Ludo Thomasson:

Hello everyone, I am Ludo Thomasson, director of wealth management at Ensemble Capital. Thank you for joining us for our Winter 2018 conference call. Today, the focus will be on the current market and economic situation, and two of our portfolio companies, Prestige Brands and Nike.

Speaking today will be Sean Stannard-Stockton, chief investment officer of Ensemble Capital, and Arif Karim, senior investment analyst.

Sean Stannard-Stockton:

Hello everyone. Thanks for joining us.

The performance of our equity portfolios this quarter was strong and modestly ahead of the broader market. While the final fourth quarter calculation of our equity composite will not be available until later this month, our current estimate is that our composite was up 7.44% vs the S&P 500 up 6.64%. We finished the year with estimated performance for 2017 of up 21.70% vs the S&P 500 up 21.83%.

Historically, our equity strategy has exhibited an upside capture ratio of 95% and a downside capture ratio of 85%. This means that when the market is going up, our strategy tends to be up by about 95% of the amount the market goes up. So, if the market were to go up 10%, our strategy has historically generated returns of 9.5%. When the market has gone down, our strategy has tended to be down by about 85% of the amount the market declined. So, if the market falls by 10%, our strategy has historically declined by about 8.5%. The net result over the very long term has been our strategy outperforming the market by about 1.3% per year net of fees.

We are never satisfied when we underperform the market, even by a very small amount like we did this year. But our 95% upside capture ratio suggests that given the market rallying by 21.8%, our strategy "should" have only been up by 20.7% when in fact it was up by 1% more at 21.7%. In other words, we captured 99% of this year's gains, or more than we have historically. We do not expect our strategy to outperform under all market conditions. We work instead to outperform over the long term while exhibiting less volatility than the market. While our strategy under performed slightly this year, it did better than it has historically during periods of similar market conditions.

The most notable driver of our strong 4th quarter returns was the big rally in our retail related stocks. In particular we noted last quarter that L Brands, the parent company of Victoria's Secret and Bath & Bodyworks, had been a major drag on our full year results but that we hoped the worst had passed. Happily, this quarter L Brands was the best performing stock in our portfolio rallying 47% as their results stabilized in October and November as we had been expecting. We also saw Nike up 21% and Tiffany up 14%. In addition, we saw strong performance from non-retailers such as Charles Schwab & Co up 18%, Verisk Analytics up 15%, and Paychex up 14%.

On the negative side, we saw weak performance from Prestige Brands down 11%, which I'll talk about later, First Republic down 17% and Now Inc, which declined 20%.

Last quarter we highlighted how Now Inc and L Brands were responsible for dragging our strategy's total return behind the market, with the rest of our portfolio materially outperforming. While L Brands greatly recovered, Now Inc continued to face selling pressure.

Now Inc distributes products used in the exploration and production of oil and gas. Most of their revenue comes from US shale companies. With oil back above $60 a barrel, we continue to expect US shale companies to complete the many, many wells they drilled but did not complete during the last year and this completion process to greatly enhance Now, Inc financial results. So far, this expectation has not played out and drilled but uncompleted wells (knows as DUCs in industry parlance) have continued to stack up.

It may be that our analysis of Now, Inc is simply wrong. Our perseverance in holding the stock in the face of weaker than expected results is based on our continual re-examination of our thesis as new data comes in still pointing to much better results ahead. But we will not hesitate to exit the stock even with steep losses if we come to the conclusion that our analysis is incorrect.

First Republic's decline in the quarter is a great buying opportunity in our opinion and we've been adding to our position in accounts that own smaller positions than our target weight. The two main explanations for the weakness appear to be first, the company signaling that they will be investing more in growing their new student loan products and secondly, market concerns that the new tax bill's reduction in property tax and mortgage interest deductibility, will negatively impact home mortgage lending in the company's key San Francisco and New York markets.

On the student loan business, we are very positive on the company's strategy and believe the market is being shortsighted in worrying about the negative pressure on 2018 earning that will result from these investments, while ignoring the long term positive effect they will have. In decades past, First Republic, which provides high touch banking to high net worth families, has used the mortgage loan as the key product to start a relationship with young, upwardly mobile families. But while the average high income earner in their late 20s might have been in the market for a home a decade or more ago, these same families today have significant student loans and home affordability has pushed the average age of purchasing a first home into later years.

