Paul Perrino:

Hello everyone, I am Paul Perrino, a portfolio manager at Ensemble Capital. Thank you for joining us for our Spring 2018 conference call. Today, the focus will be on the recent performance of our portfolio, the current market and economic situation, our portfolio position in Netflix and our decision to exit our holding in DistributionNOW.

Speaking today will be Sean Stannard-Stockton, chief investment officer of Ensemble Capital, and Arif Karim, senior investment analyst.

Sean Stannard-Stockton:

Good afternoon everyone. Thanks so much for joining us. It is fun to see a record turnout for this call. We really appreciate your interest.

The performance of our equity portfolio this quarter was modest on an absolute basis, while being relatively strong when compared to the broader market. While the final calculation of our equity composite will not be available until later this month, our current estimate is that our equity portfolio composite was up 1.78% vs the S&P 500 down -0.76%.

Last quarter, in reviewing our performance during 2017, when we slightly trailed a very strong level of market performance, we reviewed the fact that historically our strategy has delivered a better downside capture ratio than upside capture ratio, meaning that we have been more likely to outperform during down markets than during up markets.

After a strong first few weeks of the quarter when the S&P 500 rallied 7.6% and our strategy continued to trail slightly, the market experienced its first real bout of selling pressure since early 2016. From the market high on January 26th, the S&P 500 declined by 7.7% through quarter end while our strategy declined by less than 5% for a downside capture ratio of under 65%.

While we seek to produce strong, long-term absolute returns, we know that losing less during market declines is an important element of reaching our long-term goal. Since it takes a 100% gain to reverse a 50% loss, a solid defense leaves us in a better position to play offence when the tide turns.

The most notable driver of our performance in the quarter was the over 50% rally in Netflix, which Arif will discuss later in this call. We also saw positive performance in 14 of our 24 holdings, with double digit positive performance from Broadridge Financial, Mastercard, Ferrari, Transdigm and our new position in Booking Holdings (previously named Priceline), which we initiated during the last week of December.

On the negative side, we saw continued negative performance from Prestige Brands (which we added to in February after the stock declined sharply on a weak quarterly earnings report), as well as L Brands, which unfortunately reversed much of the very strong gains it posted in the second half of last year, and in

DistributionNOW, which we exited after their disappointing earnings report which I will discuss in more depth later.

Prestige Brands sells health products in niche, slow growing categories where it generally holds dominant market share because the size of the category is too small to invite serious competition. A good example is Dramamine, their leading brand of motion sickness remedy. If you are a parent with small children who get car sick or are unfortunately one of the minority of adults who get car or seasick, you are almost certainly familiar with Dramamine. If you have ever experienced motion sickness, it is likely you have only ever used Dramamine and may not even stopped to consider whether another brand exists.

While Prestige dominates the niche categories in which they operate and as a result generates industry leading profit margins and sky-high returns on capital, these categories are slow growing. The stock now offers an 11%+ free cash flow yield meaning this is approximately the return shareholders could expect over the long term without any growth in the business. We believe that while Prestige will never grow quickly, they can indeed continue to grow slowly as they have in the past. But in the most recent quarter they reported effectively flat organic revenue growth and some investors are worried that the business may in fact be declining. After our discussions with management and our analysis of their results, we've come to the conclusion that while they may see some transitory periods of shallow declines in revenue, their multiyear history of modest growth is likely to continue for the foreseeable future.

Prestige is the only consumer stable type company in our portfolio. While organic growth has also been hard to come by at many well-known consumer staple companies, most of those stocks trade at free cash flow yields of closer to 5% or 6%. Thus those stocks require a significant reacceleration of organic growth to justify their current valuations, whereas we believe Prestige shareholders will do fine even with little to no organic growth, despite our expectations that modest growth will reappear.

We've written on Intrinsic Investing, in our multipart series titled The Death of (Many) Brands, about the major concerns we have about the consumer staples industry and we exited our successful investment in Pepsi last year due to us losing confidence in their future organic growth opportunity in relation to the valuation level at which the stock was trading. But we believe that Prestige's focus on niche categories with limited competition and the market's low expectations makes this a good investment in an otherwise tough industry.

The strong performance in Broadridge Financial and Mastercard has been a more pleasant experience. We've been long time holders of both stocks and they've both generally sat near the top of our holding list. While this continues to be true and we think both stocks have material upside from current levels, we also think the market has begun to better appreciate the appropriate valuation levels at which these stocks, as well as other financial technology companies outside of our portfolio, deserve to trade at and we've begun trimming these holdings modestly.

