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Discussion with Markel

*The Common Denominator:
Tencent, JD, Facebook, Google*

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Saber Approach - 2 Buckets

“Every day you either get better or you get worse.”

- Former Michigan football coach Bo Schembechler

There are two types of companies in the investable universe:

- Bucket A) Those that are growing their intrinsic value over time
- Bucket B) Those that are shrinking their intrinsic value over time

Money can be made in either bucket, but **I prefer to stick with Bucket A.**

Saber Approach - 2 Categories of Investments

Within “Bucket A” (the companies that are growing their value over time), there are two sub-categories:

- **Category 1:** “Compounders” - Growing Companies with a Long Runway
- **Category 2:** “Stalwarts” - Durable, Mature Companies at a Discount

Saber’s investments typically fall into one of those two categories.

Category 1’s are very rare but can produce large winners;

Category 2’s yield lower profits but occur much more often.

Even Large-Caps Get Mispriced

Top 10 Largest Companies in S&P 500 (as of 6/24/2016)						
Company	Ticker	Current Market Cap (\$ billions)	52 Week Low	52 Week High	% Change (High/Low)	\$ Change in Market Value (\$ billions)
Apple	AAPL	\$511	89	133	49.4%	\$239
Google	GOOG	\$459	515	790	53.4%	\$187
Microsoft	MSFT	\$391	40	57	42.5%	\$134
Exxon Mobil	XOM	\$370	67	92	37.3%	\$106
Amazon	AMZN	\$330	426	731	71.6%	\$145
Berkshire Hathaway	BRK-B	\$326	124	148	19.4%	\$60
Facebook	FB	\$320	72	121	68.1%	\$141
Johnson & Johnson	JNJ	\$318	82	118	43.9%	\$100
General Electric	GE	\$274	19	32	68.4%	\$117
AT&T	T	\$255	31	42	35.5%	\$69
					Average % Change High/Low	48.9%
					Average \$ Change in Market Value	\$130 billion

What is the Common Denominator?

What do all of these companies have in common?

- Facebook
- Amazon
- Netflix
- Google
- Tencent
- JD.com

Common Denominator #1 - Culture

- Culture
- Mission-Driven Focus
- Most Important Moat (User Experience and Customer Value)

“I think of our engineers as missionaries, not mercenaries” - early Googler

Most Important Moat

The most important moat is a company that is focused on providing great value for its customers over the long-term.

- Technology touches all industries today
- Change is much more inevitable and occurs much more rapidly
- I believe the most effective antidote to “disruption” is a management team that is driven by something larger than profits
- A company that is motivated to provide great value for its users and customers has the potential to establish a long-term advantage over the vast majority of companies that manage their businesses for the short-term

Most Important Moat

All of those companies offer the customer/user significant value:

- Facebook - free social connections/chat; high ROI for advertisers
- Amazon - incredible convenience (in addition to low prices and wide selection)
- Netflix - large library of movies and shows at a fraction of your cable bill
- Google - indispensable search tool, email, maps, storage, video (all free); high ROI for advertisers
- Tencent - indispensable app for anyone living in tier 1 or tier 2 cities in China; great value in a variety of other products for both users and businesses that desire to reach those users
- JD.com - speedy delivery, authentic merchandise, low prices

Mission-Driven Companies

“Our mission is to make the world more open and connected”

- Facebook Mission Statement

“**We don't wake up in the morning with the primary goal of making money**, but we understand that the best way to achieve our mission is to build a strong and valuable company.”

- Mark Zuckerberg, Letter to Prospective Shareholders (IPO Prospectus)

“I look at people here as missionaries, not mercenaries.”

- Alan Eustace, an early Google engineer

Culture - More Than Buzzwords

Firms that have established a certain type of culture often exhibit this type of value-focused and mission-driven attitude, which I believe is a moat that is very difficult to replicate for those companies that don't have it:

- “The Markel Style”
- “Don't Be Evil”
- “Think Different”
- “The Hacker Way”
- “Customer Obsession”

Why Does Culture Get “Mispriced”?

