Mike Navone:

Hello everyone, I am Mike Navone, an investment advisor here at Ensemble Capital. Thank you for joining us for our Fall 2018 conference call. Today, the focus will be on the recent performance of our portfolio, the current market and economic situation, and a discussion of two of our holdings, Trupanion and Booking Holdings.

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

Sean Stannard-Stockton:

Good afternoon everyone. Thanks so much for joining us. It has been a real pleasure to get so much positive feedback about these calls. If you ever have a particular company you are hoping to hear us discuss or a topic you'd like our take on, please feel free to reach out to us at info@ensemblecapital.com.

The performance of our equity portfolio this quarter was strong, but modestly trailed the boarder market after our relatively strong first half. 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 5.71% vs the S&P 500 up 7.71%. Year to date, that brings our performance to up 12.59% vs the S&P 500 up 10.56%

The performance in the quarter was fueled by 10%+ gains in Starbucks, Apple, Oracle, Broadridge, Mastercard, Verisk, and Landstar. Weakness was seen in declines from Broadcom, which was down 14% before we exited this investment. Netflix and Trupanion which were down mid-single digits after being our best performing investments in the first half of the year with Netflix up 105% and Trupanion up 35% during the six weeks after we purchased our initial holdings during the second quarter. Booking Holdings and Charles Schwab & Company were down a couple percentage points in the quarter.

The gains in Starbucks and Oracle were relief rallies as these out of favor stocks seem to have seen selling exhaustion and investors are starting to get more comfortable with the medium-term outlook. While investors have sold both stocks down on growth concerns, we would note that consensus estimates call for high single digit EBTIDA growth at both companies highlighting that while each company has seen headlines calling their growth potential into question, they are still both expected to continue to produce solid growth with very strong returns on capital.

Apple rallied strongly in the quarter on good Q2 results and the market's growing comfort in the sustainability of both iPhone unit sales and the associated cash flow streams which increasingly include services and accessories that improve cash flow per iPhone user. After owning Apple as one of our largest holdings for much of the last nine years, we've trimmed our position over the course of this year so that it now ranks near the bottom of our holdings. This reduction in our position size does not reflect any downgrade in our assessment of the business. Instead it is simply the fact that with a market cap of over $1 trillion we think the current market value no longer represents a material discount to the underlying company value. That being said, the company demonstrated strong pricing power in raising the flagship X model starting price to $1000 last year and this year they are pushing ahead with broad price increases across their model lineup. With an iPhone still costing about $1 a day while commanding an average of three hours a day of usage, it may be that Apple still has more untapped pricing power than we are giving them credit for. On the other hand, there is no guarantee that they will be able to maintain and slightly grow unit volumes over the very long term. We think the current market price comes close to balancing the risks and potential that the company faces and so we've reduced our holding to reflect this outlook.

Meanwhile, Broadridge, Mastercard, Verisk, and Landstar, a group of companies that provide a mix of software, services and data processing, were all up 10% to 15%. These businesses serve very different customers and end markets, so there is no good reason to think that the strong and tightly correlated performance of these stocks was due to a common fundamental driver. But each of them do benefit from improving economic conditions, which have been playing out in recent months, while also operating asset light business models that cushion the downside impact from a recession should one occur. As investors grapple with both improving economic conditions and increased worries that the current economic expansion may be nearing its end, these types of economically sensitive, but asset light business models may be coming into favor with investors.

While it is beyond the scope of this call to discuss each of these stocks in depth, I do think it is worth noting the incredibly strong results being posted by Landstar Systems. We've owned this truck brokerage company since 2011. Research shows that the state of the trucking industry is one of the best industry level indicators of US economic conditions. Having listened to 28 consecutive quarterly earnings calls for Landstar I can attest that our first hand experience supports the research on this subject.

After suffering from weak demand, especially for the shipment of industrial goods, over the past few years truck load volumes have exploded higher with Landstar reporting 10% year over year growth. While most government statistics are based on surveys, involving numerous estimates, with significant margin of error, and subject to large revisions many months later, truck load volumes are a real time indicator of economic activity measured by actual trucks loaded with actual goods, with no estimates involved. While most businesses don't ship goods via trucks (namely the rather large services sector), it is the manufacturing and industrial segments of the US economy which have seen the weakest growth since the Great Recession. Seeing these sectors now shipping goods at growth rates usually only seen during rebounds out of recessions is a remarkable signal of a real inflection in US economic conditions this far into the recovery.

