concentrate Capital In Your Best Ideas

Robert Luciano

Robert Luciano, CFA is the founder and Managing Partner of VGI Partners. Mr. Luciano has over eighteen years experience gained as a portfolio manager, equities analyst and accountant. Prior to founding VGI Partners in 2008, Mr. Luciano spent five years as an Executive Director and Investment Manager with Caledonia Investments in Sydney. Mr. Luciano earned his B.Com and M.Com from the University of New South Wales. Mr. Luciano is a CFA Charterholder and a Fellow of the Financial Services Institute of Australasia.

G&D: Could you talk a little bit about the background of VGI Partners?

RL: VGI was founded in early 2008 at what turned out to be the early stages of the global financial crisis. As one of my good friends said at the time, we couldn't have chosen a better time or a worse time to start an investment management firm. We started managing money for wealthy families and individuals and that remains our client base. Our focus is on concentrating our capital in our best ideas. We had some attributes that we wanted to incorporate from our experience over the last 10-15 years in the investment management industry and take some of the positives and learn from the negatives, and really go back to the basics of what absolute return investing is all about. We wanted to ensure that we as principals had close alignment with our investors, so we invested in the same funds or vehicles that they were. We also wanted a structure that was skewed toward performance and not on maximizing management fees. We are focused on returns, and on the alignment of interest between the manager and the client. That's the crux of what VGI is about, and what its modus operandi has been from day one. We assembled a group of highly focused, highly talented people who, along with me, are equity partners in the firm and have a very substantial amount of their own and their families' net worth invested in VGI and the Fund. This creates a very unique alignment of interest, which is so important and yet so few people have it these days. It's one thing to have money invested in the funds that you manage; it's another thing to have the vast proportion of your net wealth invested in the funds that you manage. That focuses your attention very substantially and it causes you to focus on preserving capital first and foremost, and then secondly, on generating returns on a risk adjusted basis. So it ensures that you think about Ben Graham's great concept of margin of safety all the time. For example, we don't allow personal trading at VGI, which means that everyone here focuses exclusively on what we're doing. We are looking for high quality companies and high quality investments. We limit the amount of capital we raise, aiming to manage money only for people who share our time horizon and investment philosophy. That's wonderful for us because it means we have an excellent client base that understands our style of investing, and when there is volatility, we are not worried that we'll have upset investors. That's a key issue these days, when many fund managers have money under management that can cause them to embark upon what Warren Buf-

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fett calls "the institutional imperative." It is important to have the right people and infrastructure, the right investment philosophy and alignment of interest, which goes hand in hand with the right compensation policy, and the right capital meaning the right investor base. That's difficult for many managers to put in place and particularly as they continue to grow, it becomes very complicated.

G&D: A lot of fund managers we speak with often say that finding patient capital is one of the biggest challenges in investment management. What is your secret sauce?

RL: Part of it is simply that we manage just under $300 million and have grown organically and via client referral. When you manage billions of dollars, the incremental capital that you raise can become lower quality and is more difficult to manage. Every incremental billion becomes harder and harder to manage as size is an anchor on performance. We have decided to close to new investors when we reach around $1 billion under management, and the reason for that is that we like to invest 50% of our capital in our top 5 ideas. So with $1 billion, an average core position size is going to be around $100 million, and for some small to mid-size companies it becomes difficult to invest more than this due to liquidity constraints and other factors.

G&D: Would you explain the reasons why you prefer to run a very concentrated portfolio?

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RL: We subscribe to the Buffett and Munger philosophy, where one of the key tenets is concentration of capital in your best ideas, and we believe in concentrating in our best ideas for a number of reasons. For instance, we can only analyze and know so many companies in detail at a single point in time. Also, by concentrating our capital in our key ideas we are hopefully able to optimize our return on capital. Concentration allows us to focus all of our research and continuous learning efforts on a relatively small number of great businesses. We have six people on our investment team, so we can harness a large amount of resource and focus on a number of companies, so we can build up knowledge on specific companies very rapidly. As time goes by your knowledge on these companies increases and this improves your understanding on how the business makes money, its sustainable competitive advantage, the industry structure, the company's financial statements and its future earnings power. It allows you to bring a lot of things together and that's particularly helpful during times of volatility when share prices can fall sharply, and the rest of the market is fearful, you have the courage of your convictions and because you've done your work and your analysis, you can buy more. That's one of the key Graham tenets - that you need to understand the business, to back your conviction and your analysis, and even if the