The reasons for why I think this can be a durable edge are the **same reasons** why large-cap, widely-followed stocks get mispriced:

- Everyone knows that providing value to customers is important, but actually doing this can cause short-term pain (it takes long-term investments, R&D, lower near-term profits and underperformance relative to peers, etc...)
- Very few companies have the structure for such long-term focus (both a patient ownership base and an aligned management team are required)
- **Because of these structural hurdles and near-term incentives that drive behavior, I believe that culture can't easily be copied by competitors**

Summary

- Both long-term time horizons and culture are widely respected attributes but rarely implemented
- Job security (incentives), an unwillingness to wait long for payoffs, and general human nature make it difficult for most people to make decisions that will create the most value long-term but could have negative short-term consequences
- This leads to two conclusions:
 - Stocks - regardless of how widely followed they are - can become mispriced at times
 - It is difficult/impossible to clone “culture”, which means that those companies that possess it have a competitive advantage

Common Denominator #2 - Network Effects

- **Huge Network Effects**
 - Facebook has 2 billion users and 70 million businesses on its namesake platform (not to mention Instagram, WhatsApp, or Messenger)
 - WeChat has 1 billion users that are highly engaged (spending over an hour/day on average and using the app over 10 times per day)
 - Google has the most comprehensive index and best search product, which has led to billions of users for its search, browser, email, maps, and other products
 - YouTube's 1.3 billion users watch over 1 billion hours on the platform *every day*
- **Feedback Loops**
 - Data Feedback Loop: A good product leads to more users, which provides more data, which improves the product, which leads to more users, and still more data, etc...
 - Price/Volume Feedback Loop: Low prices lead to more customers, which leads to cost savings from suppliers, which can be passed to customers, which brings in more volume

Common Denominator #3 - Large Markets

All of the companies operate in markets that Buffett would call “inevitables” (meaning, it is nearly certain that these markets will continue to grow over time).

These companies have dominant positions in fast-growing industries:

- Digital Advertising
- Ecommerce (and retail in general)
- Payments
- Cloud
- Media
- Gaming

Common Denominator #4 - ROIC

These companies are making investments in data centers, technology, warehouses and other growth oriented investments, but they require very little capital to grow:

	TCEHY	GOOG	JD	FB	Totals
Net Income (\$B)	\$9.7	\$19.5	\$0.0	\$15.9	\$45.1
Tangible Capital	\$3.2	\$40.6	\$1.9	\$16.8	\$62.5
Return on Tangible Capital	303.1%	48.0%	N/A	94.6%	72.2%

Also, ad platforms like WeChat, YouTube, Google, and Facebook have massive incremental margins.

Common Denominator #5 - Rapid Growth

The combination of strong moats, large and fast-growing markets, and very low capital requirements has led to explosive growth:

	TCEHY	GOOG	JD	FB
Revenue Growth (yoy)	61%	23%	40%	48%
Operating Profit Growth (yoy)	57%	22%	N/A	63%

Common Denominator #6 - Underearning

These companies have other businesses that are very valuable but aren't major contributors to revenue yet:

- **Facebook:** Instagram produces only a small portion of FB's revenue, and WhatsApp & Messenger have over 1 billion users but produce no revenue yet
- **Tencent** is very profitable overall, but WeChat only does ~\$4 billion in ad revs (compare to \$40 billion at FB); other areas such as payments, cloud, and media content have lots of potential
- **Google:** Core search is a 40%+ margin business (\$95b revs in 2017); YouTube shows over 5 billion videos a day and climbing; Cloud is a \$4b business in an industry that will be hundreds of billions; Waymo? Health care? AI technology? Hardware and IoT?
- **JD.com:** "Rent" their infrastructure (third-party sellers, third-party logistics)

Tencent (TCEHY) – A Huge Moat in China

Tencent Holdings (HK: 700; OTC: TCEHY)



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Buffett's "Inevitables"

- Companies that Buffett felt were sure to do well over time due to structural competitive advantages
- But some of these structural advantages have been eroded, due to unforeseen technology
- Today's inevitables are not the companies that are resistant to change (because change impacts all now)
- Today's inevitables understand change and can adapt, while always focused on customer value
- Google, Amazon, & Facebook exhibit these qualities
- There are also numerous "inevitable" companies today in China...

