PALM CAPITAL

Q1 2021

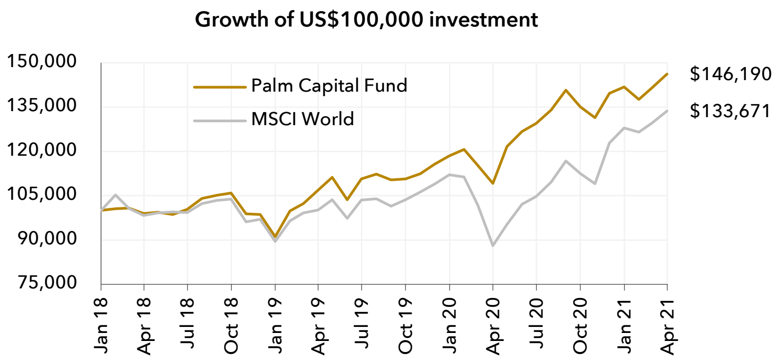
April 2021 | Mahomed Ibrahim

At Palm Capital, we look for businesses with durable competitive advantages run by exceptional managers. We patiently wait to invest when their prices are less than we think they are worth, aiming to benefit as they compound economic value over time. We only sell if fundamentals deteriorate, or we find others offering potentially better after-tax returns.

Our performance

Over the three months ending 31 March 2021 our portfolio increased by 3.1% after management fees & trading expenses. Over the same period our benchmark, the MSCI World Index, increased by 4.5%.

Since we started, just over three years ago, our portfolio has returned 46.2% in US Dollars cumulatively after management fees & expenses. We have outperformed our benchmark by 9.4% cumulatively or by 2.8% per annum while holding better businesses than the benchmark and buying them below their worth.



The internet revolution

The internet bypasses the constraints of the physical world and its widespread adoption is one of the most revolutionary changes in human history. It is changing the way humans interact and, in the process, upending the advantages of some business models and giving rise to other, much stronger ones.

A good example of the former can be found in the business models of Consumer Packaged Goods companies and physical retail stores and the interaction between the two.

Before the internet was widely adopted, consumers shopped mostly in physical stores. Prime shelf space in these stores is limited and highly sought after. And to ensure foot traffic through the door, these retailers are more likely to allocate this space to the well-known consumer brands than less well-known brands. But the internet, through e-commerce, removed this physical constraint. On the internet, shelf space is unlimited. And so, online, the large incumbents must compete for consumer attention on the same level as the smaller players. In the process, the internet has disrupted distribution advantage of large incumbent Consumer Packaged Goods companies like Unilever and Procter & Gamble.

Another physical constraint that is a part of this dynamic is location. A good location was an advantage for a physical store as it was a key consideration for customers to choose which to visit. And good locations are limited. But e-commerce has made location largely irrelevant for many stores, diminishing this advantage.

And finally, before the internet, cable TV networks via their established physical infrastructure to homes, controlled the media available to consumers. They dominated their attention. Prime viewing slots were limited and very valuable. And only the large consumer product incumbents could afford to advertise their products at these times. But the widespread adoption of the internet has brought new forms of media to people. And these new forms of media allow small companies to reach as many consumers as the large incumbents. In the process, the internet has diminished the advertising advantage of the large companies.

The internet has given rise to a 'winner takes all' effect

In effect, the internet has been commoditizing distribution – shelf space, location, and cable in the example above. This in turn has been creating an abundance of supply. And this has placed a premium on companies that aid the discovery and curation of this supply – companies like Google with its search engine or its Android app store, Facebook with its Facebook or Instagram social media networks and Amazon with its third-party Marketplace business.

These companies all have phenomenal business models, much stronger than the ones the internet displaced. Their cost of sales is negligible as they incur no expenses to produce products or services but merely facilitate an exchange. Their cost of distribution is also negligible as they deliver their services over the internet. They don't need physical locations with staff or salespeople to reach their customers. This means that they are able to grow their revenue more quickly and their profit margins to higher levels than traditional businesses. And most importantly, they lend themselves to network effects. By attracting users to their sites, this attracts suppliers which in turn attracts more users – creating a virtuous cycle and giving rise to a 'winner-takes-all' effect. They have come to control the entry point for users of the internet – customers and suppliers alike.

It explains why these aggregators have been able to continue growing at astonishing rates and have achieved profit margins higher than most businesses. And it is these reasons, along with their attractive valuations, that we have owned all three of the companies mentioned above – Alphabet, Amazon and Facebook – since we began investing for clients.