On the weaker side, we had Netflix and Trupanion pull back after very strong performance earlier in the year. Todd will talk about Trupanion in more detail in a moment. In Netflix's case, the 4% decline in the quarter minimizes the fact that the stock fell 25% from its early July high to its mid-August low before bouncing back considerably. The proximate cause of the decline was the company missing expectations for new subscriber additions. While the 5.2 million in new subscribers was similar to the number they added in Q2 of last year and three times the number of additional subscribers they added in Q2 of 2016, it fell short of company guidance and Street expectations by about one million subscribers. However, to put things in perspective, the company still grew their subscriber count by 25% over the last year. Along with raising prices by an average of 14%, this resulted in 40% growth in revenue.

At a time when many companies struggle to pass along even inflation level price increases, only a company with a truly remarkable value proposition could successfully raise prices by 14% while still seeing a flood of new customers signing up for their service. We believe Netflix subscriptions are deeply underpriced and that over time the company will be able to significantly raise subscription prices while still offering the best value for quality video content on a global basis. While TV viewers in the past have sometimes been concerned that streaming services might not carry the content they most want, with Netflix's own shows winning the most Emmy awards this year, the tide may be shifting so that consumers begin to worry instead that they won't have access to the content they want most if they don't subscribe to Netflix.

While the subscriber addition miss at Netflix didn't concern us much, Broadcom's acquisition of CA Technologies was thesis breaking for us and we exited the stock shortly after. Prior to the CA deal, we believed that Broadcom CEO Hok Tan was nearing the end of his incredibly successfully acquisition spree to consolidate significant portions of the semiconductor industry. We believed that after being blocked in his audacious attempt to acquire Qualcomm, Tan would continue to seek out appropriate acquisitions but would shift the company's significant cash flow production to more dividends and share buybacks.

When the company announced plans to buy back 10% of their share count and executed on 15% of the authorization in just the first six weeks after the announcement we believed that our thesis was playing out. But then the company shocked us by buying CA Technologies, a company that earns 90% of its profits from mainframe software. It wasn't just us who were shocked. The stock fell over 10% and today if you google "Broadcom buys CA" the top result is a newspaper report on the deal with the headline "Weirdest. Acquisition. Ever."

Now here's the thing. Hok Tan is a gifted CEO. Broadcom stock returned nearly 30% a year for quite some time. We thought there was a strong case for him being named CEO of the decade if he had kept things going for another couple of years. And if he manages to make the CA deal work, maybe he still will. But when we invest in a company, we are investing in a business as well as a management team and that team's strategy. The purchase of CA was inconsistent with our understanding of Tan's business strategy and focus on extending Broadcom's moat in the semiconductor sector. Instead it appears Tan has changed his strategy to being more of a publicly traded private equity firm focused on buying up a collection of legacy cash generating businesses. It may work out well, but it is a very different strategy than the type we're comfortable with of owning growing, focused, competitively advantaged businesses. Therefore, we decided to reallocate our clients' capital to back companies in which we have stronger conviction in management's fidelity to strategies we believe will win over the long term.

Now before I hand the call over to Todd to talk about Trupanion, I want to talk about a new vocabulary we've developed to describe a certain type of investment that appears in our portfolio from time to time and of which Trupanion is a good example. In general, our focus is on companies with strong and established competitive moats. These businesses typically have a long history of generating strong returns on invested capital and the barriers preventing other companies from going after their profit streams are well defined. But as long-term investors we seek not only companies that have strong competitive positioning today, but which we believe are very likely to exhibit these traits over the next five to ten years or even more.

Research from Morningstar, which is the only sell side firm that assigns competitive moat ratings, shows that the best performing stocks are those whose moat ratings improve; no moats establishing a narrow moat, or narrow moat companies building a wide competitive moat. Similarly, RS Investments has published research showing that it isn't just high returns on invested capital that drive stock performance, but in particular companies that report increasing returns on invested capital see their stocks outperform.

With this is mind, in addition to businesses with established competitive moats, we make some investments in businesses that we deem to have an emerging moat. Briefly, we define emerging moats as companies that may not have a moat today, but are, in our estimation, on the way to building one. While we're optimistic about the potential of emerging moat stocks, we're also cognizant that they come with greater uncertainty. As such, emerging moat stocks will have smaller position sizes in our portfolio relative to companies with established moats but we believe will offer much higher rates of return if they are successful, which will make them impactful to the portfolio on the way up but limit their risk if they are not.

One current example of an emerging moat business in our portfolio is Trupanion, which I'll have Todd tell you about now.