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market disagrees with you for a period of time, allocate your capital accordingly. If you don't know the companies well, it's very difficult to gain the conviction to buy more when the price falls sharply. We realize that we have finite capital, so to optimize our return on capital we allocate our efforts and our capital towards our best ideas. We are not going to spread the portfolio across 50 or 100 stocks because we don't think it makes any sense. We want to concentrate capital in our best ideas, and we think over time this will give us a superior return to the market or a portfolio that has a high degree of diversification. Most importantly, that superior return will be achieved with lower risk, because we understand the companies in depth and we have selected them one by one. We think we reduce the risk in our portfolio by ensuring that we only invest in high quality businesses and we define risk as the permanent loss of capital, not as standard deviation of return.

"A great investment is one you'd never have to sell. It's an asset that you bought at a reasonable price and which continues to deliver a return that you are pleased with. Its return exceeds your hurdle rate, whether that's a property, a private business or a listed security."

G&D: Would you explain a little more about your investment criteria?

RL: A great investment is one you'd never have to sell. It's an asset that you bought at a reasonable price and which continues to deliver a return that you are pleased with. Its return exceeds your hurdle rate, whether that's a property, a private business or a listed security. When it comes to stocks, what we're looking for are companies that we can understand that have relatively simple and straightforward business models and attractive industry structures. We don't like complexity in terms of conglomerates or opaque financial institutions. We then narrow this list to find companies with a truly sustainable competitive advantage. I think you can only ascertain whether the competitive advantage is truly sustainable by understanding the business model and industry structure. If you can find a company that has a sustainable competitive advantage and you can buy it at a reasonable price, then you're on your way to a successful investment.

G&D: But wouldn't those companies be priced at an appropriately high valuation?

RL: In a normalized market environment, yes, this is usually the case, particularly if it is a well known stock. However in the past few years, you have been able to buy some of the best companies in the world at significantly marked-down prices. One of our largest positions is The Coca-Cola Company which was trading in the low $40s in late '08, early '09, and that stock until only just recently has been trading at a considerable discount to intrinsic value. Coca-Cola is one of the greatest businesses in the world that epitomizes sustainable competitive advantage. Our job is to find companies that have these characteristics and buy them at a reasonable price. So for our investments, we look for companies that are relatively easy to understand which often means avoiding some companies whose businesses are extremely vulnerable to technological innovation. Sustainable competitive advantage is very important, and the key is to buy it at the right price. If you overpay for a wonderful business, you can generate low or even negative returns for a very long time. Investors in Coca-Cola would have ex-

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perienced this if they paid around 50x earnings in the late 1990s. You could have bought Coke stock then and made no money for over 10 years. I guess this perfectly highlights Warren Buffett's point about "paying a high price for a cheery consensus."

G&D: Where have you typically found your best ideas? Do you run screens?

RL: There are a variety of ways we come across our best ideas. A lot of it is comes through general knowledge and combined experience. I've been looking at public securities since 1996 and reading hundreds of annual reports, as well as Outstanding Investor Digest, *Graham & Doddsville* and other investing publications. So our knowledge of securities has accumulated over time. Investing is one of those wonderful careers where the more time goes by, the better you get, unlike an athlete that has a finite career. Charlie Munger and Warren Buffett are a testament to this. They have gotten better as they've gotten older. So I guess it's collective learning – we have a short list of businesses we'd like to own, and sometimes price gets in the way of that. Sometimes it's our own fault where we don't want to pay up for a great business and the stock just keeps going up or we simply miss it. Sometimes we find them through screening, other times we find them from speaking with other companies. We typically conduct more than

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350 company meetings a year either through company visits, conference calls, or one-on-one meetings at conferences. We regularly ask companies who their key competitors are and who in the industry they recommend that we speak to. We ask management who they respect and admire and which other companies we should be speaking to. So there is no single approach, there is no single technique. Sometimes we may have an idea for a long time, for example Colgate-Palmolive which we have in the portfolio. We have been long-term admirers of the company, and for whatever reason didn't buy it during the financial crisis. The stock got quite expensive at one point, and then there was an opportunity to purchase Colgate in August 2010 when there was some concern over what we thought was not a serious matter. There was the devaluation of currency in Venezuela and also threat of competition from P&G which we assessed to be temporary and not material to valuation so this gave us an opportunity to buy the stock at very attractive levels. This is an example of a company that we had on our watch-list, we missed an initial opportunity, but we continued to watch it, and when the stock was sold off it was a very quick decision to build a substantial position in Colgate. It's important to keep watching great businesses because invariably you get these opportunities over time.