Thus, helping a young, high income earning family to refinance their large student loans is emerging as an excellent relationship building strategy for First Republic and filling a pipeline of clients who will turn to the bank for a mortgage loan when the time comes to buy their first house. While building this pipeline costs money and reduces near-term earnings, we think it is greatly beneficial to the long term intrinsic value of the business.

Before moving on, I'd also like to comment on the fact that last quarter we made note of our growing cash position in client portfolios. At the time, we said that "A superficial analysis might suggest that this high cash weighting implies we are bearish on the market or expecting a short-term decline... [but] we will not necessarily wait for a market pullback to put the cash to work. We are constantly looking for new ideas and even as the market makes new all-time highs, that does not imply that every stock is making an all-time high or is trading above fair value. We will continue diligently looking for investment opportunities in which to deploy our clients' cash, but we will not dilute our stringent requirements for investment, even if that means sitting on cash for a period of time."

During the fourth quarter, we saw declines in some of our holdings that allowed us to add to them at attractive levels and we established new positions in Priceline and Broadcom. In total, while the market appreciated during the quarter, we deployed our excess cash into positions that became newly attractive during that same period. This is why we say that cash levels are not reflective of a market call on our part. We generally hold an agnostic view on future market performance, which we believe is generally unpredictable, while we hold very strong views on the future performance of a limited set of securities on which we have done significant due diligence.

While we don't target cash levels based on an outlook on market returns, we would point out to investors that market performance in recent years has been much stronger than average and downside volatility has been more limited than is typical. In fact, 2017 was the first year in the history of the US stock market that saw positive returns during every month of the year.

Historically, 5% market corrections have occurred about three times a year, 10% corrections about once a year, and 20% corrections about once every three to four years. There is no reason to think that corrections of this severity and frequency won't continue to occur going forward. So while we describe ourselves as agnostic on market returns, we do believe that our clients should be prepared for more frequent and deeper market corrections in the years ahead than has been experienced in the past few years.

Now let's discuss a couple of our portfolio holdings. First Arif will discuss Nike and then I'll talk about Prestige Brands, which we added to significantly during the quarter.

You're on Arif.

Arif Karim:

Thanks, Sean. Nike is a globally recognized brand for performance shoes and clothing with $34 billion in sales and 35% return on invested capital (ROIC).

This brand is built on the strength of its product innovation and performance, innovative marketing tactics, and global capabilities in manufacturing and distribution. All of these aspects of the company provide it with a moat that allows the company to charge premium prices, earn strong profits, and stay resilient in light of new and existing competitors and waves of fashion trends that have threatened it over time.

Its sales are 50% larger than its closest competitor Adidas and it is more than twice as profitable. The next few competitors, like Under Armor and Puma both at $5 billion, are markedly smaller in scale. When Nike was founded in 1964 by Phil Knight, Adidas was a much larger incumbent in the sneaker business and Nike was the scrappy startup. Knight was a passionate competitive runner and recruited others passionate about running or Nike's business to build its early success, with a strategy that eventually centered around leading product innovation and more aggressive and creative marketing tactics than the incumbents' as described in his memoir, *Shoe Dog*. In time, Nike opportunistically expanded to other sports like football, baseball and basketball.

Over the years Nike successfully built its moat as its brand came to represent innovation, performance, style, and, in the spirit of its name sake, winning. Winning meant partnering with winners, which became a hallmark of Nike's marketing – signing endorsement deals with athletes who were stars or showed potential to become star performers. They used Nike's products and their fans bought the shoes their heroes wore to feel connected with their favorite athletes and teams. As more people wore Nike's shoes in and out of their workouts, fashion became an increasingly important part of the successful shoe formula, blending the utility of performance with fashion elements of everyday style.

As the success of the company grew, it was able to get more stores to carry its products, increasing distribution. Nike got its wholesale retail customers to even commit to advanced orders to secure the most popular styles for their shelves 6 months out. This gave Nike increasing visibility into demand but also created a symbiotic relationship between the company and its key retail partners in both driving and managing demand, which allowed Nike to better manage its supply chain and costs.

