

FARNAM STREET CAPITAL LIMITED

Thursday 25th October 2018

Dear Investors and Friends,

Final Report for the period ending September 2018 – Net Asset Value: £169.5

During the year to September 2018 the fund NAV rose in value by 3.1%. This is the net return to investors after all fees and the funds modest running costs. Post a significant move up in the funds NAV in the previous year (+ 31%), this twelve month period returns were more modest. Whilst parts of the portfolio may look similar to a year ago we really like its combined level of undervaluation vs what we assess as its underlying intrinsic value. Also, despite recent record high US stock-market levels we are still finding good new ideas. In short, we very much like what we own at today's prices.

The economic backdrop

In past letters we started by outlining the economic and investing backdrop that we are investing against. However our contrarian nature encourages us to do less of this now. Depending on which side of the Atlantic an investor is based they will be bombarded with either fears over Brexit or fears over global trade wars and rising interest rates. We will offer only a short view on each below.

Brexit we feel is one of our three cycles in full flow – the political cycle. We think it unlikely it will have a damaging effect on the UK economy. Does it create uncertainty? Yes, but does it really create a risk of a lasting nosedive for the UK economy? We believe not. We note that the further up the ivory tower commentators are located (CBI + Bank of England Governor), the more worried by the lasting economic effects of Brexit they seem to be. We see things rather differently. The real UK economy outside the City of London and Whitehall is lots and lots of people constantly adapting to the circumstances that they find themselves in their business and daily lives. The secret of 'UK plc' is that it is a dynamic economy and as such its occupants are versatile. Very few outside parliment or boardrooms watch and wait for a grand plan. They adapt to the challenges and opportunities that confront them on a daily basis. Brexit is/will be just something else to adjust to. As such we feel that much of what we are all listening is noise and *some* of it might create investment opportunities.

As for rising US rates. Well a few short years ago all were fearful of lasting low growth and the deflation spiral it would create. At those times we stated that we were not worried about rates rising – we were worried they might not (ie that deflation would become a reality). As such we welcome both the stronger growth of the world's biggest economy and the normalisation of interest rates that now accompanies it. At a sector level we find it amusing (and as shareholders, a little frustrating) that fears over US banking profits have in the space of a few weeks gone from how "hard it is for them to make money in a low interest rate environment" to now: "how higher rates may cause loan default problems". For a long time, the US economy was perfectly able function with the Fed Funds rate at c.4%. Maybe it can again?

The longer we run money for the less time we spend thinking about the macro drivers of the economy. As contrarians much of what we tend to be looking at/ buying is in places that are neglected. Often the companies we buy might be near say the five year low of its share price. As such; timing, markets, or indeed the economy will not help us a great deal (even if we could do it right).

We of course however need to be mindful and careful of the cyclical and leverage risks that some companies can come with. That said, at some points even these risks can be mispriced as well. We are minded to side with the great man below: It is not that we enjoy all this perceived uncertainty but we sure enjoy the lower share prices it often brings.

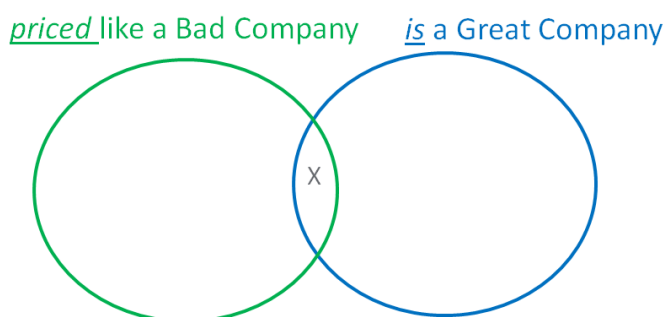
“It is not that we like bear markets, but we like the prices they bring” Warren Buffett

Franchise investing by example

Over the last ten years since we began writing and investing under our own banner we have strived to both improve and simplify our investment process – passing on our learnings along the way to clients. The desire to improve our process so that we can better understand what constitutes a great company is understandable, but the need to simplify we think, is crucial too. Only by doing so can we, and we hope you, more easily put into practice improved thought processes.

Some years ago, we stumbled across the following Venn diagram – immediately it struck a chord with us. We have used it in our letters before and make no apology for doing so again. We think it simplifies tens of thousands of slide presentations done by thousands of investment managers all over the world.