Last quarter, we mentioned that "historically, 5% market corrections have occurred about three times a year, 10% corrections about once a year, and 20% corrections about once every three to four years. There is no reason to think that corrections of this severity and frequency won't continue to occur going forward. So while we describe ourselves as agnostic on market returns, we do believe that our clients should be prepared for more frequent and deeper market corrections in the years ahead than has been experienced in the past few years." It is often better to be lucky than good and when it comes to short term timing, we think luck is the biggest driver of investor outcomes. So the fact that the market quickly pulled back 10% after we made those comments is no reflection of prescience. But while we know we cannot accurately forecast the timing of market declines, we can build a portfolio of companies that is designed to survive and even opportunistically benefit from those declines whenever they might occur.

Of note is that the recent market correction was not sparked by fears of an economic slowdown, as has been the trigger behind most market corrections since 2007. Instead, the initial decline in the market from the January 26th high was due to a growing belief that the US economy is heating up, with the 10-year treasury yield spiking from 2.4% at the beginning of the quarter, a level that is in line with the benchmark rate's average yield over the past five years, to a high of 2.94%, just barely below the 3% high that the 10-year treasury last yielded in late 2013.

In a seemingly perverse situation where the market sold off because the economy is heating up, the subsequent market decline was led by historically defensive, low volatility sectors such as Consumer Staples, Real Estate and Utilities, all of which declined more during the quarter than the historically more volatile Technology, Industrial and Consumer Discretionary sectors. This dynamic is one we've long thought would play out over time.

We described the historically extreme valuations being assigned to traditionally defensive sectors and their relationship to abnormally low interest rates in our 2016 Intrinsic Investing post titled "A Case Study of the Bubble in "Safe Stocks". Due to these dynamics, we have had little exposure to the traditionally defensive sectors of the market because we believe that in fact today these are the higher risk segments of the market due to their elevated valuations. For at least this last quarter, our avoidance of these sectors benefitted us in the first material market pullback since we wrote the case study post on this topic. While we cannot predict how the economy or interest rates will behave in the near term, we continue to believe that investors who are expecting these traditionally defensive sectors of the market to protect them during market declines are likely to be unhappy with their results with this most recent quarter demonstrating a microcosm of market behavior that may well unfold during market pullbacks that will occur over the next couple of years.

Now let's discuss some of our portfolio holdings. First Arif will discuss Netflix and then I'll talk about DistributionNow, which we exited in February.

Take it away, Arif.

Arif Karim:

Most of us are familiar with Netflix. The stock has been a controversial and volatile high-flyer for the past few years. As users, we've consumed a lot of our TV and movies through the service, but as moat-focused investors we had been skeptical like many others about the sustainability, competitive advantage, and the returns the company would actually be able to accrue over time.

Our view started to change, however, back in 2016 when we did a deep dive into the media industry and the impact both the internet and connected devices had on consumers' viewing habits and, as a result, where economic value would shift within the media value chain. We've published two blog posts about our findings on Intrinsic Investing entitled "Of Moats and Media" and will be publishing more of our thinking soon.

What we found in our analysis was that the Internet has changed the way people consume media, the type of media that could profitably be produced, and the scale of the media business.

One major beneficiary of these shifts has been Netflix, which has seen massive adoption of its service globally, growing 5x from 20 million subscribers in 2011 to over 100 million in 2017. In the US, it has more subscribers than all of the cable TV companies combined, and it has a penetration rate of about 40% of all US households. And it's still growing. Based on its massive global subscriber base, Netflix is now the 2nd largest pay TV service in the world behind just China Radio & TV. Yet Netflix is still growing subscribers at a 20% clip globally. Meanwhile, traditional cable TV service has seen subscribers decline at an accelerating rate.

As Netflix's subscriber base and revenue increases, its content spending power increases too. Meanwhile, the stagnation and decline of the traditional media companies' revenue hastens the erosion of their ability to reinvest in their content moats. In our research process, we call this moat relevance, which indicates what is happening to the value of the moat on the margin. Netflix has seen rapidly increasing moat relevance while most traditional media companies have seen their moat relevance decline.

As the leading global scale media company, we believe Netflix has created both a capabilities moat, as well as a rapidly growing scale advantage, in buying, producing, licensing, and distributing content globally. Just as Amazon has driven its growth by leveraging the Internet's new capabilities and its increasing scale to offer greater selection, convenience, and lower prices than any other traditional retailer could, Netflix is doing the same for video entertainment, offering greater selection, convenience, and lower prices than has been feasible in the past by leveraging Internet distribution and its global scale business model.

None other than the "Cable Cowboy", John Malone, the business genius who pioneered the development of cable TV, shares our view on this topic. Talking to CNBC last year, Malone said that the most important question in the TV industry is "Can Netflix get enough scale that nobody really can challenge them?" and then went on to say that in his opinion the traditional pay TV companies no longer have any chance of overtaking Netflix. When the interviewer asked if the pay TV industry could band together to create their own Netflix-like service as Malone had been urging for years, he simply replied "It's way too late."

