Booth Laird
Investment Partnership

July 9, 2014

Q2 2014 Newsletter

Update on General Motors

- The stock price dropped further after our Q1 2014 Newsletter from $34.11 to as low as $31.93, at which point we bought even more GM TARP Warrants (deep-in-the-money GM stock options that expire in 2019). The stock has since rebounded to $37.58 as of close of business yesterday.
- Despite the pullback this year, we are still up 30% on the GM stock and up 66% on the GM TARP Warrants we purchased in 2013. We are also up 19% on the GM TARP Warrants we purchased earlier this year on the pullback.
- The independent investigation regarding the delayed recalls was completed and the results released publicly. As we confidently felt would be the case, the delay was due to good old fashioned incompetence rather than a vast conspiracy to cover up less than 50 crashes among over 90 million GM cars on the road at any given time.
- GM announced a compensation plan for crash victims to be managed independently and without financial limits by Kenneth Feinberg, the attorney and crisis expert who also aided victims in the aftermath of 9/11 and the Boston Bombing. As we predicted based on prior court cases and settlements, the payout per person is likely to be $10M or less.
- GM has expanded the recalls to over 29 million vehicles for model years as far back as 1997 as the company continues to go way above and beyond to ensure it clears its name. To date, less than 20 fatalities are linked to recalled vehicles, and, while tragic, not all fatalities can be confidently attributed to a defect in the vehicle.
- Despite the increasing number of recalls, GM has posted three consecutive months of higher than expected sales growth results. As we noted in the last newsletter, consumers have short memories unless directly impacted. It helps that General Motors is not the actual brand name of any vehicles, helping to avoid a negative association with the actual U.S. brand names of Chevrolet, GMC, Buick, and Cadillac. Anecdotally, dealers are also taking the opportunity to sell new GM vehicles to consumers bringing in their old GM vehicle for a recall notice. Even more impressive, this success has been achieved despite price increases well above the industry average.
- We have adjusted down our exit price to account for the cost of the additional recalls, but that exit price still exceeds the current market price.

Venture Further into the Unloved – Retail

Few industries are as unloved by the stock market as retail at the moment. While the S&P 500 continues to set new highs, many retail companies are hitting 52-week lows. Certainly, much of it is deserved as many retailers respond to competition from e-commerce by cutting costs and staff to the detriment of the shopping experience, driving even more people to shop on Amazon or Overstock. We have seen the toll that the internet can take on brick-and-mortar stores, such as the collapse of Blockbuster and Borders and the decline of shopping malls and big box electronics stores.

So imagine my surprise when I came across a retailer that has experienced 21 years of uninterrupted revenue growth while maintaining high gross and operating margins, high returns on invested capital, no debt, and positive free cash flow even as e-commerce was born, took off, and toppled many a competitor. It was not some tucked away retailer in a high end area that protects it from e-commerce but instead a retailer with 1,500 locations nationwide and counting that sells quality goods at reasonable prices with exceptional customer service and a great shopping environment. The retailer was Bed, Bath, & Beyond (BBBY). Despite knowing the poor fortunes of brick-and-mortar retail, we could not pass up an opportunity to look into a company which had just hit a new 52-week low, down 22% on the year, and available at a 10% free cash flow yield ex-cash.

As I read through the latest annual report and latest earnings call transcript and reviewed the investor relations section of the website, it struck me that BBBY reminds me of another well-run company you may have heard of – Berkshire Hathaway (BRK), helmed by Warren Buffet and Charlie Munger.