Fig.1: What we are all looking for



Source: Holland Advisors

The crux of what we are all trying to do on a daily basis is to invest in great companies that are priced like bad ones. For this to be so, other investors have to either not be looking or be fearful (of something) for us to be offered the value we seek. However, it is only by having a clear understanding of knowing exactly what we are looking for that leads to the conviction required to buy (in bucketfuls) the shares in a wonderful company at the very point others doubt them. Such decisive actions can really help an investor move up the compounding curve. The theory sounds easy, but the difficult bit is the psychology associated with doing something when all around you are telling you that you are wrong.

Patience, Discipline and Grit: *“value is not quite enough. Buying low is a start, but you need the patience discipline and grit to buy lower (and lower still) if the opportunity presents itself, shutting out the extraneous noise coming from within the market and over the airwaves” Seth Klarman*

A practical example – Ryanair (€12)

Ryanair perhaps unsurprisingly reduced its profit outlook for the current year recently. Investors should, we think, take note of the key factor driving this reduced profit target. It was not extra wage costs due to labour disputes, but reduced expected fare levels.

These being impacted by customers rightly concerned about the effect strikes will have on the airline's near-term reliability. After all, we'd all rather pay €100 for a flight that did not get cancelled than €60 for one that might. Post the shares falling another 10% from an already depressed level the company is now trading at a multiple of 10-11x of what we would suggest is a depressed level of earnings. For a variety of reasons (mostly industry cost leadership) we think Ryanair an exceptional business model. Its 20y compounded growth rate of EPS of 18% pa (a 28x fold increase no less) would suggest we have a point. Up until recently Mr Market seemingly agreed and was happy to pay a fair price for this attractive business – thus for many years the shares were priced at between 14-20x earnings. Today, it is priced at 10x what we think is a depressed level of earnings. To put this all into context we highlight a few points:

- Ryanair is the lowest cost provider of airline travel in Europe by a significant margin and each year it grows it further reduces its cost per passenger increasing this cost advantage over its peers.
- Our work on the company leads us to conclude that its actions in the sector are currently depressing fares. Longer term, we expect average sector short-haul fares to be a little higher than today. The companies that control the end (consolidated) market will benefit disproportionately.
- In FY18, staff costs represented c.13% of Ryanair's total operating expenses.
- Thus, if Ryanair decided (post already raising pilot pay last year) to implement say a further 20% wage boost to its entire workforce (at a cost of c.€150m), its operating profits would fall by only 9%.
- However, if it did so:
 - a) Its unit cost per passenger would still be significantly below its peers;
 - b) Such a surge in staff costs could be compensated for in profit terms by a €1.23 (i.e. 3%) increase in average fares!
- We note however that the best lowest price owner managed companies like Ryanair, JD Wetherspoon and Sports Direct rarely pass on cost increases in this reactionary way. These companies are always careful to balance customer price perception (especially when times are tough) and hold back on flexing their pricing muscle until such times as customers can more easily tolerate it (or don't even notice).
- The effect is sometimes a more protracted downturn in profitability that otherwise might be expected (this we believe is the case at Sport Direct currently – a company that could easily have raised prices a year ago). These periods of disconnect we think can be great share buying opportunities.

Great companies at great prices

The great compounding businesses' not only have moats (scale and costs advantages) they also have an ability to deploy more capital at high rates of return in the future. Ryanair's continued roll out of new capacity (at unit costs its competitors cannot match) is this theory in action. Each leg of expansion brings ever lower unit costs to a business model that already has scale advantages into a market they are consolidating.

"It is better to pay a fair price for a great business than a great price for a fair one"

Charlie Munger

We are ever mindful of Charlie's quote above. It is a business's own intrinsic value compounding that really makes an investor money over time so sometimes it is better to pay that fair price for a great compounding franchise.

Whilst we initially bought our Ryanair position after the Brexit vote in 2016 at c. €11 we felt that Munger's mentality easily justified the 14-16x multiple the company then traded on in the 2016-2017 period.

Indeed, at that time from a €15 starting price our best guess was that Ryan shares would compound at c.15-17% pa rate for the next 5 years. Today the same company with what we believe are the same growth prospects is now offered at €12 per share. The result is that we think Ryan's shares could grow at an eye popping 23-26% pa compound rate over the next 5 years.

