January 26, 2020

2019 Annual Letter

We completed our first (partial) year as a registered investment adviser (RIA) at the end of 2019. We began our RIA journey offering just one strategy, the Absolute Return Strategy. As the year moved on and I continued to learn more about the advantages of managing separate accounts—as opposed to a fund structure—I realized that we could potentially help clients who may want or need something different from a one-size-fits-all strategy. So we now have added flexibility in our structure, although my main focus continues to be the same—finding value among individual stocks that we can hold for the long term.

During 2019, all client accounts were in the Absolute Return Strategy. I am a firm believer that almost any asset is a good value at one price and a bad value at another price. But valuation as a discipline is somewhere between an art and an inexact science, especially when it comes to valuing businesses and, therefore, also the part-ownership of those businesses—better known as stocks. So while there may be a price being offered for a stock that makes it clearly a *buy*, and a price that makes it clearly a *sell*, there is a much larger middle ground at which a stock, or almost any other asset, is a *hold*.

For this reason, client portfolios and returns, even within the same strategy, may vary substantially over time. We aim to invest in the stock of companies at a price that we believe will give us good absolute returns over a 5-to-10-year holding period. But we always consider downside first, and our estimation of an investment's downside risk—i.e., what we think we'll lose if things don't go as planned—is much more important when determining our *buy* price than potential upside return. We look to buy right, and then hold on as long as our expectations for the business remain intact. If the stock price of a business in which we've invested enters the *hold* range and exits what we consider the *buy* range, then we won't buy it for new clients (or with new cash) unless or until we once again believe that we have sufficient downside protection.

With all of the above being said, all clients at Sorfis ended 2019 with about the same portfolio composition, which consisted of three high-conviction stocks and a fairly large allocation to cash. And while the returns varied slightly depending on when accounts were opened, everyone achieved a return in the 8–10% range during the year.

Viewing Client Accounts as Holding Companies

Philosophically, we view each client account as a holding company for a permanent, mini-conglomerate; and we aim to increase that conglomerate's earning power over time. While we look to buy stocks that we think are undervalued to both protect our downside as well as earn extra return should the undervaluation re-rate to a fair valuation, our expected returns center around our share of the earnings of the businesses in which we invest. By way of illustration, consider an example with the following four companies:

	Stock Price	Shares Outstanding	Market Capitalization	Net Income	Earnings per Share (EPS)
Company A	$5	15,000,000	$75,000,000	$7,500,000	$0.50
Company B	$10	10,000,000	$100,000,000	$10,000,000	$1.00
Company C	$20	20,000,000	$400,000,000	$30,000,000	$1.50
Company D	$40	2,000,000	$80,000,000	$10,000,000	$5.00

Now, let's assume that a client has a portfolio invested in those four companies, along with a cash position, in the following amounts:

	Shares Held by Client	Total Value	Company EPS	Client's Share of Company Net Income
Company A	30,000	$150,000	$0.50	$15,000
Company B	10,000	$100,000	$1.00	$10,000
Company C	15,000	$300,000	$1.50	$22,500
Company D	5,000	$200,000	$5.00	$25,000
Cash		$250,000		
Total		**$1,000,000**		**$72,500**

In this example, the client's total share of the earnings of the companies in which he or she is invested is $72,500. On the total portfolio value of $1,000,000, this would equate to a 7.25% earnings yield, or a 9.67% earnings yield on the capital that is invested and not held in cash ($72,500/$750,000). Because we take the mentality of owning the whole company when we invest, we consider that 7.25% to be our base, expected return for the year, and the yield we'd compare to a bond yield, savings account yield, or other alternative for the capital invested in those businesses. But there are a few important caveats to add to that expectation:

1. Business earnings can be volatile, hard to predict, and sometimes illusory—but they also have the benefit of growth. For these reasons, it's important that we estimate company earning power by, to use a phrase from value investor Seth Klarman, "compounding multiple conservative assumptions."
2. Our actual return is going to depend on how much of those earnings we receive in cash (dividends), how much is reinvested to grow the businesses, and any change in the multiple the market assigns to each investee's valuation. As such, it's important to think hard about a company's reinvestment prospects, as well as the valuation the market is assigning to those prospects.
3. As the example shows, cash can be a significant drag on expected performance, but it also gives one the benefit of optionality if a great opportunity comes along. Over the long term, the value of cash is nearly guaranteed to decline via inflation, so for us, cash is not a long-term, strategic allocation, but rather a temporary allocation until we can find an investment that meets our investment criteria. There will be times when we hold a large amount of cash, possibly for years, and times when we hold almost none.