Todd Wenning:

Thanks Sean.

Earlier this year, we made an initial investment in Seattle-based pet insurance provider, Trupanion.

We think Trupanion is on the way to building a competitive moat in the typically commoditized insurance business.

First, a little about the industry. In the U.S., just 1-2% of dogs and cats have some form of insurance. By comparison, European countries range from 5-25% penetration. One reason for this is that the U.S. pet insurance industry is newer and previous versions here have, frankly, not been consumer friendly offerings. Insurers wouldn't cover enough, wouldn't cover breed-specific illnesses, or would drop coverage on sick pets. U.S. vets naturally grew skeptical and frustrated with the plans, as did pet owners.

Though it's taken some time for the industry to repair its image, pet insurance is quickly building traction – gross premiums recently topped $1 billion in the U.S., more than doubling since 2013. It's not out of the question that one day your vet's receptionist will ask, "And who is your insurance with?" much like they do at your own medical doctor's offices.

There are a few secular trends here worth noting, most notably the humanization of pets. Nearly two-thirds of pet owners consider their dog a part of the family while 42% of all dog owners let their pets sleep in bed with them at night.

There's also improving veterinary care, the costs of which are rising at about 6-7% per year. Finally, demographic trends are encouraging. Millennials and Baby Boomers – the two largest population cohorts – are big pet spenders, as the former group has deferred having children and the latter are now primarily empty-nesters.

So where does Trupanion fit in this? Trupanion is the second-largest pet insurer in the U.S., behind Nationwide, and accounts for about a quarter of the market. Trupanion was founded by current CEO Darryl Rawlings in 1999 and has taken a unique approach to building its business through the veterinary channel. Trupanion employs independent salespeople, called Territory Partners, who call on veterinary hospitals in their respective regions around the country. Territory Partners educate vets and front office staff about Trupanion and how Trupanion can not only help their clients, but also the vet practice. Historically, about 80% of Trupanion's leads come from the vet channel and customer referrals.

Trupanion helps pet owners by having a straightforward offering: it covers 90% of qualified claims after the deductible is met. It's not designed to cover regular checkups, but large one-off expenses and/or recurring treatments for ailments ranging from cancer to diabetes. New pet owners may be shocked to learn that emergency care for a pet can cost thousands or even tens of thousands of dollars. An unexpected $10,000 vet bill is always painful, but particularly so for those in the early part of their career and those living on a fixed income. Trupanion helps pet owners budget for such events and alleviates some of the emotional stress involved in caring for sick pets, who are again, increasingly considered part of the family.

Sadly, economic euthanasia, the putting to death of a pet whose owner cannot pay for needed care, does occur – a situation where no party (the vet, the pet owner, and the pet, of course) comes away happy. So emotional is economic euthanasia that many vets will operate anyway and either offer extended payment plans or risk taking on a bad debt just to save the pet. Trupanion turns this negative experience on its head. The pet gets the treatment it needs, the pet owner can proudly afford to take care of the pet, and the vet can treat the pet the way it thinks best.

An important point here is that Trupanion prices its policies based on how much it costs to treat a certain breed of a certain age in a certain zip code. Once Trupanion determines how much it costs to service an average pet based on the previous data points, it adds a 30% margin to calculate the pet's premium payments.

The 30% margin covers Trupanion's expenses and allows them to reinvest in the business. Given its cost-plus model, Trupanion doesn't work off a benefits schedule, as other insurers do. This allows the vet to price the treatment as they see fit, which, along with the fact that insured pets visit the doctor more often, is likely more than enough incentive to encourage vets to recommend Trupanion to pet owners.

We're particularly optimistic about Trupanion Express, which we believe will make Trupanion's offering even more valuable to pet owners and veterinarians. Trupanion Express is a patented software program installed at a vet's front office that can process claims in less than 5 minutes and for some basic claims, within a few seconds. This is great for the pet owner because they don't have to front the full bill and wait weeks for the check to come in the mail. It's great for the vet because they get paid immediately and also bypass credit card processing fees of 2-3%, which means a lot to vet offices that typically have EBITDA margins around 9-10%. Trupanion has Express installed in over 2,000 of its 8,500 active hospitals, who are its most active referrers, with a goal of adding Express in more than 500 hospitals in 2018. Express also provides Trupanion with more real-time pricing data and pet health data, which we believe will help it become a better underwriter.

