INVESTMENT MANAGER COMMENTARY

PALM CAPITAL

Q4 2021

January 2022 | 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.

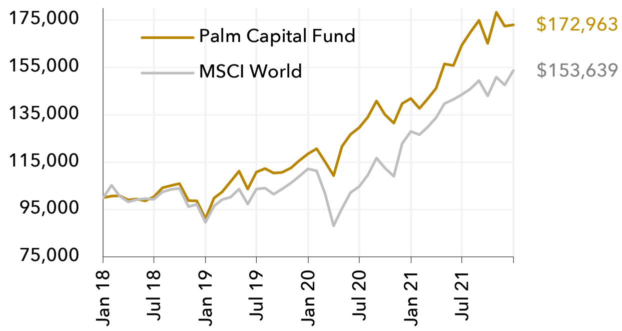
Our performance

Over the three months ending 31 December 2021 our portfolio increased by 4.8% after management fees & trading expenses.

Since we started, four years ago, our portfolio has returned 14.7% per annum after management fees & expenses. We have outperformed the MSCI World Index by 3.0% per annum while holding better businesses and patiently waiting to buy them below their worth.

Period ending 31 December 2021	Our Return^λ	MSCI World	Out-performance
Quarter	+4.8%	+7.5%	-2.5%
1 year	+22.0%	+20.1%	+1.5%
Since inception (annualised)	+14.7%	+11.3%	+3.0%

Growth of US$100,000 investment



Inflation and growth shares

'Growth' shares began to wobble towards the end of 2021, and this has since turned into a full-on decline in the new year. While it's always difficult to pinpoint the cause of short-term market movements, the slide appears to have been precipitated by a market narrative that implies that high inflation is bad for growing businesses.

The narrative goes that high inflation lifts interest rates and discount rates, disproportionately reducing the valuations of growth shares. This is because these businesses have a greater portion of their valuations linked to their earnings in later years which in turn fall more the higher the discount rate.

As our investment approach favours businesses that are growing in economic value over time and are therefore being affected by the sell off, let us address this argument.

Firstly, as long-term investors, we use a discount rate based on a long-term expectation of inflation and interest rates that is materially higher than current interest rates. So, a short-term rise in interest rates doesn't warrant a change in our discount rate or valuations.

Secondly, we only invest in businesses that are already highly profitable. Even though they are growing quickly, their valuations are less sensitive to discount rates than most other growth businesses that have thin or negative profit margins.

And thirdly, and most importantly, as we have no expertise in forecasting interest rates or inflation, our investment approach bypasses the need to do so by focusing only on businesses that are very likely to grow their earnings despite higher inflation or interest rates.

These are businesses that provide a critical or unique product or service to their customers and can thus increase prices to pass on inflation. They are also innovative and disruptive, repeatedly developing new products and services that act as new sources of revenue and taking market share from incumbents. These sources of growth continue irrespective of inflation.

So, overall, we aren't paying much attention to short term inflation and even if it turns out to be a lot higher for a long enough period to warrant a change to our long-term discount rate, the businesses we own should largely be unaffected.

Once again, the sell-off has provided us with an opportunity to add to our ownership of exceptional businesses at attractive prices. We will outline two of our favourite ones that we have been buying over the past few months below.

Constellation Software

Constellation Software was founded in 1995 by current CEO, Mark Leonard, who is one of the best capital allocators of all time. Identifying the attractive economics of software companies – stable revenue, low capital intensity, high margins and high and steady cashflows – he set out to create a long-term acquirer of these businesses.

Within software, he identified critical, founder-led, mature, and market-leading vertical managed software (VMS) as having the strongest of these characteristics and set his sights on these.

His reasoning was that critical software that costs a small fraction of the operating expenses of a customer has much stronger customer stickiness than peers. Not only does this allow them to weather economic downturns, but it also endows them with pricing power.