This is driven by continued growth in its traffic, some expected normalisation of air fares and a recovery in the rating Mr Market puts on the shares. Needless to say, we have been adding to our holding in recent weeks. It is now one of the largest in the Fund.

"I think over the medium term, our revenue per passenger will rise. I think we're very much in the same situation Southwest was in 10 or 12 years ago where they enjoyed, I think, 12 or 14 years of yield growth."

"if I had known being nicer to our customers was going to work so well I would have done it years ago" – Michael O'Leary, May 2012

Portfolio structure

In our report in March we outlined three mental models that we have been using for the last year or so to sub divide our portfolio. The use of these has helped us better find the exact type of business models we are searching for and to avoid what some might call 'value traps'. It is also helping us focus on what/where we should be spending our time when looking at new ideas. These titles and the biggest companies we own within them are listed below:

Rare birds: Very usual companies with exceptional business models and a long runway of growth that justify paying a slightly higher price for. Holdings:

- (WWE, Formula 1)

Mispriced compounders: Businesses where we have a high degree of confidence in their compounding characteristics, but current earnings, the multiple, or both may be depressed. Holdings:

- (Ryanair, Sports Direct, J D Wetherspoon, Wells Fargo, UK Banks, US Banks, Fairfax Financial, Exor, Liberty Global, Allison Transmissions)

Capital cycle plays: Companies where capital has been extracted from the industry for a lengthy period potentially leading to a lasting recovery in returns. Holdings:

- (Teekay Shipping, Goldman Sachs)

Whilst we do not list all of the portfolio holdings above, we will disclose that today above 90% of the portfolio would fit within these three buckets. We are aiming for this number to be as high as possible and for it to favour the first two categories.

Where do we get our ideas from?

One question we get asked perhaps more than any other is: where do we get our ideas from. Whenever this comes up we recall a Berkshire annual meeting some years ago where a “*how do you do it?*” type question was asked of Munger. He responded that there are three things you should do in investing:

1. Look at the Cannibals – i.e. companies buying lots of their own shares back
2. Focus on the Spin-outs – i.e. neglected rumps of companies being spun out (not IPO’d)
3. Look at what the smart people are doing

When not looking at the companies already in our portfolio we spend a great deal of time looking for new ideas in numerous ways.

These three areas do not represent an exhaustive list of our sourcing, but we do return to them regularly. Also, having been analysing and investing for many years now another source tends to throw up ideas also. We call it “*what else looks like this*”. We may have had an experience with a stock like WWE inside the portfolio or say Fever Tree outside it (that we missed). Seeing the success of such companies gets us thinking “*what else looks like this*”. This is a huge advantage for us as we do not have to start out thinking from scratch. We are pleased to report that two new companies we are looking at today were sourced in this way.

US Banks

In our September 2016 letter, just before this sector and our Fund had a leg up in value we described our holdings in the US Banking sector under the heading – ‘Blind spot or sweet spot’. This encapsulates well our view on the sector today also. As we observed earlier it is strange for a sector to leap from one bad reason not to own it (low interest rates) to another (higher interest rates). We feel this shows the hatred still held by investors for banks that a quite plausible economic scenario somewhere between these two extremes is dismissed. More importantly we think the changes within the sector and companies themselves are completely ignored. In short, balance sheets are strong, regulatory intervention has peaked, lending has been careful and the whole sector is run for the benefit of shareholders (a first in its history). A few have been rewarded with higher share prices (JP Morgan) but many are still dismissed as plausible investments despite very strong market share positions and compelling compounding characteristics.

Our exposure today is a little more widely spread than our positions of the past. Today we hold between 2-5% of the Fund in each of Goldman/Citigroup/Lloyds/RBS/BONY+JPM. In addition, our current Wells Fargo position stands at 7%. This in total adds up to 26% of the funds’ assets. The average PE of these holdings is c.9.5x with an average Return on Tangible assets of c.15%. All of these companies are distributing most (or all) of these earnings to shareholders thus giving an implied earnings/income yield of 10%. By contrast the S+P PE is 20x. We realise these is a wider complexity to this sector and spend a great deal of time analysing it. However, the value on offer in high market share companies that offer compelling compounding characteristics should not be ignored.