G&D: Are there any industries that you find yourself investing more than others?

RL: We avoid certain industries and therefore, by doing that, we tend to focus on what's left. We avoid banks and insurers because of their complexity and opaqueness that makes it difficult to forecast the earnings power of these businesses and to ascertain what their true intrinsic value is. We don't feel we

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have any adequate edge to price those securities with the amount of information available in the public filings. We also tend to avoid resource companies because we find it difficult to value them due to the uncertainty of longer-term commodity prices. It is one thing to have a sense of volume; it is another thing entirely to try to ascertain what the longer-term price of a commodity will be. We currently do have a focus on business service software that has recurring revenue at the core of the business model. We like recurring revenue businesses in general, whether it's in software, in financial services, in media or in healthcare. We don't tend to do top-down analysis, but rather focus on bottom-up analysis - we focus more on companies than industries per se. Having said that, we are very mindful of longer term trends, so for instance an ageing demographic is a very powerful longer-trend trend in many Western countries. So we're mindful of secular trends or shifts in terms of industries or sectors that we can invest in, and I think it is important to be mindful of these types of secular changes that are going on, but we don't invest based solely on those criteria.

G&D: Could you talk about some current ideas?

RL: One of our key positions is Oracle Corporation. We think Oracle is an excellent business, and particularly attractive at these prices. It's a stock that is out of favor with the market. We've owned it from the high teens and it's about $30 at the moment. Oracle dominates the industry in relational database software. It has evolved substantially in the last 15 years from selling software on a one-off basis to selling software with a recurring revenue stream attached to it in the form of Update & Support fees. So effectively the Update & Support fee has evolved to being the biggest component of Oracle's revenue. The Update & Support revenue for Oracle is linked to the initial purchase price of the software, and is about 22% of the purchase price per annum and indexed to inflation. Roughly 96-97% of Update & Support contracts are renewed annually; the small amount that is lost is usually due to M&A and bankruptcy. So what they've done is built up this recurring revenue stream. In 2001, recurring revenues were $3.5 billion while one-off revenues were $4.5 billion. In FY 2011, the recurring revenues were $14.8 billion and new software fees were $9.2 billion. The delta between $3.5 and $14.8 billion has a gross profit margin of about 90% and the incremental gross profit margin is even higher.

"We like Oracle along with SAP because they're both mission critical software businesses that have established a very strong recurring revenue base. They are must-haves for large global corporations and it's very hard to dislodge Oracle or SAP once they have been installed."

G&D: So what is the market most concerned about in pricing this stock?

RL: We like Oracle along with SAP because they're both mission critical software businesses that have established a very strong recurring revenue base. They are must-haves for large global corporations and it's very hard to dislodge Oracle or SAP once they have been installed. The market is likely focused on some weakness in new software license sales for Oracle, as it can be a driver of near term results, but if you're looking at it on a longer term basis, the recurring revenue stream and