His reasoning for favouring founder-led businesses is best explained in his own words:

"When a founder invests the better part of a lifetime building a business, a long-term orientation tends to permeate all aspects of the enterprise." Mark Leonard, 2013

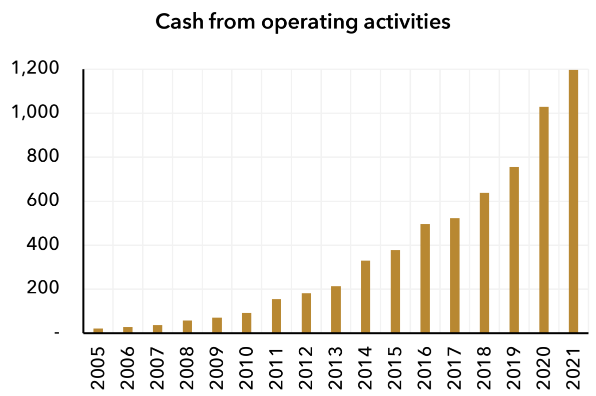
And while mature, market-leading, VMS companies have small addressable markets and little room for growth, this makes them less appealing to typical software acquirers such as Venture Capitalists. As a result, it keeps acquisition multiples low. It also creates an inherent barrier to entry in this space as the small size of the target market makes it less economical for new entrants. The incumbents have typically invested years of Research & Development and Sales & Marketing budgets into building custom products and trust that entrench them with customers. Furthermore, their market-leadership position means that they generally have low customer concentration adding a layer of defensibility to their revenue.

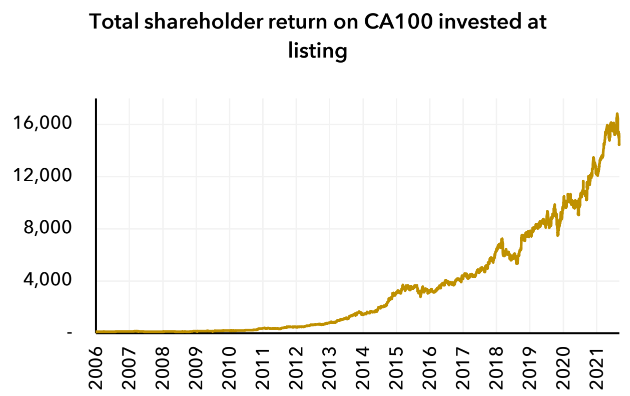
Importantly, by addressing small markets, these companies themselves can stay small and nimble – an important attribute that allows them to avoid corporate red tape and stay close to customers.

"The larger a business gets, the more difficult it becomes to manage, and the more policies, procedures, systems, rules and regulations are generated to handle the growing complexity. Talented people get frustrated, innovation suffers, and the focus shifts from customers and markets to internal communication, cost control, and rule enforcement." Mark Leonard, 2017

Most[1] of the companies they have invested in have less than 100 employees.

The company has executed and perfected this playbook with remarkable discipline over the decades, continually reinvesting profits from acquirees into others that fit this profile while never paying much more than 1 x sales[2]. It now owns more than 400 niche and critical software companies across dozens of sub-industries. The company has a net cash position on its balance sheet and has never issued shares to acquire a business.





Source: Palm Capital analysis, Company financials, Yahoo Finance

[1] Over 80% at the last time of disclosure in 2017

[2] Estimated based on company's ROIC and various financial information. This equates to a 3-4 year payback period.

Since listing in 2006, it has grown its cash from operations by 41 times. CAD100 invested in its shares at the time of listing, with dividends reinvested, would be worth approximately CAD14,500 today.

The most impressive aspect of this company is the strength of the management team and the unique structure and culture they have built. The business is highly decentralised. It is split into six separate divisions, each with its own set of operating and portfolio managers trained in and responsible for executing the same investment playbook. And acquirees are left to operate on their own, only being offered coaching or guidance if facing difficulties or if there are suggestions for improvement.

Constellation shuns corporate complexity, even advocating the breakup of businesses as they grow too large.

"Some BU Managers lack the humility, some lack the courage, and most lack the time for reflection, to notice that their task is getting too large, and the sacrifices are getting too great. This is the point at which our Operating Group Managers or Portfolio Managers can provide coaching. If a large BU is not generating the organic growth that we think it should, the BU manager needs to be asked why employees and customers wouldn't be better served by splitting the BU into smaller units. Our favourite outcome in this sort of situation is that the original BU Manager runs a large piece of the original BU and spins off a new BU run by one of his/her proteges." Mark Leonard, 2017

Portfolio managers spend a lot of time collecting and analysing data from acquirees and the market, looking for insights that can be taken from one vertical to another, that can improve their acquisition process or help build up a picture of acquisition targets. This data set is unique given the scale and history of the business.