The charts at the end of this letter illustrate two things:

- 1) That Wells Fargo has grown its intrinsic value steadily over time; and
- 2) That Mr Market has not always felt so depressed about the company’s prospects as he does today– ascribing it for many years teens multiples of its earnings.

The market consensus forecasts for the company for 2019 and 2020 are shown and the PE ratings that will result. Our work suggest that these earnings estimate figures can in fact be exceeded. As the company’s Return on Tangible Equity is set to recover quickly.

We also think there is a good chance that Mr Market changes his mind about this company once again. Higher returns and a higher than forecast PE will yield very attractive investor IRR's we believe. All coming from one of the safest financial companies in the world.

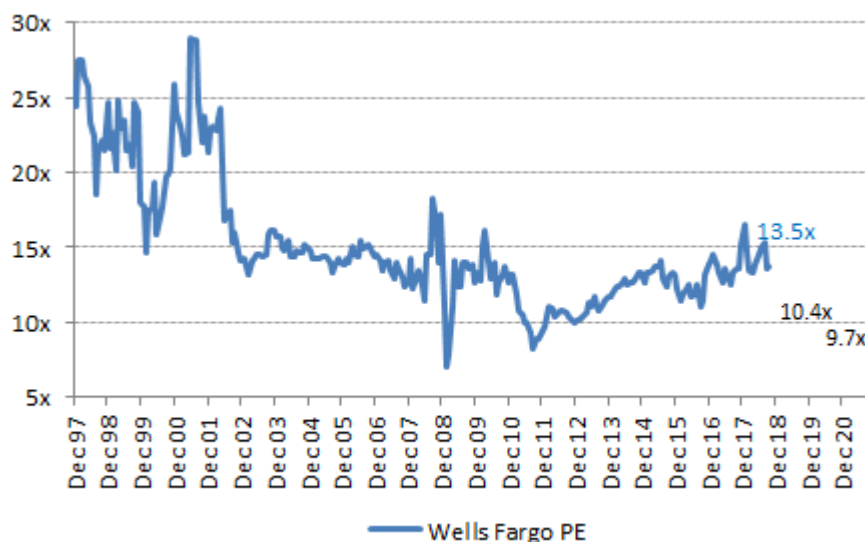
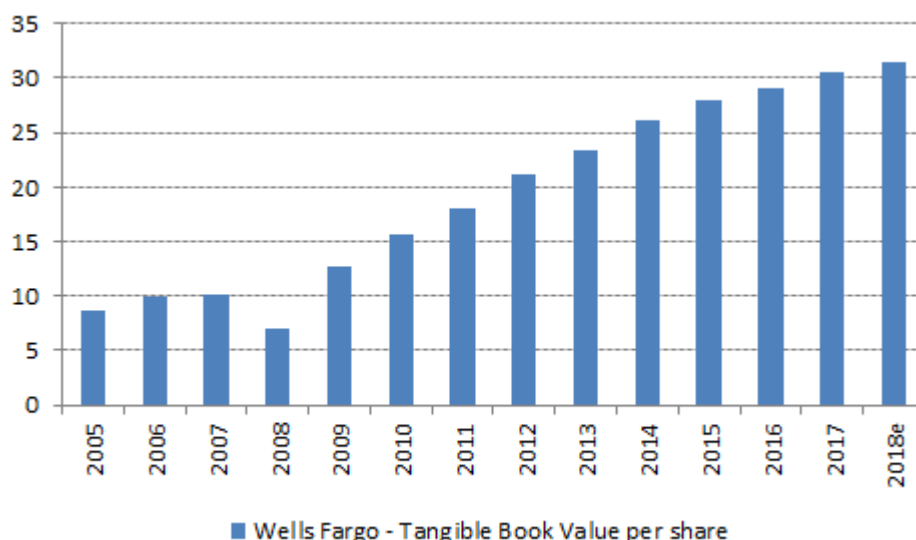
In the portfolio today, we are sitting on a cash position of 4% and the 53% of assets are invested in US dollar priced securities. As we observed at the start of this letter we very much like the quality of the business that we own and think (particularly after some falls in prices in recent weeks) that they offer excellent compounding characteristics from today's starting prices.

Thanking you for your ongoing interest and support.

With kind regards,

Andrew J Hollingworth, Fund Manager

*Some percentages discussed here are at the time of the letters publication so may differ slightly from those shown on the End of September Factsheet



Source: Bloomberg/Holland Advisors

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