Why BBBY reminds me of BRK

1. Both have two 75+ year old men leading the company, each of whom has held that position with the company for at least 40 years.
2. Both companies prefer to promote from within and command strong employee loyalty. BBBY's executive team outside of the co-chairmen/founders have been with the company for a minimum of 18 years on up to 43 years, which happens to be how many years ago the company was founded. BRK has a stable of managers leading its many businesses, many having founded their respective businesses before being acquired by BRK.
3. Neither company panders to Wall Street. Both do not participate in any investor conferences of any kind, issue very few press releases (BBBY had 4 press releases in 2013, one for each earnings call), have sparse investor relations websites, and have no "investor presentation" slide deck or fact sheet of any kind. The track record of both companies affords that privilege in my view.
4. Neither one has issued a dividend for at least 30 years (surprisingly, BRK is the only one of the two to have ever issued a dividend), instead preferring share buybacks when warranted. BBBY has returned 90% of its operating cash flows to investors the last two years via buybacks. As you know, we prefer buybacks to dividends if the stock is undervalued.
5. Both are focused on fostering the appropriate corporate culture throughout the organization. BBBY store employees and store quality are a testament to this.
6. Both are proponents of decentralization.
7. Both dislike debt and love cash. BBBY has maintained a substantial net cash position for at least 22 years. BRK carries a good bit of debt, but it is well supported by its assets and cash flows. BRK keeps a minimum of $20 billion in cash for “peace of mind” in any case.
8. Both have achieved a consistent record of high returns on capital invested well in excess of each company’s cost of capital (re: growing shareholder value every single year).
9. Neither one conducts a typical earnings call. BBBY does not accept any questions on its calls, and BRK does not conduct one at all.
10. Both lead off the annual report with a snapshot of the company’s impressive track record under current management. BRK shows 50 years of BRK performance versus the S&P 500. BBBY shows 22 years of fairly detailed financial data, including revenue (21 years of uninterrupted

growth), gross profit, operating profit, net income, store count, square footage, same store sales growth, and some balance sheet line items.

The company's track record, of which the last 22 years are conveniently provided on the first two pages of the annual report, speaks for itself. The company has grown from 38 stores in 1993 to 1,496 stores in 2014, only 1,014 of which are actual Bed, Bath, and Beyond stores. The rest are comprised of Harmon Health and Beauty (acquired in 2002), Christmas Tree Shop (acquired in 2003), buybuy Baby (purchased in 2007), and Cost Plus World Market (purchased in 2012). BBBY also purchased Linen Holdings, a B2B business with no store front, in 2012. The company has also grown comparable sales per store nearly every year over the last 21 years. Revenue CAGR over the last 21 years was 20.8%, which dips down to 9.9% over the last 10 years and 9.8% over the last 5 due primarily to starting with a much higher base in the last decade. That growth can be broken down into two parts: 1.6% over the last 21 years from growth in sales/square foot (2.1% over the last 10 years and 3.7% over the last 5) and 19.2% over the last 21 years from growth in overall square footage (7.8% in the last 10 years and 6.1% in the last 5 years).

The company has remained highly profitable throughout that time on all metrics: ROE has averaged 25.3% over the last 21 years (22.6% over the last decade increasing to 23.1% over the last 5 years and 25.5% over the last 3 years) and ROIC has averaged an outstanding 38.5% over the last 21 years due to net cash reducing the invested capital base (39.0% over the last decade and 38.5% over the last 5 years). Gross Margins have averaged an impressive 41.5% over the last 21 years fairly consistently, dipping in the last year and a half to ~39% due to product mix and higher coupon redemption rates. Operating margins have averaged 12.8% over the last 21 years and have only improved with time, averaging 13.8% over the last decade and 14.6% over the last 5 years despite the inclusion of recession years and recovery.

The company believes there is room to grow Bed, Bath, and Beyond store count another 30% to 1,300 stores. The company only entered Mexico and Canada within the last 6 years and have no other international presence. Management also believes they can grow the other brands as well. The company's track record shows it can do so while maintaining and even improving profitability.