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its growth are far more apparent. Oracle recently acquired Sun Microsystems, and the market initially was concerned about this acquisition because Oracle was effectively buying a hardware company that was not making any money. The market was worried that the company was "deworsifying" but it turned out that the company ended up reducing cost, cutting out unprofitable revenue and ended up acquiring Sun for what looks like less than 2.5x EBIT which is a very attractive acquisition price. That concern faded away, but another concern may be that the management team is shrinking the revenue base of Sun as it gets rid of non-essential revenue lines and low margin products. It appears to concern people that the hardware revenue is shrinking, and I think there's a broader concern that the arrival of cloud computing would dislocate Oracle's dominance in relational databases. What we're focused on is this remarkable increase in the recurring revenue stream, which has only accelerated post the financial crisis. The recurring revenue was $8.3 billion in 2007 and grew to $14.8 billion in 2011, and we're looking for a number of around $16 billion in 2012. That's a staggering growth rate on a revenue line that has a gross profit margin of over 90%. Even if we assume that the company no longer grows its 2011 free cash flow in perpetuity you'd still get a valuation that is around the current stock price. We think that is remarkable, because you don't get that type of margin of safety in many stocks today. We read a 120 page report on Oracle from the sell-side a while back that had no mention of the recurring revenues! I don't understand how such a large revenue base with such a high gross profit margin goes unnoticed in a 120 page report. It reminds me of McDonald's, how the market was obsessed about food prices a few years ago while forgetting that McDonald's was one of the most diversified property owners in the world. The high food prices were somewhat relevant as they would affect the franchisees, but to be obsessed with them didn't make much sense. What sometimes can happen is that analysts can become stuck in a certain way of analyzing a company, and the same analysts cover the same names for many years, and they sometimes just don't pick up gradual shifts in business models. They focus on the data that they have populated their models with and they miss the new data.

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G&D: Is there another name that you are currently excited about?

RL: WD40 is a global consumer products and brand management company. The vast majority of WD40's revenue is generated from selling cans of the world famous WD40 branded industrial lubricant (G&D: WD40 stands for Water Displacement, 40th attempt which was the laboratory name used by the chemist who developed the product in 1953).

WD40 manufactures the WD40 concentrate inter

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nally to protect its secret formula. WD40 ships this concentrate to external 'aerosol fillers' and outsources the majority of the manufacturing of its product to third parties. As a result WD40 has only two employees in its manufacturing operations. This asset-light business model enables WD40 to operate with very little capital and only 334 employees.

WD40 generates greater than US$1,000,000 in revenue and US$171,000 in EBIT per employee. These metrics are particularly high for an industrial company and highlight how management operates the business. WD40's outsourced-manufacture business model means that it has lower fixed operating costs than a typical manufacturing company. This allows WD40 to shut down production rapidly when there is a sudden drop in demand, as we saw in 2008/2009, which helps protect WD40's profit margins. WD40's dividend payout ratio is around 50% which we think is impressive and it is now embarking on substantial share buybacks. Last year, WDFC bought back $41 million of stock on top of paying dividends, for a total return of capital to shareholders of $60 million, which we think is extraordinary. The stock at these levels is still undervalued at a 7% free cash flow yield for a company with such high quality characteristics. At this point, you're not paying anything for a takeout premium, and we think this mono-line business with no debt and high cash flows is a standout candidate to be taken private.

G&D: You started VGI Partners in Sydney initially, given your background. How did you decide to open a NY office?

RL: We have primarily focused on equities outside of Australia since our founding in 2008 because the opportunities internationally have been so substantial. As we became better known to investors, we have had more interest from outside of Australia and we came to the realization that we needed to have a base in either the US or Europe to help us grow and allow easier access to companies and management teams. We had a choice between New York and London and we decided to work closely with a large investor in New York. New York is a great place to be and we also get terrific access to first class graduates who can potentially join us and help us grow VGI Partners.

G&D: Any advice for students thinking about entering the investment industry?

RL: I think that this profession largely chooses you. Most people who I think have become successful in investing have shown character traits at an early age that suggested that they would be successful in investing or in business. I don't think that this is a career that you can force upon yourself, because it is something that you have to be genuinely interested in. My advice would be to learn from Charlie Munger and Warren Buffett, read all their speeches, and read all the original Buffett Partnership and Berkshire Hathaway letters. I would also highly recommend reading Phil Fisher's "Common Stocks and Uncommon Profits." The teachings of Ben Graham go hand in hand with the teachings of Warren Buffett, and the "Intelligent Investor" is a must-read. I would also spend as much time as possible studying accounting. It is something that I feel a lot of modern finance courses underestimate. One of the keys to being a successful analyst is understanding accounting and financial statement analysis, and that is vastly underappreciated. I was trained as an accountant; some of our team members were trained as accountants too and four of the Investment team, including myself, have completed the CFA program which puts a lot of emphasis on financial statement analysis. Finally, don't focus on the monetary outcome, if you are a good analyst the monetary outcome will find you.

G&D: Thank you very much, Mr. Luciano.

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