Rather than build relationships with vets, which have high upfront costs, most traditional insurers aim to acquire pet policy holders through the direct-to-consumer channel or as "add-ons" to existing insurance policies. We think these channels produce lower-quality policies. To illustrate, you're more likely to type "pet insurance" into Google when you see your pet limping. By going through the vet channel, Trupanion wants to capture more puppies and kittens – well before they have exhibited any health problems. About 80% of Trupanion's sign-ups are either puppies or kittens or new pet parents and approximately 12 million puppies and kittens visit the vet each year, making this a massive opportunity for Trupanion.

There's a lot more to say on Trupanion, but for brevity's sake I'll make a final important point. Trupanion is not without controversy. There is high short interest in the stock and the price can be volatile, as it has been in recent weeks. We've evaluated the bear cases, the strongest of which are concerned with Trupanion's Territory Partners and veterinary referral practices and whether they are in line with state-by-state license requirements. In fact, the recent sell-off was triggered by a headline that Trupanion was being probed by the New York Department of Financial Services, its primary insurance regulator. The headline, generated by an article from a research firm that is popular with short sellers, was quickly walked-back after the New York regulator said it was simply "resolving" two consumer complaints. The stock's reaction that day – down 10% - speaks to the sensitivity of the stock to regulatory worries.

Each state has its own insurance regulations and Trupanion says its Territory Partners are licensed where they need to be. Technically, Territory Partners do not sell directly to policyholders in the veterinary channel and Trupanion does not pay veterinarians or their staff for referrals. The actual solicitation of the policies is done on Trupanion's website or over the phone with one of their licensed agents. We also believe Trupanion has increasingly viewed state regulators as partners and it has added to its compliance department in recent years. That said, state insurance regulations are intentionally vague and give regulators a lot of discretion in enforcement. As such, we won't be surprised if there's some adverse regulatory news during our investment. But the magnitude of these events and their impact on the long-term success of the business should be kept in context. For instance, we note that a recent report in the financial news media discussed fines the company has paid in the past. But the size of those fines, $75,000 and $150,000, amount to 0.06% of the company's revenue during that time period. You might think of these fines as similar to "fix it tickets" rather than reckless driving charges.

We think some controversy should be expected considering that Trupanion is operating a unique business model in a relatively new and rapidly-growing industry. While insurance regulatory rules are complex and vary by state, we think the focus for investors should be whether or not Trupanion is doing anything unethical or harming their customers in anyway. We believe that Trupanion customers are by-and-large extremely satisfied with the product – Trupanion consistently produces monthly retention rates above 98.5% and has growing customer referrals. Surveys also show that veterinarians recommend Trupanion more frequently than any other pet insurance offering. We also believe that the company is facilitating a positive ecosystem that creates value for all the parties involved -- pet owners, pets, and veterinarians. Given that Trupanion is solvent and has happy customers, we see little reason why regulators would "crack down" on it in a manner that would break Trupanion's business model. In short, we think the opportunities outweigh the risks in Trupanion.

Back to you, Sean.

Sean Stannard-Stockton:

Thanks Todd. One thing we would like to see the company change is their obvious irritation with short sellers. While we can understand why entrepreneurs who have invested their lives in building a company would be greatly bothered by short sellers publicly rooting for their demise, we believe that short sellers are a healthy part of financial markets. We respect the work short sellers do and sometimes find their research informative. In fact, we're pleased to note that one notable Trupanion short seller is listening in on this call today. While our elected representatives in Washington don't seem to agree, at Ensemble we believe that intellectual debates, even when you've put money on the line behind your point of view, are fun and positive activities. There is no reason to hate people who disagree with you and there's no reason for public companies to fight a battle against short sellers other than issuing statements correcting misinformation, as Trupanion did in regards to recent false statements about an investigation.

One of the things you learn in this business is that change can take longer to occur than most people anticipate but the magnitude of change can be larger than most people expect when it does end up occurring. With Trupanion, we know it will take many years for the company to lead the pet insurance industry towards a customer friendly business model. But if that change takes hold as we expect, it is not at all unreasonable to think that pet insurance will go from a specialty insurance line to something that vets talk about with every new puppy owner. If this happens, pet insurance could become a standard purchase for a large segment of new pet owners, as it already is in counties like the UK.

Once big changes take place, in retrospect they always look inevitable. In the late 1990s, investors came to believe that the prospects of every Dot Com business were outstanding with profitability just around the corner. Services like food delivery (remember Kozmo.com?) and grocery delivery (Webvan went public and hit a $6 billion valuation on $5 million in annual revenue before declaring bankruptcy just 8 months later) are common today and seem almost inevitable in retrospect. So it is important to note that many of the promises of the Dot Com boom did indeed come true. They just took longer to arrive than most people expected. But when they did arrive… boy oh boy have they changed our world.