All of the above may make our investment process sound mathematical and precise, but it is not. There is art to the investment process, which gets painted by the judgment that comes from some loose combination of experience, effort, and luck. Our job is to deploy client capital the best we can, given the opportunities at hand among those we can understand, all while trying to get a little more capable of doing it well as we go along.

Holdings Update

Because all clients ended the year with the same three holdings, below are overviews of those investments.

Tandy Leather Factory, Inc.

Tandy Leather Factory is a specialty retailer of leather and leathercraft-related items. Leather is ~40% of sales, hand tools ~20% of sales, and then there are a bunch of items that make up a single-digit percent of sales (dyes, finishes, glues, hardware, kits, stamping tools, etc.). It is basically a one-stop shop, and by far the largest player in this niche.

I’ve followed Tandy for nearly 15 years, although it had been almost a decade since I’d owned shares in the company—until last year. The catalyst for becoming a shareholder once again occurred during the fourth quarter of 2018, when the company made both a management and strategy change. I think the previous management team, comprised of longtime company veterans, did a good job over the years, but as is often the case, especially in the micro-cap world, it put too much emphasis on top-line growth rather than economically profitable growth. And when cash flow slowed a bit, this team started trying new things such as starting a district manager program; continuing to operate the international stores which lacked scale and were unprofitable; and taking a shot at some other initiatives that may have been reasonable experiments, but resulted in poor returns on investment (conference sponsorships, opening on Sundays, etc.). More expectations were also put on store managers to get out and sell non-retail / commercial business, which took them away from running their stores and providing great customer service to the retail customer base.

The new management team is more focused on cash flow and is updating company technology that was in need of a refresh, such as point-of-sale and accounting systems. During this refresh, the company noticed some accounting issues, and opened an independent investigation into the valuation and expensing of inventories, which has delayed it from filing its last two quarterly reports and caused a significant drop in the stock price when it was all announced.

After following the company and previous management for more than a decade, I thought the accounting issues were unlikely to be anything major that would impair either the earnings power of the business or the cash in the bank—which was equal to almost half of the market cap (the company is also debt free). The issue seemed likely to be related to the technology upgrades and unlikely to be anything major, but because I couldn’t know for sure, I only added slowly to the position on the way down. When the company announced an update in October 2019, which showed that the issues were in fact quite minor, as well as a business that continued to generate cash during the first 9 months of the year, I thought the stock price was going to open up well above $5 per share the following day. When it didn’t, and because I judged that the odds of being right about our thesis had significantly increased, and the odds of losing money significantly decreased, I added to our position, and made it our largest holding by a decent margin.

The market hates uncertainty, and the best opportunities for us will often come when an uncertain opportunity comes wrapped in a package with downside protection. The time we’ve spent following the company and management over the years, our high regard for its Board of Directors, and the company’s balance sheet, gave us the information we needed to invest and then make it our largest position, even though we’re still awaiting updated company financials.

Tandy's share price moved up a bit at yearend, and the company ended 2019 with a market cap of about $51 million. The cash balance at the end of September was $22.6 million, and we estimate that the after-tax earning power of the company is somewhere between $5 million and $9 million. At our average cost, we believe we bought shares below the liquidation value of the company and at a single-digit multiple of after-tax earnings (i.e., at a double-digit earnings yield).

While we prefer to mostly focus on the downside and use earnings yield as a base return, we do like to get a sense of likely upside and fair value. Multiples of small, private businesses with $5+ million in EBITDA that 1) have a good competitive position; 2) aren't necessarily growth businesses; and 3) also aren't too capital intensive, tend to sell for 6–8x EBITDA. Assuming a 12.5% normalized operating margin—which is on the lower end of Tandy's margin from 2012 to 2016—and $80 million of sales, we get $10 million in operating earnings plus about $1.8 million in depreciation and amortization, so $11.8 million in EBITDA. Based on comparables, this would give us a valuation range of $70.8 million to $94.4 million. Assuming 9 million shares outstanding (i.e., buybacks roughly offset issued restricted shares), and $1 to $2 per share in excess cash at yearend, we'd get a fair valuation somewhere in the $8.85 to $12.50 per share range.