As its scale grew towards becoming the largest shoe company in the world, Nike was able to leverage its scale to control the relatively few shoe manufacturers in Asia. Making a shoe is a much more complicated process, with more specialized manufacturing, than making clothing, which is why there are generally fewer opportunities for competition in footwear by new companies. Innovative performance materials, efficiently scaling manufacturing techniques across thousands of SKUs (stock keeping units), comfort, fit, and durability are all key aspects in succeeding in the shoe business at scale. This makes companies with a greater emphasis on footwear, like Nike with 60% of sales from footwear, much more durable than competitors like Under Armor whose sales are much more skewed towards clothing, which is more easily penetrated by new players. You'd rather be the brand leader in athletic shoes while pulling in ancillary clothing sales than the reverse because your core is a much more competitively protected business.

In retail's age of disruption, this is a key distinguishing characteristic under the constant threat of ecommerce's behemoth, Amazon, with its crushing scale, speed, and resources, while on the other end are the plethora of smaller startups leveraging social media and fast turn retail techniques to disaggregate markets into smaller tailored niches they could better serve. Through this disruption, we believe the survivors will be those companies with strong emotionally charged brands that can connect with customers, with quick global product design, manufacturing, distribution, and marketing capabilities, efficient scale, and a resilient and adaptable organization.

All of these represent strong aspects of Nike's moat that position it to continue doing well over the long term, from its world-renowned brand that connects with its customers across channels (via stores, web, mobile apps, and social media), the scale to invest in innovation in product, production, marketing, and distribution, and its ability to seek out and retain the top athlete endorsements in the world in a variety of increasingly global sports like basketball, soccer, running, and tennis.

As an example of the symbiotic cobranding appeal of Nike and its roster of athletes, its most successful partnership with Michael Jordan still drove $3 billion in revenue for Nike's Air Jordan line in its last fiscal year (about 10% of total Nike brand sales) reportedly netting Michael Jordan royalty payments over $100 million in 2017 some 15 years after his third and final retirement from the NBA. Most of the NBA's top stars are still signed up with Nike in large endorsement deals worth hundreds of millions with notable exceptions being Stephan Curry and James Harden. The scale needed to compete for these endorsement deals across global sports makes it increasingly difficult for new brands in retail to compete and increasingly irrational for the very top athletes to sign with brands that may not be able to endure over time.

While a brand like Amazon also has emotional ties with its customers, it is inherently based on higher level utilitarian, rational appeals. Amazon is great at executing in retail areas where selection, price, convenience, and reliability are paramount. Undifferentiated retailers just cannot compete. However, Amazon has not been able to develop brands that have ties to deeper, lower level emotions that are potentially more powerful such as team loyalty, hero-worshipping, self-confidence, and self-identity that a company like Nike appeals to. It is no easy feat to create a brand that does this effectively and the impact this has on its consumers is powerful because it's hard to quantify or articulate that emotional boost, giving the company the upper hand in pricing negotiations in the consumer/company relationship at the purchase point moment of truth.

We got our opportunity to start buying the stock about a year ago as growth began showing signs of slowing from the double-digit range in the prior 5 years to more like the mid to high single digit range that we foresaw over the next 5 years. The reset in market expectations in spite of continuing strong returns on capital caused the stock to fall from a high in the $60's to a low of about $50 a share. Its valuation went from a 29x price to earnings ratio to 20x. Our research and valuation work suggested that in our normalized reasonable baseline scenario the stock was meaningfully undervalued given the durability of the brand franchise and returns on capital, as well as the global growth opportunity ahead in underpenetrated regions like China, Europe, and the emerging markets.

While the previous 5 years had seen strong growth from the more mature North American market with the trend towards causal/"athleisure" wear and the emergence of a stronger fashion and collectability trend among "sneakerheads", 2016 and 2017 saw a plateauing of this trend and, in fact, a shift towards a different style of casual streetwear that corresponded with Adidas' strategy of partnering with popular celebrities and its retro styled sneakers. In addition, channel shift has been an ongoing theme over the past couple of years as brick and mortar stores have seen declines in foot traffic and ceded share to ecommerce players, disrupting traditional sales and ordering patterns. While this sort of shift is always a threat especially when the market leader like Nike accounts for half the market, we believe the shifts are a short-term dynamic which will stabilize.