From a shareholder's perspective, management are refreshingly transparent. They give detailed disclosures of their acquisitions and are forthright with their thinking, mistakes, and learnings. They are also aligned with long term owners. Management own 7% of the company and senior employees are obligated to invest a portion of their bonuses in shares. And their incentives are tied to the drivers of long-term economic value creation with an emphasis on organic growth and return on capital.

The company is a compounding machine that fits the profile of the type of company we like to invest in.

The big question every investor and analyst who has looked at Constellation Software in the past decade has faced is whether they can continue growing. At the average ticket size of acquisition of $5-10m, the company must make close to 100 acquisitions each year while still being patient and disciplined on multiples they pay. On the surface, this seems like a mammoth task.

However, we think they are up to it. This is primarily because the company has proven its ability to scale up via its tried and tested decentralisation model. And its potential pool of targets is still massive. The 400-odd companies that Constellation own make up less than 1% of the highly fragmented VMS market. Even if we screen for those that fit Constellation's strict criteria, this percentage is still below 10% of the market. The company has now also come around to the idea of increasing their ticket size of acquiree. Although this would mean being willing to pay higher acquisition multiples, it increases their opportunity set even further.

And the reputation Constellation has built over the years is not lost on potential acquirees. It sets them apart from competing investors. The company is known as a long-term, stable home for VMS companies as they let acquirees operate on their own while still playing a 'big brother' role of giving advice and lending a hand when needed. Their expertise and reputation often makes them the first choice for VMS companies looking to sell.

The current share price implies that the company will grow its free cashflow at 7% p.a. over the next 10 years versus a historic free cashflow growth of 30% p.a. since 2006 or 20% p.a. over the past 5 years. We think that this is a very low ask for this incredible management team and that it more than prices in the risk of a quicker slowdown than we expect.

Salesforce

Identifying the power of the internet to vastly improve the delivery of software to customers, current CEO, Marc Benioff, founded Salesforce in 1999. The company's initial product - Customer Relationship Management (CRM) software – wasn't very different from that of the well-established incumbents. But delivering it over the internet resulted in a much better user experience.

It removed the high upfront costs of purchasing software packages as well as expensive upgrade exercises. It also eliminated the complex task of installing the software for customers – a process that could take years in large enterprises. It created predictability in their expenses and ensured their software was always up to date. And it allowed them to access the software from any location and any device that had an internet connection.

Salesforce quickly ate up market share. It was a pioneering idea that has since been copied by most software companies globally.

Software is an industry where a provider's sustainable advantage is the prohibitive cost and risk a customer incurs to move to a competitor. Customers don't take a decision to change providers lightly. As a result, retention rates on critical software are typically very high.

Distribution is crucial in building this advantage.

Marc Benioff understood this early on.

"How do you achieve manifest destiny in the software market? It's all about distribution. Do you have enough salespeople to cover the millions of companies in the world who need this product?... Our ability to invest and grow distribution, which is one of our core assets and I would say one of our core competencies at Salesforce, and the ability to consistently execute that in a public environment over so many years; 13 years of operating history now." Marc Benioff, 2012

Leveraging their success from delivering the software over the internet, the company always prioritised investments in distribution over short-term profits. It has grown into a distribution powerhouse.

This has enabled Salesforce to get to a 20% market share in CRM – four times that of its closest competitors Oracle and SAP. And it is growing at a much quicker pace. Furthermore, by executing a classic 'land-and-expand' strategy, its distribution advantage has enabled the company to grow into numerous adjacent areas of enterprise software. The company is rated as a leader by Gartner in multiple products including salesforce automation, multichannel marketing hubs, digital commerce, analytics, and business intelligence.