While many of the Dot Com stocks were flameouts that never capitalized on the long-term opportunity, a few companies, such as Amazon and eBay did end up living up to the promises of the Dot Com era. Another company that delivered on that promise is Booking Holdings, known until last year as Priceline.com. For those of you old enough to remember William Shatner's Priceline Negotiator character seemingly appearing on every commercial break (yes, back then we had commercials), you may also remember Priceline's stock falling 99% from $531 to just $6.60 a share.

But the promise of the online travel agency was real, and Priceline lived to capitalize on it. Since the stock bottomed in 2002, it has returned an astounding 29,500% or 43% per year, vs the S&P 500's gain of 275% or 11% per year. Even Amazon has returned "just" 11,600% during that time period or 35% per year.

While Priceline was known for their Name Your Own Price bidding process, along the way they acquired a small online travel business called Booking.com. In what turned out to be arguably one of the best acquisitions in the history of the internet age, ranking alongside Google's purchase of YouTube and Facebook's acquisition of Instagram.

Today, Booking Holdings generates most of its revenue from Booking.com, but also owns Kayak, OpenTable, Momondo, Agoda, and RentalCars.com. They also have a significant investment in Ctrip, which I'll talk about in a moment. The company commands a market capitalization of over $90 billion making it one of the ten largest consumer discretionary stocks in the S&P 500.

Now some of you might be thinking this is amazing because you've never heard of Booking.com. While Expedia and Travelocity are more familiar online travel booking sites to many Americans, these sites are more popular in the US vs internationally and their booking activity is more skewed to airfare than to hotels. While Booking is the absolute dominant force for hotel booking in Europe and Asia. This isn't just a quirk of history. Booking has intentionally focused on these areas because hotel reservations are far more profitable than airfare and market fragmentation outside the US makes hotels far more dependent on Booking than those in the US. In the US, the top 10 hotel chains lead the market with many travelers going directly to

Hilton.com or Hyatt.com to book a room. While in Europe and Asia, independent hotels dominate, and these hotels need some sort of central "marketplace" on which travelers can find them.

While some of the most well-known Dot Com busts offered great services (heck, in 1999 Kozmo.com delivering a pint of Ben & Jerry's ice cream to my apartment in Boston at almost no markup to the retail price was amazing!), they didn't have a business model that worked. But Booking.com is now known as being the most monetization optimized website on the globe. They relentless test how to get visitors to book rooms and their efforts have paid off with company generating $14 billion in revenue that is still growing at a mid teens rate. Despite spending 40% of revenue on sales and marketing, the company commands operating margins of over 35%.

Booking is so dominant that one risk they run is letting their heavy spending on advertising (Google ads or ads on other travel sites such as TripAdvisor) push up the going rate on these auction-based ads. With that in mind, the company strategically reduced their spending on these sorts of ads starting last year in an attempt to reduce market prices and reinvest in driving visitors directly to their website.

One casualty of this move was online hotel metasearch site Trivago, which was so dependent on Booking's ad spend that the company's strategic shift lead to Trivago's revenue growth to fall from +70% to a 20% decline over the last year, sending the stock down 80%. Rarely in our memory can we recall a competitive move by one of our holdings so completely debilitating another member of their industry.

With Booking making strategic shifts in the very intentionally, experimental, data driven way they always have, we are confident that their long-term prospects are very bright. But investors focused on a short-term horizon have worried that the changes they are making may hurt growth for a period of time. This may be true, but the capacity to suffer short term pain for long term gain is at the very heart of being a great business and is a critical skill for investors to cultivate.

Before I wrap up I want to circle back to Bookings stake in Ctrip, the leading Chinese online travel agency. Like Baidu being the Google of China or Alibaba being the Amazon of China, Ctrip is the Booking of China. But unlike Baidu and Alibaba which have no joint venture with Google or Amazon, Ctrip and Booking have essentially declared a truce with Booking owning a large stake (with the right to buy more) of Ctrip. In essence, their agreement funnels Chinese travelers using Ctrip to travel outside of China to Booking.com while many non-Chinese travelers traveling to China via Booking.com are routed to Ctrip.

Why have they made this deal? Well, in the words of Ctrips CEO Jane Sun, "Booking.com is a global brand and in hotels, they are just so far ahead of anybody else. I think it will be very difficult for anybody to come close to them."

We couldn't have said it better ourselves.

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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