The internet has strengthened the business models of software companies

Another industry where the internet has given rise to stronger business models is enterprise software - software used by businesses and organisations to support their operations. Before the internet became widespread, software companies sold packages that were typically installed with a disk and could only be run on individual machines. These software companies earned revenue from licence sales and from fees for servicing, support, and upgrades. And their cost of sales comprised developing the software as well as installing it on customer premises.

The sale of licences was lumpy and as upgrades were optional, fees from upgrades were erratic and would dry up in tough times. Most of their customers were running outdated software which was very inefficient as a result. The model also required their customers to incur a high level of fixed costs – running servers and having IT professionals on-hand to fix any problems that arose. And it was not uncommon to find many of their users running pirated software.

Pioneered by Salesforce and enabled to a large extent by Amazon Web Services' cloud revolution, the internet gave rise to a different business model for enterprise software – the subscription model – or Software as a Service (SaaS). In return for monthly or annual subscription fees, customers could now access the software over the internet (the cloud) from any location and any device that had an internet connection. This made the customer's businesses flexible and resilient. At the same time, it freed up their IT budget as fixed costs of servers and IT professionals gave way to variable costs that moved in line with their usage.

The SaaS model hasn't only been good news for customers. It is a much stronger business model for the providers than the one it replaced. And for those providers selling software that is critical to their customers' operations, it is one of the best business models around. We will use the example of Adobe to illustrate this.

The example of Adobe

Adobe has a near-monopoly in content creation software with dominant applications including Photoshop, Lightroom and Illustrator that are critical in the lives of creative professionals. These applications are not only the best in the industry but also have high switching costs as it takes designers many years to become adept at using them. This investment of time is a sunk cost and makes it costly for designers to switch to an alternative. Additionally, as most creative professionals use Adobe's suite of products it also has a network effect advantage – creative professionals use it because most other creative professionals do.

This creates stickiness of revenue, the visibility of which is enhanced by the fact that more than 90% of Adobe's overall revenue is subscription-based and a large portion of this is paid in advance.

As Adobe's programs have already been developed and they are now largely distributing this over the internet, the company's gross profit margins are a towering 85%.

Adobe also has great economics. It is capital light. This means that it does not need physical assets like machinery, property, or stock to operate. As its assets are intangible, it does not need to take on debt to finance them. And its marginal cost of serving additional customers is minimal. The company is highly cash generative, not only because some of its revenue is received upfront, but also because it pays a large portion of salaries with shares and share options. This is evident from its balance sheet – it has had a large net cash position for seven of the past ten years. Furthermore, investments in its intangible assets are expensed rather than capitalized resulting in a low tax burden relative to typical capital-intensive businesses.

Finally, Adobe has lots of room for growth. The shift to digital creates a strong underpin for demand growth over the long term. And Adobe's switching costs give it the power to grow revenue by increasing prices. Additionally, the subscription model is growing Adobe's market in several ways. Firstly, it makes it affordable for small businesses, opening a new market to Adobe. Secondly, by freeing up IT capex and fixed costs, the model also makes it more affordable for large businesses, incentivizing them to take on pricier options. Thirdly, as the company is not updating its products that were sold under the licence model, the subscription model is beginning to capture many non-compliant users.

Over the next ten years, we expect Adobe's sales to more than double and its free cashflow margin to expand to almost 40%[1].

These characteristics make Adobe an exceptional business and it is one half of the reason we have been invested for nearly three years.

This example as well as our examples of the aggregators earlier illustrates the impact that the internet has had in not only creating more profitable, less capital-intense businesses but also in allowing businesses to grow to much larger sizes at a much faster pace than before. It partly explains the pace with which new businesses are reaching $100bn valuations whether on public or private markets.

Our activity over the quarter

The SaaS providers have been beneficiaries of COVID as the pandemic gave businesses an accelerated push to digitise. But since the announcement of COVID vaccines last November, in anticipation of better relative short term financial performance, the market has shifted its favour to businesses that were hit harder by the pandemic and away from the winners.