What I really like about BBBY is the consistency and simplicity. The message really has not changed in 20 years. I read one of the company's annual reports from the mid-90's, and the business section describing the business was almost word for word exactly the same as the most recent annual report, down to the description of merchandise assortment and presentation as well as advertising and customer service. I particularly like the advertising blurb from the latest 10-K: "In general, the Company relies on 'word of mouth advertising,' its reputation for offering a wide assortment of quality merchandise at competitive prices and the use of paid advertising." That paid advertising does not include any TV or radio advertising, the most expensive kind. It also speaks volumes that a company can grow revenue year-in and year-out without using TV or radio ads.

The company's focus on the shopping experience is apparent. While it regularly ranks among the best retail chains in terms of customer service, it more importantly has low instances of poor customer service experiences. Numerous studies show that customer service has become the most important factor among retail shoppers, even more so than price, and that poor customer service will cause customers to switch to a competitor. MSN commissioned Zogby Analytics to conduct a study on customer service experiences in 2012 and in 2013. The customers were asked to rate their customer service experience with 150 large companies as excellent, good, fair, or poor. It would seem logical that the "poor" category is the most important because that is where you lose customers. In the 2012 and 2013 studies, only 2.45% on average rated their customer service experience at BBBY as "poor." Only Marriott International (1.6%), Amazon (1.95%), Holiday Inn (2.0%), and Auto Zone (2.35%) were lower, and of those only Amazon is a competitor. Compare that to brick-and-mortar competitors Target (5.7%), Dillard's (5.6%), Macy's (4.3%), and Wal-Mart (10.9%).

BBBY's stores are highly conducive to a positive shopping experience. The stores are relatively small compared to a typical big box retailer and contain one u-shaped path that takes you through the entire store past numerous alcoves packed floor to ceiling with homogenously-grouped product categories, making it easy to find what you need while also discovering lots of other products you were not looking for without making you feel lost in a maze or overwhelmed. You can take in everything the store has to offer in a relatively short time, a convenience certainly not afforded at its competitors. Certain areas have dedicated employees, every employee is likely to greet you warmly when they see you and to ask you if you need any help, returning gifts is a painless process, and those "20% off" coupons are honored regardless of expiration date. Further, there is a wide variety of reasonably priced products, neatly organized and well stocked. Finally, the stores are typically stand-alone buildings or part of an outdoor shopping center rather than an indoor mall, making it easy to find a parking spot and get in and out quickly if desired. It is easy to see why BBBY is so popular for wedding registries.

The company is not resting on its laurels, choosing to continue investing in the stores and in the infrastructure. The company is improving the point-of-sale system at stores, installing energy efficient lighting, heating and cooling systems, and deploying new and enhanced systems and equipment to take advantage of new technologies and processes. The company is also adding new product categories at select stores such as health and beauty, specialty food and beverage, baby, and fine tabletop and giftware that leverage the knowledge and assets from its recently acquired store concepts. The company just completed the construction of a new data center and is in the process of building a new distribution center. In addition, BBBY is also focused on constantly improving its e-commerce capabilities, including relaunching the websites for buybuy Baby and Bed, Bath & Beyond, replatforming the mobile sites and apps, and adding a selling component to the Christmas Tree Shops website.

The company also has a stellar balance sheet. As indicated earlier, the company has not had any debt in the past 22 years and only recently took on a very manageable sale/leaseback as part of the acquisition of Cost Plus World Market in 2012. Even so, the company still had a net cash position of approximately $695M at March 1, 2014, which was ~18% of stockholder's equity. Further, the company appears to be improving its working capital management. A retailer is typically going to have a positive cash conversion cycle – meaning the company's vendors are paid off before the company receives the cash from the customer. As a result, a retailer should see increases in working capital to support growth due to rising inventory balances that are not quite offset by rising accounts payable and accrued liabilities. Due to its significant growth, over the past 22 years BBBY has been no exception. However, despite same store sales growth that has averaged 4.6% per year over the past five years, the company has experienced a net decline in non-cash working capital over that time. That is the first net decline in non-cash working capital realized by BBBY over any five year period since at least 1993.

