

SABER

SABER CAPITAL
MANAGEMENT, LLC

Discussion with Markel

*The Common Denominator:
Tencent, Facebook, Google*

John Huber

Saber Capital Management, LLC

www.sabercapitalmgt.com

john@sabercapitalmgt.com

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, and lower prices, etc...

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. Even the largest companies are still producing huge returns on capital invested:

| | TCEHY | GOOG | FB | Totals |
|----------------------------|--------------|-------------|-----------|---------------|
| Net Income (\$B) | \$11.3 | \$19.5 | \$15.9 | \$46.7 |
| Tangible Capital | \$3.2 | \$40.6 | \$16.8 | \$60.6 |
| Return on Tangible Capital | 353.1% | 48.0% | 94.6% | 77.1% |

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 | FB |
|-------------------------------|--------------|-------------|-----------|
| Revenue Growth (yoy) | 57% | 23% | 48% |
| Operating Profit Growth (yoy) | 71% | 22% | 63% |

Growth rates will slow down going forward, but will likely continue to be significantly greater than the average company for many years to come.

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)



SABER

SABER CAPITAL
MANAGEMENT, LLC

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** – 1 billion 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** – 135 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



SABER

SABER CAPITAL
MANAGEMENT, LLC

Highly Profitable & Growing Fast

Growth has actually accelerated in the past couple years.

| <i>Tencent Holdings Income Statement Snapshot</i> | | | | | | | | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|------------------|-----------------|
| <i>(\$ in millions; 1 USD = 6.30 RMB)</i> | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 5-yr CAGR | Yr-on-Yr |
| Revenues | \$ 6,967 | \$ 9,593 | \$ 12,529 | \$ 16,327 | \$ 24,117 | \$ 37,739 | 40.2% | 56.5% |
| Pretax Profit | \$ 2,389 | \$ 3,060 | \$ 4,605 | \$ 5,749 | \$ 8,196 | \$ 14,002 | 42.4% | 70.8% |
| Pretax Margin | 34.3% | 31.9% | 36.8% | 35.2% | 34.0% | 37.1% | | |
| Net Profit | \$ 1,869 | \$ 2,461 | \$ 3,779 | \$ 4,572 | \$ 6,523 | \$ 11,351 | 43.4% | 74.0% |

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)

SABER

SABER CAPITAL
MANAGEMENT, LLC

WeChat's Massive Network

- Over 1 billion users
- Tens of millions of 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.

Valuation

- Tencent (TCEHY)
 - \$475 billion market cap at \$50 per share
 - Tencent has roughly \$60 billion of excess net cash and investments
 - 2018 estimated owner earnings: \$16 billion
 - 2018 P/E (ex-cash): **26**
 - Last year's earnings growth: **70%**

- Facebook (FB)
 - \$490 billion market cap at \$166 per share (\$41 billion net cash)
 - 2018 estimated owner earnings: \$22 billion
 - 2018 P/E (ex-cash): **20**
 - Last year's earnings growth: **63%**

Valuation

- Alphabet (GOOG)
 - \$756 billion at \$1073 per share (\$100 billion net cash)
 - \$656 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**
 - Last year's earnings growth: 22%
- Notes:
 - Net income 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 (specifically Tencent, Facebook, and Google) are very reasonably priced given their significant competitive positions and growth potential
- 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?

Contact info for **John Huber** and **Saber Capital Management, LLC**:

- Saber Capital Management: [sabercapitalmgt.com](https://www.sabercapitalmgt.com)
- Investment Commentary: [basehitinvesting.com](https://www.basehitinvesting.com)
- john@sabercapitalmgt.com
- 919-610-6809

Thank You!