Cambria Automobiles plc

Cambria Automobiles is a multi-brand auto dealership in the United Kingdom. It was established in 2006 with a focus on buying and turning around underperforming dealerships. The company raised £10.8 million to get started, which is the only outside capital it has raised. The company is run by an owner-operator in Chief Executive Officer Mark Lavery, who owns 40% of the shares outstanding and has never sold a share, which includes the 2010 initial public offering (IPO). Cambria currently has 27 dealerships representing 41 franchises and 16 brand partners.

The company underwent a transformation in its focus beginning in 2014 with the purchase of the Barnet Jaguar Land Rover (JLR) business. Prior to 2014, the company had only £0.3 million of goodwill on the balance sheet, as it had basically turned dealerships that were losing money, which it had bought at or below book value, into a business making more than £4 million in operating profit. It paid a premium to book value in the Barnet acquisition, as well as for a couple of subsequent acquisitions, in order to deepen its exposure to the JLR brand as well as work toward increasing further exposure to the High Luxury Segment (HLS) of the market. Cambria also made it a priority to upgrade its overall real estate portfolio.

While the company has continued to look for acquisitions, it's been disciplined about not overpaying, and has instead looked to develop its plans by trying to earn new greenfield projects (essentially another form of acquisition, without paying goodwill). This effort has started to pay off, as evidenced in 2018 when the company was awarded five new HLS dealerships (one McLaren, two Bentley, and two Lamborghini). The HLS segment is especially attractive because it is less cyclical, and much of the inventory gets sold before the cars even come to market because those manufacturers limit supply and generally have waiting lists for many of their new models.

The company experienced some disruption to operations as the real estate development and re-franchising occurred. But most of that is now behind it, and it has now occupied the major sites that were under development. This has started to show up in the numbers, as the company reported a significant improvement in results for the fiscal year ended August 31, 2019, both compared to its own previous results and compared with the rest of the industry, as the overall new car market in the United Kingdom has remained difficult. In fiscal 2019, the company saw a 4.4% increase in revenue to £657.8 million, and a 24.7% increase in after-tax earnings to £9.78 million (9.78p per share).

The company has the same 100,000,000 shares outstanding it had at its IPO, and thus at the yearend share price, it traded at around 7x after-tax earnings. Given that it normally takes anywhere from 3–5 years for a new dealership to reach maturity as it builds out its customer database, earnings should continue to grow for at least the next couple of years from the dealerships recently opened, as well as from a couple of future projects already in the works. The company has 65.6p per share in net asset value, which provides some downside protection. This includes 21.5p per share in intangibles, but given that well-run HLS dealers tend to sell at a premium to book value, and real estate values on the balance sheet are estimated to be at least as understated as the intangibles, buying anywhere close to net asset value should provide good downside protection if one can hold for a few years. The company also pays an annual dividend of 1.1p per share.

As far as potential upside, if the company gets to its £1 billion revenue target and a 2% operating margin, net income should be somewhere in the £16 million range. It's hard to get a good sense of what informed buyers would pay for this in a stable market environment, but Lavery helped to lead and sell a previous dealership group for 18x after-tax profits and more than 2x book value. Even if one assumes an after-tax multiple somewhere in the 10-15x range, then you'd get to a stock price on Cambria somewhere in the £1.60-2.40 range after the company meets its revenue and margin target. If it happens in 5 years, which is my base case, then one gets a great return buying at the current price. And the upside case to that is that a proven management team does a bigger deal if the opportunity comes along, and/or the focus on the HLS segment ultimately leads to slightly higher margins.

Berkshire Hathaway Inc.

Benjamin Graham, the “father of value investing,” wrote in his most noted works that “An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return.” In my mind, there are few businesses which—if one is able to buy at a reasonable price and hold for several years—meet Graham’s definition more than the conglomerate run by his most famous pupil, Berkshire Hathaway Chairman and Chief Executive Officer Warren Buffett.