The bigger growth opportunity going forward comes from the international markets, where Nike expects 75% of its future growth to come from and now accounts for about 60% of sales. In addition, this growth is likely to be more profitable over time as its direct to consumer business via its own stores, website, and app will account for a greater percentage of its total sales while creating a more direct relationship with the customer. What excites us is that Nike has oriented itself to take advantage of technological and cultural changes to improve its customer connection, brand experience, and retail position in contrast to most brands that are finding themselves in more defensive positions in adapting to these changes. Its recent shift to its "Triple Double" strategy – 2x Innovation, 2x Speed, and 2x direct customer connections – while reorganizing itself from an organization comprised of functional teams towards a more agile one centered around the 12 most important local influence markets it serves (12 major cities across 10 countries around the world), are examples of the company's resiliency and adaptability.

The success of this positioning is already showing up in Nike's latest quarterly results in which its digital sales grew 29%, total direct sales (about 30% of total sales) grew 15%, and international sales grew 14% driven by growth in China and Europe.

While the past couple of years have seen some challenges to Nike's growth expectations, we believe that the next few years will see a return to healthy growth with improving profitability as a result of the changes management has made to its tactics built on the foundations of the company's existing moat.

Back to you Sean.

Thanks, Arif. With the steady drumbeat in the media that retail is dead, it may be surprising to some clients that we allocated a meaningful portion of our portfolio to retail stocks about a year ago. Given that every staff member at Ensemble Capital is an Amazon Prime member and neither Arif nor I visit brick and mortar retailers with any frequency, we fully buy into the idea that much of retail will never recover from the changes that Amazon has wrought on their industry. But we invest in individual companies, not sectors. Retail is not a monolithic industry and we believe that some companies in the sector became excessively cheap about a year ago as investors failed to differentiate between companies within the industry.

We note that not only did Nike and our position in jewelry retailer Tiffany outperform the S&P 500 in 2017, but they both trounced the S&P Retail industry as a whole. And amazing even to us is the fact that Best Buy, a company we do not own and which we would not have thought would successfully navigate the Amazon threat, rallied by 65% and actually outperformed Amazon's stock in 2017. It is during periods of industry disruption when we sometimes find individual businesses that are being thrown out by other investors.

Another position we established in our portfolios in early 2017 is Prestige Brands. Prestige Brands is a small company that owns big brands in small markets. While their competitors include huge companies like Novartis, Johnson & Johnson, and Procter & Gamble, within the niche markets where they compete, their products generally hold #1 or #2 market position and often have market share of well over 50%. As a comparison, Coke holds 42% market share in carbonated soft drinks and so Prestige's market share in their niche markets can be seen as more dominate than the hold Coke has on the soda market.

The company sells over the counter consumer health products that typically do not have any kind of prescription competition or any direct relationship with the health care or health insurance system. This is important because it means that the health insurance system, which we view as fundamentally broken and likely to undergo significant changes in the decades ahead, has not inflated prices in their end markets (in other words, customers pay 100% out of pocket for Prestige's products), yet the demand dynamic is driven by the same steady, non-cyclical growth dynamics that drive the health care sector.

With no prescription competition, the company operates in markets where customers use brand as a key signal of quality and effectiveness. If you have a sore throat, itchy eyes, a wart, or your kids are car sick, you want to be sure that what you buy works and buying an established brand is the best way to make sure you get what you paid for. Whether you go to the drug store or order online to treat the conditions I just mentioned, you are very likely to buy products from Chloraseptic, Clear Eyes, Compound W, and Dramamine. All of these brands are made by Prestige and every one of them has the #1 market share position.

Owning these strong brands, in small niche markets, results in Prestige generating the highest profit margins in their industry. While Procter & Gamble and Johnson & Johnson might be a lot more well known, Prestige Brands turns every dollar of revenue into 34 cents of profits while P&G and J&J manage to squeeze our just 26 cents of profits.