We believe that Netflix has been offering consumers an exceptional value. This has been a key part of its growth strategy in order to drive its subscribers, revenue, and content spending power quickly in this nascent, disruptive market. In doing so it has reinvested all its cash flow (and more) into growing its content offering to make the service more compelling, which has driven even more consumer value and subscriber growth.

In concluding that the strategy has worked, and that Netflix has passed the tipping point in developing the scale of its content moat, we are starting to see Netflix flex its pricing power. To wit, it has raised the price of its service three times in the past four years without a material impact to its long-term growth trajectory while also increasing margins in its maturing US business from 17% to 37% over the past 5 years, demonstrating the business' earnings power.

Based on our estimate of where the service can be fairly priced over time and normalizing its earnings power for that level, we believe Netflix's current normalized P/E stands at 20x, which is very reasonable relative to its fast subscriber growth rate, compelling value proposition, its low global penetration, and rapidly increasing moat relevance.

We initially bought Netflix stock in the summer of 2016, amidst market worries that price increases would dampen its long-term growth trajectory, which would have indicated a lack of pricing power. However, our work had given us the confidence to buy Netflix in the midst of these worries. We thought ourselves and our clients fortunate when the stock rapidly appreciated by over 50% during the next six months. As it crossed our estimate of the company's intrinsic value at that time we were happy to take the gain.

But when we sell a great company because we believe it has become temporarily overvalued in the market, we continue to follow the business. As the business progressed, it became apparent as Netflix continued to raise prices with little impact on their subscriber growth, that we had initially underestimated their earnings power and thus the intrinsic value of the business.

While the stock had risen beyond where we had sold shares initially, we came to the conclusion that it was still significantly undervalued. While it can be difficult for an investor to buy a stock back at a higher price than it was previously sold, we're committed to making our buy and sell decisions based on the difference between share price and our best current estimate of intrinsic value without regard for our past trading decisions. Thus, we bought the stock again in October of last year and continue to hold the company in our portfolio today even after an additional 50% gain over the past six months because we believe its intrinsic value is higher still.

Back to you Sean.

Sean Stannard-Stockton:

While Netflix has been a huge winner for us, DistributionNOW, otherwise known as Now, Inc has been a material drag on our performance. Last quarter, in discussing our persistence in holding this underperforming position I said, "It may be that our analysis of Now, Inc is simply wrong. Our perseverance in holding the stock in the face of weaker than expected results is based on our continual re-examination of our thesis as new data comes in still pointing to much better results ahead. But we will not hesitate to exit the stock even with steep losses if we come to the conclusion that our analysis is incorrect."

Unfortunately, this is exactly what happened. DistributionNOW, is one of two companies that dominate the distribution of products used in drilling and production by the oil and gas industry. During the course of 2017, the company saw a strong recovery in revenue after the depressed results recorded in 2015 and 2016 during the oil bust. But while revenue was up 26% last year, this was much less than we expected and much less than the 71% increase in active US drilling rigs.

During last year, we chalked up the falling level of revenue per rig that DistributionNOW was reporting to the many, many wells that US shale companies were drilling but not completing. We viewed these drilled but uncompleted wells (knows as DUCs in industry parlance), as a form of deferred revenue. Since energy companies do not drill wells without plans to eventually complete them, we believed that once oil prices increased (which they did) well completions would start running at rates ahead of drilling activity (which they did) and that this would lead revenue per rig to increase leading to a strong inflection in revenue growth. But this last critical element of our analysis did not play out as expected. Instead, US revenue per active US rig actually declined slightly.

At Ensemble, we believe that running a focused portfolio of high conviction positions is a prerequisite for active, fundamental equity investors to hope to outperform the market. But a key requirement of success is that you must understand the businesses in your portfolio extremely well. While we worked very hard to understand the key dynamics that drive DistributionNOW's business, the results reported in February forced us to draw the conclusion that our core analysis was flawed. While we continue to think the company will do fine over time and we even think it is more likely than not that the stock will do well, our conviction in this belief has declined to a level that no longer meets our standards.

When this happens, we will never hold a stock because it seems cheap or based on the hope that things will recover. Instead, we will always liquidate the position and redeploy our clients' capital into a company in which we have much higher conviction. Fortunately, the market selloff have us the opportunity to reinvest the DistributionNOW sales proceeds into some of our favorite companies.

So, thank you all for joining our call today. During this call, we referred to the portfolio holdings of Ensemble Capital Management. If you would like to request a copy of Ensemble Capital's historical equity composite performance or our 13F holdings disclosure, please send an email request to info@ensemblecapital.com.

Thanks for listening. I look forward to speaking with you on our next call.

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