Shilpa Andalkar:

Hello everyone, I am Shilpa Andalkar, a wealth manager here at Ensemble Capital. Thank you for joining us for our Spring 2019 conference call. Today, the focus will be on the recent performance of our portfolio, the current market and economic situation, and a discussion of two of our holdings, Landstar Systems and Alphabet, otherwise known as Google.

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

Sean Stannard-Stockton:

Hi there. Thanks for taking the time to join us today. It has been a real honor to see the audience for these calls growing rapidly over the last year. We appreciate your interest in what we have to say.

The performance of our equity portfolio this quarter was strong, showing a sharp reversal in both absolute and relative performance compared to last quarter. While the final calculation of our equity composite will not be available until later this month, our current estimate is that our equity portfolio composite was up 16.38% vs the S&P 500 up 13.65%.

The strength in our equity strategy during the quarter was supported by positive returns from every stock in our portfolio with notable 30%+ moves from Netflix, Ferrari, TransDigm, and Tiffany and 20%+ rallies in Mastercard, Paychex, Trupanion, Fastenal, and Verisk. On the weaker side we saw low single digit gains in Sensata, Charles Schwab & Company, and Booking Holdings.

While over the medium to long term our investment returns are primarily driven by security selection and the individual corporate performance of the companies in our portfolio, the dominant driver of our strategy's performance over the last two quarters has been shifts in market expectations around economic growth. We have been relatively overweight more economically sensitive names for much of the past few years due to these types of stocks generally being relatively inexpensive in our view, while more economically defensive companies have seen their stocks trading at historically rich valuation. This led to our portfolio exhibiting more downside than the market as recession fears became pervasive in the fourth quarter and to strong outperformance this past quarter as market action was driven by the idea that recession fears had become overblown and decent economic data was reported.

The rally in Netflix was primarily driven by a general reversal of the downside that many higher volatility stocks saw during the fourth quarter. However, Netflix also reported another strong quarter of new subscriber additions and very importantly they announced a large price increase. Netflix strikes some people as an atypical investment for Ensemble. With its very high PE ratio on current earnings there is a general perception that it is more of a momentum play than a long-term cash generation machine of the type we seek. But we believe that Netflix is building a dominant global media company and importantly they are currently intentionally underpricing their service as part of a strategic plan to build a subscriber base well in excess of any competitor. While we have yet to see how it impacted first quarter subscriber growth, the almost 20% price increase on the heels of high single digit price increases in recent years demonstrates the strong pricing power both we and the company believes they have.

The rally in Ferrari was supported by the company's earnings report in which management said that they had not seen any unexpected impacts to their order books as a result of the recent global market volatility. While it seems obvious that an entirely discretionary product like a Ferrari would see significant weakness in demand during recessions, historically Ferrari has been the most recession resistant automaker. Due to the long wait list to buy a Ferrari and the fact that the vast majority of Ferrari buyers can still afford a Ferrari even in the midst of a recession, the company does not see the sort of drop off in sales that most automakers experience during periods of economic weakness.

TransDigm's rally was particularly satisfying for us. Back in early 2017, a well-known short seller accused the company of a wide range of bad behavior that focused on defrauding the Department of Defense via overcharging them for the company's spare airplane parts. After extensive diligence on our part, we came to the conclusion that these accusations were wrong. After a near 25% decline in the wake of the short report, the stock has more than doubled in the past two years. During the last quarter, the Office of the Inspector General that had begun auditing the company's sales at the request of two politicians who were sent the short report concluded their work. While the audit found that TransDigm earns very high profit margins on their sale of aftermarket parts to the Department of Defense, it did not find any wrongdoing and it supported our view that sales to the Department of Defense were done at similar pricing to what commercial airlines pay. As the sole source provider of low-cost parts that are required to be replaced on set schedules by the FAA, TransDigm earns very strong profit margins and returns on capital. But that does not mean they are overcharging their customers. While the Office of the Inspector General recommended that the military begin requesting much more stringent cost information even for low priced products, the Department of Defense has been moving in the opposite direction in recent years as they attempt to streamline purchasing of low-priced products so that they can efficiently ensure a fully operational air force.