BBBY does not just let that cash sit idle on the balance sheet and collect dust. The company is a voracious stock cannibal. BBBY is a healthy re-purchaser of its stock, having returned 90% of cash flows from operations to investors via stock buybacks the last two years. The company still has $861M remaining in its current share repurchase program and just authorized an additional $2B in buybacks. The combined $2.861B in buybacks represents 24% of the current market cap. At least $861M is expected to be used to purchase stock by March 1, 2015, which is the company's fiscal year-end.

The stock price was already down 22% on the year prior to its latest earnings release due to missed earnings estimates and lowered guidance earlier in the year. During the latest earnings release just two weeks ago, the stock dropped a further 9% in one day when the company missed revenue by $30M (roughly 1% below analyst estimates), missed EPS by 2 pennies, and maintained its previous guidance. That 9% decline in the market cap represented approximately $1.2B. Who knew 2 pennies were worth so much? Part of the fear is declining margins due to product mix and increased coupon redemptions. We have been down this road before with Apple when the market panicked about gross margins declining a few percentage points. We only cared about what would happen to free cash flow. So far, we have been rewarded handsomely for our exclusive focus on cash flows with Apple.

We seek out opportunities like this when the market appears short-sighted and seems to be missing the forest for the trees. We are unlikely to find many retail companies better run than BBBY. An easy way to think about the value of the company is to focus on cash flow per store, which have been remarkably consistent over the past 22 years. The company has averaged operating cash flows per store of $760K over the last 21 years, $840K over the last 10 years, and $890K over the last 5 years. That is a heart-warming trend, especially considering the economy was still recovering from the recession over the last 5 years. The company also grew store count 40% over the last five years and still improved profitability per store. If the company continues growing store count another 20% as it projects, the operating cash flows should be higher than today even if cash flows per store decline. Once the company finishes expanding, there will be a lot less pressure on working capital to continue growing and capital expenditures should settle at a lower maintenance level. The result is higher free cash flows than today even if margins continue to decline as the market fears. We conservatively calculate a valuation roughly 50% above the current share price, a share price that will only benefit from management buying nearly $3B of stock over the next few years.

Just as important is how protected the downside is from here. Even if we assume no growth in store count and a decline in operating cash flows to a level not seen since the company had 40% fewer stores (approximately half the current cash flow levels) as well as elevated capital expenditures, a scenario highly unlikely to ever occur, we still only calculate a downside of approximately 20%.

While not as direct as other potential investments and not the primary reason for the investment, BBBY does offer a potential play on future housing growth. While BBBY continued to grow sales even through the recession, it did see a dip in operating margins that quickly rebounded. Housing has not come back as strongly as many predicted it would by this point, but it has recovered a great deal. As the economy and jobs continue to recover, millennials continue to obtain gainful employment or become more secure in their current jobs and purchase homes (or at least move out of mom's basement into an apartment), BBBY is likely to benefit to some degree.

Otherwise, BBBY is a time arbitrage play, which means there is no concrete catalyst that will boost the stock price other than beating the lowered expectations over time. Our average purchase price is $59, and it is a moderate position size. As always, should the stock price drop further, we are ready to add to the investment.

2014 Annual Meeting

As a reminder, the 2014 Annual Meeting will be held on Monday, July 21, 2014 from 11:00 am to 1:00 pm at the Renaissance Hotel on Bluebonnet in Baton Rouge. It is the same place we held the meeting the last two years and will probably be in the same room. Lunch will be provided. **All interested parties are welcome – bring a friend.**

11:00-11:30 - Meet and greet & self-serve lunch
11:30-12:30 - Meeting officially begins - Kevin and I will go over our prepared remarks
12:30-1:00 - Q&A

As usual, during the prepared remarks, Kevin and I will discuss the current state of the Partnership, select holdings, where we see opportunity, and our plans and expectations for the upcoming year and beyond. In addition, we will reveal and discuss our "best idea" at the moment. We hope this will be the highlight of the meeting. We look forward to seeing you there.