Berkshire owns a diversified group of insurance and non-insurance operating businesses. It has spent decades building the world’s best insurance company and developing an underwriting culture that gives it—along with its flexible and fortress-like balance sheet—competitive advantages that will last long into the future, and long after Buffett is no longer at the helm. Its subsidiaries, including the insurance businesses, offer a mix of cyclical, non-cyclical, and regulated returns to the parent company, whose flexible mandate in allocating capital gives it plenty of places to reinvest profits. The uncertainty of where, and especially when, excess capital gets reinvested; and the market’s perceived uncertainty over what happens when Buffett is gone (he’s 89 years old) often create the overhang needed to buy shares at a price that provides downside protection and an above-market expected return, as it did during 2019.

Our upside expectations on our Berkshire investment are more modest than most ideas we consider. While the company won’t be able to achieve anywhere near the returns it has in the past, we still expect returns on equity to fall somewhere in the 8–10% range during the next decade. Given that the company doesn’t yet pay a dividend, long-term earnings growth should roughly equal the return on equity. Berkshire’s current, massive cash balance as well as the cash flow that comes in to corporate headquarters on a continual basis mean that the allocation of that cash will have a decent impact on the return during a 10-year holding period. So we estimate our expected return to fall somewhere in the 6–12% range, depending on how well excess capital gets invested, even without relying on the market rating Berkshire at a fair valuation multiple.

Importantly, we also think there is very little chance of losing money in Berkshire if we are able to hold for the long term, and a very high chance that Berkshire outperforms the overall market even at the low end of our expectations. While Berkshire’s book value is both understated as well as likely to be less relevant over time if it buys back a meaningful amount of stock, that book value today is still a reasonable measure of downside protection as well as a starting point for determining a rough valuation range.

Buffett has stated that he believes the stock was substantially undervalued when it traded at around 1.2x book value, and Berkshire has repurchased shares at close to 1.4x book value, implying that he also believes it was undervalued at that level. Overall, fair value today probably falls somewhere around the midpoint between 1.5x and 2.0x book value. At our average cost, we bought our shares at a mid-to-upper single-digit earnings yield and around 1.18x the book value that the company reported at the end of September 2019. Our average cost is also around 1.35x book value at the end of 2018, before the accumulation of earnings during 2019, and at a time when Berkshire's stock portfolio was significantly depressed from where it is today.

Closing Thoughts

The New Year has started with a continuation of the record bull market and a run to new all-time highs among the major indices, whose valuation multiples range somewhere between the 90th and 99th percentiles in terms of expensiveness. While I expect annual returns on those major indices to average somewhere between very low and nonexistent during the next decade, my attitude toward the market is best expressed by one of my favorite investing quotes, again from Seth Klarman:

> "Many people believe that investors must make the macro decision to be either bullish or bearish. Our preference is to be agnostic, objectively finding absolute bargains, and in their absence, holding cash. In short, we are neither bullish nor bearish. We are value-ish."

There are good bargains to be found in expensive markets, and bad bargains that can be found in cheap markets. Structurally, we've set ourselves up to have the flexibility to invest across the market cap and geographic spectrums so that we can go find the best bargains we can find that we are able to analyze and understand.

We've made two new investments in early 2020. These investments hold smaller position sizes than those discussed in this letter. The size of a position depends on how we judge our odds of being correct, the downside if we are wrong, and the potential upside if things go as planned. While I've discussed this topic in other places over the years, my overall thoughts have evolved a bit, so I plan on releasing a more extensive summary of my thoughts on position sizing, and concentration vs. diversification, during the coming months.

All the best,

Joe Koster

<u>Investment Strategy</u>

Absolute Return Strategy

- Will focus on individual stocks, both in the United States and internationally.
- Will create a portfolio of approximately 6–12 undervalued securities (when fully invested), though the range could vary anywhere from 3–30 securities, depending on circumstances.
- Will hold cash when unable to find attractive places to allocate capital, which may make up a substantial majority of investment portfolios at times.
- Investment Minimum: $100,000.
- Management Fee: 1% per year.
- Custodian: Interactive Brokers LLC and/or Charles Schwab & Co., Inc.

<u>Legal Information and Disclosures</u>

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