The weak rebounds in Sensata, Schwab and Booking each had company specific drivers. With Sensata the ongoing threat of tariffs on autos has been a persistent concern. These potential tariffs are not just related to the US-China trade war, but also to efforts by the Trump administration to deem imported autos as a national security concern and thus allow for tariffs to be imposed on foreign automakers, including those of key allies of the United States, in ways that would otherwise violate trade rules. But we would note that Sensata sells sensors to every global automaker of note meaning that so long as cars are being bought, it doesn't really matter to Sensata which country they are being made in.

Charles Schwab & Co continues to gather client assets at an astounding rate. However, as we detailed on last quarter's call, Schwab's profit model has shifted towards their interest rate sensitive bank and so the recent declines in interest rates and flattening of the yield curve will limit the company's near-term earnings power.

While investors have been negative on Booking for much of the past year, we would note that far from seeing their growth rate crumble, 2018 saw high teens revenue growth and EBITDA growth. Their guidance for Q1 was somewhat disappointing. However, when viewed on a currency neutral basis and accounting for Easter travel bookings falling into Q2 rather than Q1 this year given the holiday falling in late April rather than late March, we think the company is continuing to see solid core demand trends. Although they are seeing some weakness in Europe, their largest market, it appears that much of that weakness is due to uncertainty related to Brexit, potential auto tariffs hurting the German economy, and protests in Paris. As those issues come to a resolution, we would expect demand in the EU to continue to be fine and would point out that Booking's strong growth over the last decade has occurred within the context of a weak Europe economic environment.

Last quarter we talked about the rising risk of a recession. At the time we talked about our outlook for equity markets and framed it by listing three primary outcomes:

1. If no recession occurs: The stock market will likely generate very strong returns over the course of the next couple of years.
2. If a mild recession occurs: With the stock market already selling off by the magnitude that would typically be associated with this outcome, there may be limited downside even if things play out this way. (To reiterate, this is what we said last quarter, prior to the recent large rally)
3. If a severe recession occurs: In this event, there may be considerably more downside for US equity investors.

While we've highlighted since September that we thought that the market was overestimating the risk of a recession, we have also highlighted that there are some worrisome signs, such as a slowing housing market, increases in unemployment claims and a flattening or even inversion of the yield curve, that have historically pointed to rising recession risks.

Today, we think recession risks are still elevated, although we do not believe that a recession in the next year or two is the most likely course for the economy. But equity markets have rallied considerably since last quarter. What this means is that we got the strong market returns we were expecting in the event that no recession occurred, yet the jury is still out on a recession. We'll continue to monitor these risks closely and while we do not think that we, nor other investors, can systemically time the market or the economic cycle, we certainly do believe that it is our job to make the best forecasts we can about the future earnings growth of our portfolio and we believe that we can probabilistically incorporate the risk of a recession into that process.

The fact is we are 100% certain that a recession will occur… someday. It is just that neither we nor anyone else knows exactly when. So in thinking about the earnings growth of our portfolio holdings, we focus more on the appropriate growth rate across a full economic cycle that includes a recession while recognizing that the exact timing of that recession is not knowable, but to the extent it becomes more likely to occur sooner rather than later, we will appropriately incorporate this into our company specific forecasts.

Now I'd like to turn the call over to Todd, who will be discussing our long time holding Landstar Systems.

Todd Wedding:

Thanks, Sean.

A lot has happened at Landstar System since we last discussed it on our Summer 2016 conference call, so we thought an update was in order.

To review, Landstar System provides a marketplace of sorts that connects shippers, agents, and carriers to ensure that freight is moved across the country as efficiently as possible.

About 90 percent of the big rigs you see on the road are driven by independent owner-operators who treat their rigs like small businesses. Some of these truckers opt to join Landstar's Business Capacity Owner, or BCO, network because it provides them with steady business to keep their trailers full. This reduces the inherent volatility and uncertainty associated with trucking. BCO truckers are contracted with Landstar and provide exclusive service to their network. About 43 percent of Landstar's revenue and an even higher percentage of its gross profit comes from the BCO network.