And while it is true that some of the beneficiaries of COVID such as video conferencing and e-commerce will likely see a decline in sales with the normalization of activity, we don't think the same holds true for enterprise software. Once businesses have adopted a cloud-based enterprise software solution, it is difficult to go back. So, we're unlikely to see a decline in sales. If anything, we think that COVID has placed the risk of another pandemic at the top of most management teams' business disruption risk list giving them an impetus to digitize as soon as possible. So, we may even see an acceleration in sales. This has made us more confident of our conservative valuations of these SaaS businesses.

And so, over the last quarter, we took advantage of their price weakness to add to our position in Adobe and start new positions in two SaaS businesses. We will outline our investment thesis for one of these new positions below.

ServiceNow

ServiceNow provides software solutions to structure and automate various task and processes for large businesses. The company began in 2004 with a solution to help businesses manage the IT services they offer employees and customers. Unlike the existing solutions in the market, ServiceNow's offering was built using modern architecture that was flexible, modular, and user-friendly. And it left the incumbents – large companies such as BMC, IBM and MicroFocus – playing catch up.

As the company grew to dominate this market, it saw the opportunity to expand its offering to include the broader task of IT Operations Management – or the monitoring and control of an entire business's IT infrastructure. And over time its success in improving productivity and user experience in IT resulted in customers asking the company to expand its offering into other business workflows including HR Management and Customer Services – which it has since done.

All ServiceNow's applications (including those built by customers and third parties) are built on its 'Now' platform. This allows the company and its customers to innovate and deploy new solutions quickly. And it helps ServiceNow gather a large amount of data to gain insights into and use machine learning to build solutions to meet customer needs in other areas. Crucially, this platform can interface with other SaaS and legacy software services used by its customers. Not only does this allow an IT department to manage all the myriad software services used by a business from a single point of control, it also reduces the operational disruption risk for those transitioning from legacy software systems to the cloud.

Aside from the ease of use of ServiceNow's offerings, the other factor driving its growth is that its 'land and expand' strategy starts in the IT department of customers – the very department whose task it is to recommend other software solutions for businesses. It is therefore no surprise that more than 75% of ServiceNow's customers use more than one of its products and 80% of its new business is from existing clients.

The company now serves almost 400 of The Fortune 500 companies and counts 6,900 of the largest enterprises globally as customers. Since listing in 2012, its sales have grown 18-fold from $0.2b to $4.5b – yet another illustration of the pace with which the internet enables businesses to grow and the pace at which digitization is occurring.

[1] Free cashflow is the cash an owner can take out of a business without affecting its ongoing operations. It is calculated as cash operating profit less interest, taxes, capital expenditures & working capital investments. This implies that for every $1 of sales, we expect Adobe to be able to pay out nearly 40c to shareholders without affecting its ongoing operations.

Importantly, ServiceNow has a strong switching cost advantage. IT Operations Management is mission critical as businesses cannot afford to risk the failure of IT equipment or software given the growing dependence on digital systems. Furthermore, these services tend to have long lifecycles as change involves an investment of time and money as well as operational disruption. And this lock-in is strengthened as customers build more and more solutions on the Now platform. As evidence of the switching cost advantages, ServiceNow's retention rates – the percentage of existing customers who are still customers a year later – have never fallen below 97% since listing.

ServiceNow has a long runway of growth ahead. Not only are its existing markets growing in the high single digits as businesses digitize, it is disrupting its existing markets and entering new markets as it develops new products. Furthermore, its customers are also upgrading to premium versions of products. Management estimate that its total addressable market is in the hundreds of billions. Our conservative estimates point to a number comfortably north of $100b. This is significant relative to its current revenue and given the superiority of its products and entrenchment with its customers' businesses.

What is remarkable about ServiceNow is that it is able to sustain such strong growth while still generating high free cashflow margins – currently above 20%. And these margins will only expand over time as its operating expenses of product development, distribution and marketing decline as a percentage of sales. For example, its marketing spend is currently 40% of sales but according to our calculations, this is yielding returns well above 300%[2].

ServiceNow is run by a highly rated management team. Its founder is still Chairman. And while its CEO and CFO have recently changed, the new CEO, Bill McDermott left enterprise software titan, SAP, to join the company. Furthermore, the company has substantial management depth.

The company has a net cash position of $1.5b on its balance sheet and generated $1b of free cashflow in 2020 that we expect to grow above 20% per annum over the next five years. Based on the price we paid for the business, we expect to earn more than 8% per annum in US$ from our investment and it is the type of business we would like to own for a long time.

[2] This is based on our estimates of the lifetime value of a customer relative to the cost of acquiring a new customer

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