Note: "inevitable" doesn't mean the stock is necessarily cheap, just that the business will likely continue to do well.

The Inevitable Trend in China

- These companies benefited from the “walled-garden” internet in China...
- But, more significantly, they’ve benefited from a rising middle class that is using the internet more, and spending more online
- This is a trend that in my view is an “inevitable”.
- Internet usage will certainly grow, and thus online ads, ecommerce, and mobile payments will follow suit
- Unlike the airlines in the 1950’s, this “inevitable” industry will create massive profits for its winners
- One of these inevitable companies that will capitalize on this inevitable trend is Tencent

What Does Tencent Do?

Tencent is an internet holding company that has the following main businesses:

1. **Digital Advertising** – 938 million highly-engaged users on WeChat, the “Super-app”
2. **Video Game Publishing** – High margin, high ROIC business that throws off significant free cash flow
3. **Mobile Payments** – WeChat Pay is one of the largest mobile payment platforms in China
4. **Media Subscriptions** – Over 125 million people subscribe to Tencent’s news platforms, music, movies, video, and original content (*think Apple Music, Youtube, and Netflix combined*)
5. **Ecommerce** – Tencent is a partner & minority owner of JD.com; WeChat is a potential ecommerce hub

What If One Company Did All Of This?

facebook



WhatsApp

You Tube



NETFLIX

Apple MUSIC



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Highly Profitable & Growing Fast

<i>Tencent Holdings Income Statement Snapshot</i>								
<i>(\$ in millions; 1 USD = 6.81 RMB)</i>	2011	2012	2013	2014	2015	2016	5-yr CAGR	Yr-on-Yr
Revenues	\$ 4,183	\$ 6,444	\$ 8,872	\$ 11,587	\$ 15,100	\$ 22,304	39.8%	47.7%
Pretax Profit	\$ 1,776	\$ 2,209	\$ 2,830	\$ 4,259	\$ 5,317	\$ 7,581	33.7%	42.6%
Pretax Margin	42.5%	34.3%	31.9%	36.8%	35.2%	34.0%		
Net Profit	\$ 1,498	\$ 1,869	\$ 2,276	\$ 3,495	\$ 4,229	\$ 6,033	32.1%	42.7%
Capital Employed	\$ 1,633	\$ 1,683	\$ 2,829	\$ 8,368	\$ 13,742	\$ 19,111		
ROIC	108.7%	131.3%	100.0%	50.9%	38.7%	39.7%		

Why Tencent is a Great Business to Own

1. **WeChat's Network** – Used by everyone in China; chat, payments, work groups, social, shopping, money transfers, hailing cabs, paying bills, and much more
2. **Massive Runway** – Tencent is a leader but still has a very small slice of large, growing markets such as mobile advertising, ecommerce, payments, media content, cloud and games
3. **Great Businesses** – High margins, free cash flow, recurring revenue streams, low capex
4. **Founder/Operator** – Focused on Creating Maximum Long-term Value

Tencent's Crown Jewel: WeChat

What is WeChat?

*“Like most professionals on the mainland, her mother uses WeChat rather than e-mail to conduct much of her business. The app **offers everything** from free video calls and instant group chats to news updates and easy sharing of large multimedia files...*

*“Yu Hui’s father uses the app to **shop online, to pay for goods at physical stores, settle utility bills and split dinner tabs** with friends, just with a few taps. He can easily book and **pay for taxis, dumpling deliveries, theatre tickets, hospital appointments** and foreign holidays, **all without ever leaving the WeChat universe.**”*

- Economist article [“WeChat’s World”](#) (*emphasis mine*)

WeChat: The Everything App

“As one American venture capitalist puts it, WeChat is there “at every point of your daily contact with the world, from morning until night.”