In 2018, about half of Landstar's revenue came from its traditional brokerage business in which its agents match shippers with non-exclusive carriers. While brokerage is a lower margin business than BCO, it still leverages Landstar's network of agents and shippers and exposes more truckers to Landstar, who may eventually join the BCO network.

Now, Landstar's business model hasn't changed much in the past three years, but the North American trucking environment certainly has.

When we last spoke about Landstar three years ago, the company was facing a revenue decline, as plunging energy prices led to energy-related job cuts in North America. Some of the unemployed oil and gas workers jumped to the trucking industry to move freight. As a result, truck labor supply jumped at a time with the North American industrial economy rolled into recession. This was not a good mix for Landstar. Full-year 2016 revenue fell 4.6 percent compared to 2015.

Since then, it's been almost a 180-degree turn for the North American trucking environment. The U.S. industrial economy, as measured by US Manufacturing PMI, rebounded after early 2016 lows, as did energy prices. Demand for domestic freight carriers jumped while carrier supply was constrained in a tight labor market.

After falling 7.2 percent in 2016, Landstar's revenue per load grew almost 6 percent in 2017 followed by an astounding 16.7 percent in 2018. When you add in load growth, total revenue grew 15.1 percent and 26.6 percent in 2017 and 2018, respectively.

While freight prices seem to have peaked in 2018, we believe prices have reverted to trend after a few years of weak pricing in the middle of the decade. We've long believed, and continue to believe, that U.S. truck driver supply is structurally constrained. According to the Bureau of Labor Statistics, the average age of a U.S. truck driver is 55 years old. The core "trucking generation" aged 45 to 54 accounts for 29.3 percent of the labor force, while 25 to 34-year-olds are just 15.6 percent of truck drivers. We've seen trucking companies offering huge cash signing bonuses to licensed commercial drivers, without a noticeable jump in the driver pool. In short, there aren't enough young drivers coming up to replace the older ones.

Here's an incredible statistic from Landstar's 2018 results: the average Landstar BCO driver earned a record $197,000 in gross revenue. Now, that's before expenses like gas, maintenance, and tires, but still a great income. In fact, it was so good last year that some BCOs decided to take the last few weeks of December off – they'd already made more money than they needed for the year.

The agent node of the Landstar network also had a record-setting 2018, with 608 agents generating more than $1 million of revenue – up from 542 in 2017.

Given this success, we think Landstar's network is strengthening. It's attracting more truckers and agents – indeed, Landstar recently said both the BCO and agent pipelines are full, despite a tight labor market. This creates a virtuous cycle. When Landstar adds truckers and agents, more shippers make Landstar their first and only call to move their freight. In turn, more shippers attract more truckers and agents to Landstar. And so on.

An important point to make about Landstar is that it generates 70% incremental operating profit margins on net revenue and their market share is under 10%. We think they have plenty of room to drive profit growth in the decade to come.

Now, the two biggest questions we get about Landstar are recession risk and technology risk.

As for recession risk, Landstar is a capital-light business with a mostly variable cost structure. Remember, BCO-derived gross margins remain steady throughout the cycle. Landstar's gross margins fall in periods of strong demand, as lower-margin brokerage operations account for a greater percentage of revenue. Without the BCO structure, Landstar would be far more sensitive to the ebb and flow of the industrial economy. So, while far from recession proof, Landstar is recession resistant.

Importantly, Landstar remained free cash flow positive during the financial crisis and subsequent soft patches in the U.S. industrial economy. Because it doesn't own any trucks and operates as a marketplace, or platform, capital expenditure requirements are low – between 1 and 2 percent per year. This reliable cash flow has allowed Landstar management to make countercyclical investments and opportunistic buybacks, along with a growing dividend, across the business cycle.

One technological threat to Landstar's business is Uber-like apps that directly link shippers and carriers, bypassing the brokerage agent. But one of the reasons that Uber and Airbnb have been so disruptive is that they unlocked previously dormant supplies of cars and properties, respectively. This is not the case for trucking. Additionally, Landstar isn't sitting on its hands. They're also developing better software to save carriers load processing time that could further reduce system costs.

