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Today's Profit Margin Distortions

Dear fellow investors,

Late in bull markets there is often a pervasive excitement that arises. At that time, not all profit margins are created equal. Financial euphoria can cause distortions in industries and businesses. These distortions are due to the capital markets activities at play and investor willingness at the moment. The buyer of the 10-year Treasury note at 2.40% two weeks ago could be an example of this willingness. It seems plausible at the time for that buyer. Will they feel the same way in five years?

There is someone benefiting from this willingness. This willingness could be making the environment look better than it really is. We'd like to draw the picture of how the capital markets are distorting real or sustainable economics. We can see the effect of these distortions down to individual businesses today. We'd also like to look back to another time when euphoria caused economics to look better than they were, proving that certain businesses' profit margins were mere distortions.

Home food delivery is one of the most interesting services of today. As a consumer, I love it. My family collects meals at our front door step that are pre-prepared but need to be put together. The biggest problem with these services is that they can mess up your order. If your normal FedEx delivery person isn't working that day, the food can get mishandled and go bad. You get refunded, but that can't be good for the owner of these food delivery companies. The most important thing we end up seeing with these companies, even if everything goes well for the customer, is that there is likely no way they can make money from their customers.

"The conventional view serves to protect us from the painful job of thinking."
– John Kenneth Galbraith

It can't be as simple as capital markets are making it appear. We'll attempt to go to second level thinking to get after what is actually going on. As Charlie Munger would tell us, "Invert, always invert." To invert this, there are venture funds and public equity investors who are willing to put up risk capital for these businesses to grow their customers and revenue. These businesses say they can foresee a pathway to profitability at some point in the future. It's in their investor presentations.

If we continue to think about the investors' hopes for these businesses and the struggles these companies have, we recognize that there is one business making a pile of money from the predicament they're in. The number one way that these businesses acquire

customers is digital advertising. As evidence of this, if you go to a computer and Google "home food delivery", you will find a myriad of sponsored advertisers.

Why is this a problem? If those money-losing food delivery businesses fail, they won't be advertisers to Google anymore. What this means for Google is they have a certain percentage of their revenues and profits that are at the mercy of investment market fund raising activities, not long-term customers.

Corporate profit margins can help investors understand this in the bigger picture. The famous asset allocator Jeremy Grantham has argued vociferously over the last few years that corporate profit margins are historically high. Many point to low interest rates affecting margins. This is true, as low debt costs make margins look bigger than what they would be at higher interest rates. However, that doesn't explain why today's distortions could be the largest in history — bigger than 1999.

We believe capital raising by venture funds and public equity investors for these money-losing businesses distorts real economics today. These internet-related and conceptual businesses are operating in tangible services like taxis, video content and delivery of a variety of goods. Some are even producing profit margins based on GAAP accounting. The practicality of these businesses are of no consequence. It is the fund raising required to sustain what they do which maintains the profit margins. Where else are margins bigger than they would be if this financial euphoria ended?

The hosting business is a prime beneficiary of this phenomena as well. All the companies in these conceptual stage use hosting. As an example, Netflix (NFLX) is one of the largest hosting service users in the world. Netflix, however, is losing billions of free cash flow every year. The first quarter of 2019 was no different. How do they make up for this shortfall of free cash flow? Borrowing in the junk bond market! Investors who believe they are taking good risks are willing to put up billions for this debt instrument. It was just announced today that another $2 billion will be raised in their next debt sale. It is fine if they can issue billions every year for the next 10 years. If the sentiment of the capital markets changes, they could lose access to capital. Who would this hurt? The high margin hosting businesses of Microsoft, Amazon and Google. Grantham's corporate profit margin mean reversion becomes more real in this way.

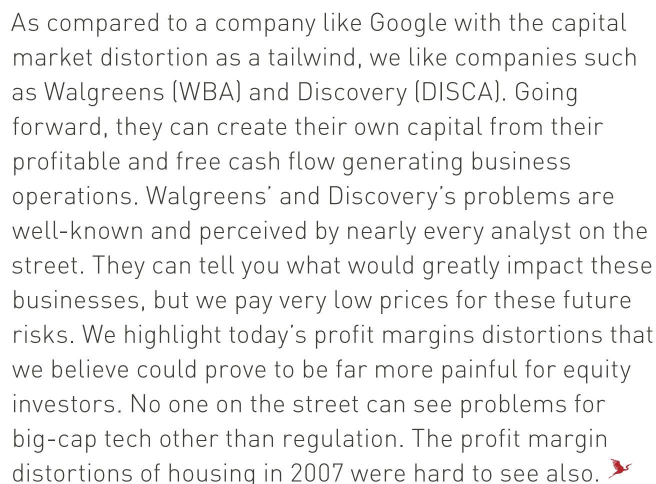
"The sense of responsibility in the financial community for the community as a whole is not small. It is nearly nil."
– John Kenneth Galbraith

Over the last 50 years there are other examples of the capital markets getting outside the realm of providing capital to sustainable individuals and entities. In the process, profit margins become distorted at the time. The last example was in 2007, when the investment markets became euphoric over the idea that homes never go down in value. Investors, both institutional and individual investors, supplied large amounts of capital to nooks and crannies of the debt market, providing credit to willing borrowers. Banks showed illusory underwriting profits in mortgages and other debt instruments. The flow of capital was too easy.

The banks' profitability was not sustainable if the supply of capital dried up. Individuals didn't need to prove they

could pay back the money. They could get credit on the conceptual belief that there could never be trouble in residential real estate. They could all see the pathway for these borrowers to succeed in the end. Washington Mutual looked very attractive and even Jamie Dimon considered buying it at lofty prices. This was all for naught. Capital markets changed, margins at the banks got crushed, investors dried up and conceptual borrowers became bad bets for the real economy.

This was a credit problem, in comparison to today's profit margin distortion from easy access to funding via public and private equity. Though low rates have affected all asset classes, the real economy is being affected by capital raising success in equities (public and private) and the junk bond market. These are some of the riskiest spheres of investing. We are fearful of the activities being practiced by investors currently. The self-funding nature of the kinds of companies identified by our eight criteria appear more valuable than ever.



As compared to a company like Google with the capital market distortion as a tailwind, we like companies such as Walgreens (WBA) and Discovery (DISCA). Going forward, they can create their own capital from their profitable and free cash flow generating business operations. Walgreens' and Discovery's problems are well-known and perceived by nearly every analyst on the street. They can tell you what would greatly impact these businesses, but we pay very low prices for these future risks. We highlight today's profit margins distortions that we believe could prove to be far more painful for equity investors. No one on the street can see problems for big-cap tech other than regulation. The profit margin distortions of housing in 2007 were hard to see also.

Warm regards,

Cole Smead, CFA

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