- Messaging (no more texts or emails)
- Social Networking
- Work Groups (Slack alternative)
- Online Shopping and Mobile Payments
- Payments at Physical Stores
- Much more.... paying bills, hailing cabs, ordering food, sending money to friends, event tickets, etc...
- **All without ever having to leave the WeChat app**

A Typical Day on WeChat

A Typical WeChat User Engages 11 Separate Times Per Day



Source: Tencent

(Source: Ycombinator, Tencent)

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A Classic Network Effect

- Network effect results when each incremental new user increases the value for everyone else
- WeChat attracts users because of its extremely high-value user experience
- Which attracts more users who want to interact with each other
- Which attracts developers, merchants, and advertisers that want to sell something to these users
- Which further attracts more users, etc...

WeChat's Massive Network

- 938 million users and still growing (up 23% yoy)
- 12 million official accounts (think Facebook business pages)
- User engagement is rapidly growing
- *Average* user spends 66 minutes a day on WeChat (more than Facebook and Instagram combined)...
- But a third of WeChat's users spend a whopping **4 hours a day or more** on the app!

Tencent's Long Runway

- Mobile Advertising: \$50 billion market that is rapidly expanding in China
 - WeChat did roughly \$3.5 billion from ad revs in 2017 (compare to Facebook's \$39 billion or Google's \$95 billion in annual ad revenue)
- Digital Content (Video, Music, Movies)
- Ecommerce
- Payments
- Video Games
- Cloud

These are very large and fast-growing markets that Tencent is well-positioned for, but has barely scratched the surface in terms of monetization.

Advertising – WeChat vs. Facebook

<i>(\$ in billions)</i>	2010	2016
Facebook Ad Revenue	\$2.0	\$27.6
	2016	6 Years Later
WeChat Ad Revenue	\$2.3	?
China Online Ad Market	\$50	?

- It took Facebook **6 years to go from \$2 billion to \$27 billion** (and \$10 billion in profits)
- WeChat has more users now (who spend more time on the platform) than Facebook had in 2010
- WeChat has a small slice of China's online ad market that is growing currently at 25% annually

Sources: Company filings, online ad market is eMarketer's estimate, my calculations based on segment data from company filings

Tencent Culture

“Wealth won’t give you satisfaction. Creating a good product that’s well received by users is what matters most.”

– Pony Ma, in 2011, shortly before WeChat was launched

- Ma started Tencent in 1998, and owns just under 10% of Tencent
- Ma is an engineer, and like Google and Facebook founders, is driven more by process than profits
- Is intensely focused on user experience above all else
- Is very focused on the long-term

This [excellent interview](#) with one of Tencent’s early employees has great commentary on Tencent’s culture.

JD.com (JD)

- I believe JD.com (JD) is an example of a company that has:
 - An outstanding **culture**
 - Owner/operator with a very **long-term vision**
 - A religious-like focus on **customer value**:
 - Authentic products (a big deal in China)
 - Low prices
 - Fast delivery

JD Investment Thesis Summary

- Massive Market
- No Fakes
- Own the Logistics
- WeChat Partnership ([My Thoughts on Tencent](#))
- Price/Volume Feedback Loop (Economies of Scale)
- Richard Liu - Founder/Operator
- Cheap (Possibly Very Cheap) Relative to Future Earning Power

Turtle Mental Model

- Every year on the North Carolina shoreline (among many other locales), turtles hatch in the sand and try to make it to the sea
- The vast majority of these turtles will unfortunately not survive
- Many don't make it to the water; and the ones that do get eaten by fish
- However, for the few that survive, they grow a very durable shell that offers significant protection, making the turtle very difficult to kill
- Thus, once the turtle reaches a certain point, the odds of survival go from very low to very high

JD is the “Turtle”

- I believe JD.com is the turtle that survived
- It would have been a long-shot bet in the early years, as retail is a very tough business and JD was competing against larger competitors with much greater scale
 - *Note: if you happened to know Richard Liu, you may have recognized that JD was in fact a good bet, even in the early years*
- It faced very near death experiences at numerous times, but managed to survive
- It not only survived, but it built out a **logistics network that I believe is now its protective shell** (very difficult to recreate this), making it likely that JD remains a major player in Chinese ecommerce for years to come