The second technological threat is autonomous-driving trucks. While the technology is perhaps already there, we think regulations will require a human driver or engineer to be in the truck cab for some time to come. Airplanes, trains, and other heavy transportation vehicles, for example, use various amounts of "autopilot" but still have captains, conductors, and engineers at the ready. As we've seen with autonomous driving automobiles, there's massive headline risk for any accident related to driverless vehicles, even if, on the whole they are safer than human-driven vehicles. Also, we expect that any initial shipments by autonomous trucks will carry commodity, low-cost items like boxes of diapers and food. Landstar carries a lot of special loads like automotive, machinery, and hazmat, where we think human drivers will remain the standard due to the costly freight and related liabilities.

So in all, we remain enthusiastic about Landstar's business model and have high confidence in its management team's ability to widen the moat and increase shareholder value.

Back to you, Sean.

Sean Stannard-Stockton:

Thanks Todd.

For the balance of this call I'm going to talk about our investment in Alphabet, the holding company that controls Google. While the company has moved into a lot of areas outside of just search advertisements, 20 years after its founding the core of the Google profit machine is still its ad business. As Larry Ellison first put it all the way back in 2006, Google is "a one-trick pony, but it's a hell of a trick.". What's amazing is how steady the growth of Google's ad business has been even in the face of massive changes to the internet, most importantly the shift to mobile computing. We believe the key metric for investors to track Google's ad business is to look at the rate of growth of currency neutral ad revenue net of traffic acquisition costs. This is basically the amount of money Google collects from all of their ad products after subtracting the amount they pay to acquire traffic on their sites. For instance, when you search for something on your iPhone the results you get are Google results. This is because Google pays Apple to make them the default search engine on Apple's iPhones. Amazingly, since 2016, the company has reported average growth in this key metric of 20% with every quarterly report showing growth of between 17% and 23%. In fact, over half of all quarterly reports have seen this metric increase by within 1% above or below the 20% average.

High growth companies aren't supposed to exhibit this sort of stability. But think about what drives growth for Google. The most important demand driver is the time people spend online. While many tech companies offer discretionary products that see variable demand and can see abrupt declines when the economy weakens, we would posit that time spent online is more of a consumer staple type behavior. In good times and bad, people around the world are turning to Google products to answer their questions. The persistent nature of this high level of growth is remarkable and has been instrumental in driving up the intrinsic value of Alphabet.

That growth is partly being driven by YouTube. With over 5 billion YouTube videos viewed every day and growing, the ad opportunity is huge. Depending on your own use of YouTube, you may not fully appreciate the power of this platform. While famous for viral cat videos and the like, YouTube is effectively the default global video platform for non-TV type content. With more and more time spent online consuming video, YouTube is in the pole position to benefit. While paid subscription products like Netflix may be a better business model for curated quality content such as TV and movies, the ad-supported YouTube format is far superior for short form, non-narrative content.

Interestingly Google does not break out the standalone financials of YouTube, leaving the investment community to guess at how profitable it currently is. Many investors believe that YouTube is currently less profitable than Google overall and yet as they grow, they will become more profitable, leading to longer, faster profit growth than might be apparent at first glance. While we are somewhat ambivalent about the validity of this thesis, primarily because we think YouTube fueled profit growth is needed to offset other parts of Google's business slowing and so is not strictly additive to corporate growth, we do think that the breaking out of YouTube's financials is going to occur before too long and it may have a dramatic positive impact to investors understanding of Google's long-term prospects.

YouTube isn't the only part of Alphabet that may have more value than generally appreciated. When they formed Alphabet, they created two subsegments, Google and what they refer to as Other Bets. The Other Bets group contains what Google historically called Moonshots, such as Waymo, their self-driving car business, Fiber and Loon, their internet access businesses and Verily, their health sciences business. Today, the Other Bets segment is losing approximately $4 billion a year. But when I say "losing" I mean they are burning this amount of cash as they seek to build profitable businesses. Today, the existence of Other Bets inside of Alphabet reduces the company's reported earnings by about 10%.

So, Alphabet could boost current earnings by 10% by simply shutting down Other Bets. Of course, that would be a mistake. Any reasonable investor knows that Waymo in particular, but the other parts of Other Bets as well, have significant value. So, in thinking about the value of Alphabet, you need to remove the currently money losing Other Bets segment, value Google as a standalone business without the Other Bets losses and then add to that whatever you think the value of Other Bets is.