It is also the reason many software companies choose to partner with or be acquired by Salesforce. Snowflake, the company that had the second-largest IPO of 2020 that counts Warren Buffett's Berkshire Hathaway as an investor, is a good example:

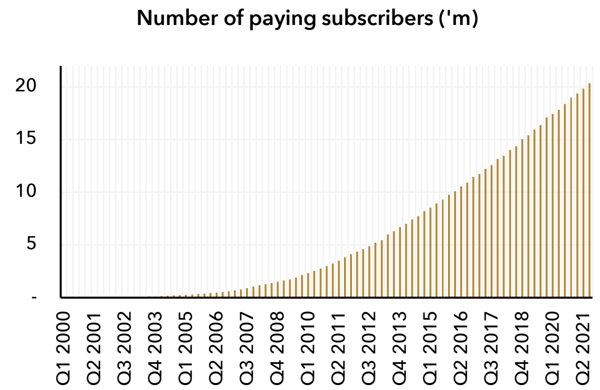
"the only reason we raised more money is not because we needed the money, it's because we were pursuing a strategic relationship with Salesforce… So that fundraise wasn't really a fundraise, it was our strategic relationship, and it was the cost of doing business for us." Frank Slootman, Snowflake CEO, 2020

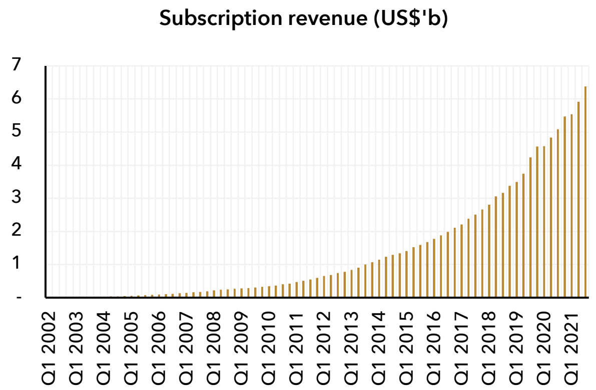
Salesforce invested in the company at a $12b valuation pre-IPO and it now has a market cap of $80b.

Because the company understand the power of its distribution, it prefers acquisitions over internal Research & Development. And it has a solid acquisition track record to prove that it works. While all the large acquisitions it has done - ExactTarget (marketing cloud), Demandware (commerce cloud), MuleSoft (API integration), Tableau (analytics) and Slack (collaboration) – were at high multiples, they have had accelerated growth post acquisition and look like excellent deals in hindsight.

Interestingly, its revenue from commerce cloud alone (10% of total revenue) is almost as big as Shopify's overall revenue. And Shopify's market cap is more than half the size of Salesforce's.

Remarkably, the company has grown its subscriber numbers and revenue for every consecutive quarter since it was founded.





Source: Palm Capital analysis, Company Financials

As is typical with dominant software companies, Salesforce has built a strong switching cost advantage. In the case of CRM software, the risk of operational downtime if Salesforce's customers decide to switch to a competitor is the potential loss of their own customers. And given that retaining a customer is cheaper than finding a new customer, this makes the risk of switching very costly. It has resulted in a retention rate for Salesforce of 90% over the past two decades.

Some of these customers are multi-billion-dollar vertical management software companies like Veeva ($36b market cap) and nCino ($5b market cap) that have built their businesses off Salesforce's platform.

In addition, the company has built some network effect advantages. Its dominance in CRM software ensures that IT managers continue to choose Salesforce over competitors because most other IT managers do the same. It's a big career risk not to choose Salesforce. It has also built an AppExchange royalty platform similar to Alphabet's Android Play Store that allows small software vendors to distribute their software. There are currently more than 4,000 software vendors on this platform.

We think that Salesforce is materially undervalued. The company has lots of room for growth from existing markets (Gartner estimates that these markets will grow in the mid-teens for the next 5 years) and new adjacent products. And it is still in its investment phase, with operating expenses at 73% of revenue versus 51% for similar-sized Adobe and 27% for Microsoft. A large part of this is sales and marketing which is close to 40% of revenue at Salesforce versus 27% at Adobe and 13% at Microsoft. With an estimated 400%[3] return on marketing investment, we expect the company to create significant value over time.

[3] Our estimate based on lifetime value versus cost of acquisition

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