JD Valuation

- \$2.2 billion FCF; 29 P/FCF
- Reasonable price for a great business that is growing at 40% per year, earns high returns on incremental investments, and has a very long runway
- Despite owning the inventory and controlling the logistics, JD deploys just \$4 billion in capital (even if we assume leases are capital assets)
- Working capital is a source of cash currently; I consider this is permanent capital if you believe that JD's business is both stable and profitable long-term
- JD's warehouse and delivery assets are increasingly being "rented" out to 3rd party sellers, which improves productivity and increases profit margins (similar to Amazon's model)

JD Long-term Potential (~10 years)

This is my view of JD's potential (shouldn't necessarily be considered a prediction):

- China GDP per capita is a fraction of its more developed Asian neighbors
- China retail is \$5 trillion, will be \$8 trillion in 10 years if it grows at half the current rate
- Ecommerce will be somewhere around $\sim\frac{1}{3}$ of all retail (\$3 trillion)
- JD GMV can be a big piece of that market (online retail is not fragmented like offline)
- I believe JD's business will be larger than Walmart's in the long run
- It will include high margin third party sales using JD's owned warehouse network
- \$600 billion revenue; 3% margins (could rise further as 3P grows)
- 5-fold+ potential from the current prices (\$64 billion market cap; \$44 stock price)

Key Point to Consider

- Ecommerce businesses benefit from the classic **Price/Volume feedback loop** that large-scale retailers like Walmart and Costco made famous
- But ecommerce companies also benefit from another important advantage that offline retailers lack: a **network effect** that results in the largest ecommerce companies potentially grabbing much more market share than the comparable largest offline retailers (e.g. Amazon takes 50% of every new dollar spent online)
- Without the physical constraints of brick and mortar retailers and because of the unlimited “shelf space”, I believe online retailers can take much greater share of the overall ecommerce market

JD Summary

- My overarching view is that **JD has carved out a durable position in China's retail market**, which has enormous growth potential as China continues to expand
- I believe JD's customer focus, its emphasis on authentic products, its logistics network, and its partnership with Tencent/WeChat are key reasons why it is likely to continue to be a major (top two) player in China's ecommerce market in the long run
- What was a very difficult business initially is now a much more predictable business

Valuation

- Facebook (FB)
 - \$533 billion market cap at \$180 per share (\$41 billion net cash)
 - 2018 estimated owner earnings: \$23 billion
 - 2018 P/E (ex-cash): **21**
 - Current earnings growth: **63%**
- Tencent (TCEHY)
 - \$525 billion market cap at \$55 per share
 - 2018 estimated owner earnings: \$15 billion
 - 2018 P/E: **35**
 - Current earnings growth: **57%**

Valuation

- Alphabet (GOOG)
 - \$768 billion at \$1090 per share (\$100 billion net cash)
 - \$668 billion EV
 - \$30 billion pretax earnings (adjusted for one-time tax and fine)
 - \$4 billion loss from other bets
 - Estimated 2018 owner earnings (after tax): \$29 billion
 - 2018 P/E (ex-cash): **23**
 - Current growth rate: 22%
- Notes:
 - This includes sizable R&D investments as well as ongoing losses from other bets
 - I believe Google's core search business (40%+ margins in 2002) is a much higher margin business than financials currently suggest

Summary

- I think these companies are very reasonably priced given their significant competitive positions and growth potential
- In the case of Google and Facebook, they have valuation multiples that are similar to firms such as McDonald's and Coca-Cola, which are growing at low single digits and have moats that aren't as wide in my view
- I believe the culture of these firms combined with their huge network effects and competitive positioning ensures that they will continue capitalize on the growth of the markets they operate in
- I believe the market's "pendulum" has begun to swung, but hasn't swung far enough with these stocks

Questions / Comments?

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Thank You!