Of course, the value of Other Bets is highly uncertain. We've seen some investors talk about the value of Alphabet in relation to a PE multiple it should trade at. But given the negative earnings of Other Bets, this methodology implicitly values Other Bets as a liability. Believe me, there is a wide range of venture capitalists who would happily take ownership of Other Bets and so it is clearly not a liability. We're also seen some analysts attribute as much as a $100 billion of value to Waymo alone. While Waymo is very valuable, in our view, on a probabilistic basis, $100 billion is way too high of an estimate. It could be worth that much, but it could be worth much less. In fact, Waymo could even end up failing without ever earning a dollar of profit.

We estimate that after removing Other Bets' losses and removing the excess cash that Google has on its balance sheet (not all of its cash, just that amount we believe is not required to run the company), Alphabet is trading at around 20x what we expect them to earn in 2019. Given the company's growth rate and its strong returns on invested capital, we think the stock will perform well from these levels.

That being said, we do have two concerns about the company's management. In general, we evaluate corporate management primarily on their ability to create value and their abilities in allocating excess cash flow. On the first question, Google excels. It is amazing that they have become one of the most valuable companies the world has ever seen just 20 years after they were founded. As I mentioned earlier, their services have become a required part of modern life, almost a form of oxygen for internet connected populations.

But in allocating their excess capital we have been less enthusiastic. While Google has been criticized in the past for the M&A they engage in, YouTube and DoubleClick are two hugely successful acquisitions with YouTube ranking as one of the smartest acquisitions in the internet age. But Google has now built such a war chest of cash that they clearly have more than they will ever need, and we think shareholders would be better served if the company began to pay a dividend, bought back stock and used more debt in their capital structure to finance more return of capital. We had hoped that Ruth Porat, the CFO they brought in from Morgan Stanley, would be instrumental in improving capital allocation. But after some initial positive signs, it seems that for whatever reason, Porat is no longer focused on making this happen.

The other management issue we're tracking is the company's relations with their employee base. For pretty much all of their history Google has been considered one of the very best places to work. They have pioneered much of what we think of as modern Silicon Valley corporate culture with an employee base that has been raving fans of the company. But last year, employee concerns around the company's work with the military and issues of gender equality and sexual harassment became flashpoints between management and employees. Of particular note to us was the various reports on the company paying large severance packages to key senior employees who were forced out after accusations of sexual harassment.

In our view, Google management's handling of these cases has not been good. We believe for the short-term health of their corporate culture and their long-term ability to attract the best and brightest employees, they must do better. By "do better" we mean behave in a way that satisfies their employee base and preserves the belief that Google is one of the best places to work for the smartest, most technically savvy people in the world. To the extent that the company is not able to manage employee relations constructively, our confidence in the long term success of the business would deteriorate and should we decide to exit our position, something we are not currently contemplating, it would be due to our assessment of the long-term health of the business, which is very much a function of the company maintaining a positive corporate culture.

In closing, I'd like to revisit the quote I mentioned last quarter from Leon Cooperman, an investor who has produced outstanding returns over many, many years. "Everyone I know that has accumulated wealth, whether it's Warren Buffett, Ken Langone, Mario Gabelli, made their fortunes out of buying weakness and selling strength… You buy weakness and you sell strength. That's the way to make money in the market."

The relatively weak performance of our strategy in the fourth quarter and the even stronger outperformance of our strategy this quarter was very much a function of our discipline in following Cooperman's advice. During the selloff, we sold our strongly performing stocks and bought weakly performing stocks. This behavior was critical to the strong rebound in our results this past quarter.

But I want to highlight that this sort of behavior by us is not possible without clients who are willing to stick with us during periods of underperformance. If an investment manager must cope with significant client outflows during periods of weak performance, it becomes even more difficult for them to stick to their core process. So, I want to take this opportunity to say thank you. While we work extremely hard to manage your assets as well as possible, we are acutely aware that it is the confidence of our clients in our process and the degree to which our clients have historically stayed invested with us during weaker performance, that has allowed us to produce a record of outperformance.

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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