We believe the company will continue to use its prodigious cash flow production (generated by outstanding returns on tangible capital of over 100%) to acquire brands that fit their criteria (those that have been orphaned by a larger company or bought from a private equity firm that has been underinvesting in the brand and/or which has untapped market extension opportunities). While Prestige Brands is a small company, it owns big brands. Five of its brands do over $100 million of revenue each year. Over the counter health care brands this big are rare and despite Pfizer and Johnson & Johnson having market caps over 100 times larger than Prestige, these companies do not have any more $100 million OTC brands than Prestige does. While we own Prestige in our portfolios due to how attractive the returns will be to shareholders on a standalone basis, it seems likely to us that at some point they will be acquired by a larger competitor after they have further built out their portfolio of brands.

It is important to recognize that Prestige is a brand management company more than a product producer. They outsource most of the capital intensive production aspects of the business. This capital light, outsourcing approach means the company only employs 520 people, generating an amazing $1.7 million per employee. In comparison, most health care and consumer staple companies do closer to $500k per employee and Apple, which has the highest revenue per employee in the technology industry does only slightly more at $1.9 million. Until their acquisition of Fleet a year ago, Prestige had only 259 employees and was doing an amazing $3.1 million per employee.

In managing their brands, they look to drive usage through new form factors or use cases. For example, when they acquired Dramamine (the #1 product for motion sickness) it was marketed only to adults. After doing market research they learned that parents were cutting the pills in half manually to give to their young children for car sickness. So they successfully launched a children's version and increased distribution in gas stations, where parents were stopping during road trips with their kids. They also learned that the main reason people did not want to take Dramamine was the fact it makes you drowsy. So they launched a natural version (using ginger) for people to take when they are concerned about this side effect. These actions have driven 10% annualized sales growth since they acquired the brand.

When they acquired Hydralyte, it was simply the leading product in Australia to address vomiting and diarrhea-induced dehydration. Over the last three years, they've driven over 60% sales growth by extending the marketing message to position the brand as the best way to deal with excessive alcohol consumption, heat exhaustion, pregnancy, fever, and travel. Google searches shows that so called "mommy bloggers" in Australia were touting the hangover relieving effects of Hydralyte at least as far back as 2006, so this is a case of Prestige recognizing an opportunity through market research that the former owner just missed.

Prestige operates in slow growth end markets. The number of people who have a sore throat or itchy eyes is not going to grow dramatically. But it also isn't going to shrink. In order to be an attractive investment, the stocks of slow growth businesses must offer investors high levels of current free cash flow yield. With Prestige's free cash flow yield hitting 10% in November, we added significantly to what had been a small position for us. We believe the stock offers the potential for steady, dependable returns over the long term that exceed the market. Importantly, these returns are not dependent on a strong economy as even in the midst of a recession, demand for their products is unlikely to drop significantly.

So, thank you all for joining our call today. During this call, we referred to the portfolio holdings of Ensemble Capital Management. If you would like to request a copy of Ensemble Capital's historical equity composite performance or our 13F holdings disclosure, please send an email request to info@ensemblecapital.com.

Thanks for listening. I look forward to speaking with you on our next call.

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As of the date of the conference call, clients, employees and/or principals of Ensemble Capital owned shares of Now, Inc (DNOW), Apple (AAPL), L Brands (LB), Nike (NKE), Tiffany (TIF), Charles Schwab & Co (SCHW), Verisk (VRSK), Paychex (PAYX), Prestige Brands (PBH), First Republic (FRC), Priceline (PCLN) and Broadcom (AVGO).

As of the date of the conference call, clients, employees and/or principals of Ensemble Capital did not own shares of Coke (KO), Adidas (ADDYY), Puma (PUM), Amazon (AMZN), Best Buy (BBY), Novartis (NVS), Johnson & Johnson (JNJ), or Procter & Gamble (PG).

Each quarter we file a 13F report of holdings, which discloses all of our reportable client holdings. Please refer to our current 13F filing or contact us for a current or past copy of such filing.

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All investments in securities carry risks, including the risk of losing one's entire investment. Investing in stocks, bonds, exchange traded funds, mutual funds, and money market funds involve risk of loss. Some securities rely on leverage which accentuates gains & losses. Foreign investing involves greater volatility and political, economic and currency risks and differences in accounting methods. Future investments will be made under different economic and market conditions than those that prevailed during past periods. Past performance of an individual security is no guarantee of future results. Past performance of Ensemble Capital client investment accounts is no guarantee of future results.