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Venture a Guess?

*In the late 1970s, one of your writers started working his first white-collar job at One Wall Street for Irving Trust Company. In this newsletter, we reminisce about a lesson learned at a two-day Irving Trust corporate finance seminar in 1979 that featured expert views on subjects ranging from newfangled money market funds and commercial paper (imagine such exotica!) to deeper topics such as venture capital and buyouts. One lasting and simple concept about investing was discussed and will be recalled here since it has timeless application for any investment opportunity – especially as we witness a spate of so-called "unicorn" Initial Public Offerings, the latest being **Snap, Inc**. (d.b.a. Snapchat).*

By way of background, Irving Trust Company, founded in 1851, was an old-line money center bank that was eventually acquired by Bank of New York. I joined Irving's stodgy but effective 18-month management and credit training program in 1978 and ascribe the start of my enduring love affair with finance to the bank. The Irving corporate finance seminar was held for around 20 Chief Financial Officers of major companies such as IBM, St. Regis Paper and the Washington Post, if memory serves. As a green 22-year-old trainee fresh from college, nominated to attend the seminar (mainly to point to restrooms and determine who liked which type of cigar), I was eager to learn, and my ears were wide open as Wall Street's finest spoke to these Fortune 500 CFOs.

The Private Secret

One question, addressed to presenter J.C. Bradford, went something like, "what is the risk and return difference between a *management buyout* and *venture capital?"* The question may seem elementary now but was prescient then since the whole concept of private equity investments by venture capitalists and management buyout firms (later leveraged buyouts, or LBOs) was just becoming popular. These CFOs were naturally curious about the subject since they were getting "pitched" by emerging private equity firms. While paraphrased after some 38 years, Mr. Bradford's answer to the question has stuck with me and went something like this:

> *In a management buyout, the future operating performance of the company does not have to be materially different than its historical pace for the deal to work out nicely. In a venture investment, the future must be far different than the past for the investment to prosper because these companies are either losing money or making very little, and are often doing completely new things. The venture scenario is therefore far riskier and investors should demand 40% or more in annual return on venture capital whereas 20-30% returns should satisfy buyout investors if they employ some leverage.*

We get jazzed at Hamilton Point by straightforward explanations such as Mr. Bradford's and the related implications for investing are ripe. Simply put, consistency of profitability matters in judging risk, and if you have to bet on an uncertain future, then you need a much higher return expectation to justify the investment. We agree and put this theory into practice when selecting the public companies we own at Hamilton Point.

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Hamilton Point's approach aligns with Mr. Bradford's definition of "management buyout" risk wherein we target companies with favorable free cash flow characteristics—something we believe (but can't guarantee) drives long-term returns. For example, we identify growing companies, worth at least $1 billion, with strong balance sheets, that have been profitable for years. We add other qualifiers like management strength, regulatory clarity and the provision of "value-added" products or services, in order to lead us to companies with cash flows we believe will be predictable. Not surprisingly many of the companies we have owned in recent years have been acquired in buyouts, such as **PetSmart, Del Monte, Kraft, Heinz, Piedmont Natural Gas** and **EMC** [1]—all to the benefit of our clients' portfolios.

We believe this disciplined investment approach is especially needed in an environment where there are many companies going public today that Mr. Bradford would likely profile as involving inadequate risk/return metrics since cash flows are often negative and valuations seem excessive relative to the hope for much higher future profits.

Something Ventured...Little Gained

To test our logic, we examined 11 initial public offerings (IPOs) in the internet software/services sector. The list included all IPOs in the sector from the great recession through 2013 (so that at least three years have passed to see how they worked out), with starting valuations over $500 million. Seven companies were losing money at the time of their IPO, and all were counting on a future that would be different from their pasts.

If one invested $10,000 into each of the IPOs, the $110,000 cumulative investment would now be worth around $177,000 in portfolio value—not a bad return, but pretty paltry given the risk taken for investing in a series of unproven companies. Just five companies have had positive returns with only four of those outperforming the S&P 500 since IPO. For comparison, if the investor had instead bought $10,000 in the S&P 500 on the same dates of the 11 IPOs, the $110,000 investment would have nearly doubled and be worth over $209,000 [2] – a substantially higher return, especially on a risk-adjusted basis.

To be clear, we believe venture investing can be done quite profitably by careful investors, and there are some opportunities for investors to buy companies that project bright futures that are markedly different from the past. However, Mr. Bradford's advice sets a high bar for judging these companies, and in our view, too many IPOs are priced at a level where reasonable return expectations are not commensurate with the risk being taken. Investors ignoring this dynamic are at odds with Mr. Bradford's wisdom from so many years ago, and in our opinion, do so at their peril.

Financial Disappearing Act?

For our part, we will continue buying relatively unleveraged public companies with understandable, and fairly predictable, business models. This brings us to **Snapchat.** Unlike **Kodak** in its heyday that made money helping customers take keepsake photographs, Snapchat loses tons of money by helping adolescents take pictures that disappear (go figure). Snapchat lost nearly $900 million cumulatively in their last two calendar years — losing substantially more in 2016 than they did in 2015 — and went public recently at a $24 billion valuation.[3] We think Mr. Bradford would declare it a venture risk that just might be mispriced.

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1) For a free list of all recommendations made by Hamilton Point during the last year, please contact us.
2) List of IPOs based on FactSet industry identification of Internet Software/Services with initial valuation of greater than $500 million and IPO date from 2009 to 2013; current value of investments based on total return from offering price to 2/28/17 or acquisition date in the case of the two companies acquired; calculations for S&P 500 based on total return for index from IPO to either acquisition date or 2/28/17, as applicable.
3) From SEC filing 424B4 filed on 3/3/17.