Columbia Heights Partners, LP

July 2, 2020

Dear Partners:

Columbia Heights Partners LP returned 40% for the quarter ended June 30, 2020.

	Columbia Heights Partners LP	S&P 500	MSCI World (ACWI)
Q1 2019	10%	14%	12%
Q2 2019	18%	4%	3%
Q3 2019	22%	2%	0%
Q4 2019	9%	9%	9%
2019	72%	31%	27%
Q1 2020	(19)%	(20)%	(21)%
Q2 2020	40%	24%	18%
2020	14%	0%	(6)%
Annualized	57%	20%	13%
Total Return	96%	31%	19%

Columbia Heights Partners LP is an investment partnership focused on long term investing.

We focus on buying high quality companies for the long term. A smaller portion of the portfolio will look at asymmetric risk/reward opportunities (10x-100x upside), special situations, deep value and distressed.

Currently, the partnership holds 6 securities and 40% cash.

We look for 4 things in stocks:

1) Enduring Competitive Advantage
    a. High Return on Equity, High Margins, Monopoly Businesses, **<u>Predictable Earnings</u>**

2) Great Management
    a. Smart Capital Allocation, Dividends, Buybacks, High Free Cash Flow Conversion, High ROI Capital Expenditures

3) Growth Companies

a. Revenue, EPS and Cash Flow Growth for 5-20 years, **Organic Growth**

4) Invest for the Long Term
   a. Secular trends in growing market with compounding growth

The current portfolio has an average return on equity of 98%, 36% Net Income Margin, 314 bps spread to the 10 year treasury based on 2022 earnings, a monopoly or duopoly business, was founded between 1860-1971, 15%+ EPS Growth since 2000, 51% EBITDA Margin, 10% Revenue Growth since 2000, 14% EBITDA Growth since 2000, and 2.85% dividend and buy back yield.

The Fed Has US Boxed In

The yield on 10 Year Government Bonds is between 0-1% in most developed countries. Suddenly, equities at 3-5% yields look interesting relative to bonds.

Given the alternative yields in bonds of 0-1%, high yield bonds at 5% and equity index yields of 3-5%, we like our portfolio of high quality businesses at a 3%+ yield. We believe the market under prices the quality of these businesses and growth trajectory.

Critically, we believe these businesses have a 5-10 year runway to maintain their return on equity, provide predictable earnings and strong organic growth. I would rather own this portfolio of high return on equity names at 3% yield than the S&P 500 at 3% yield and be exposed to many businesses with sub optimal return on equity (less than 20%) and some are also subject to secular decline.

Quality Businesses

Most businesses are not quality businesses. In fact, most businesses are mediocre. The reason this exists is generally because the capitalist process works and once a company finds a new business with a high return on equity, other competitors will enter that business and drive down returns and drive down return on equity to a normal profit.

The importance of high quality businesses, high free cash flow conversion and high return on equity can be described through a thought experiment on 2 restaurant businesses.

If Business A opens a new location at a cost of $1 million and the restaurant earns $200k in cash flow in Year 1 for a return on equity of 20%, that is a reasonable return and business. This business may wait 5 years to use the cash flow to open a 2nd location.

Business B might open a similar restaurant but because of a variety or proprietary reasons may be able to generated $600k of cash flow on that same $1 million cash investment. This will be a 60% return on equity. This business may open a second location in the 2nd-3rd year. If he is able to get a 60% return on equity investment on the 2nd location, he may open more locations if he can sustain these high returns. He may raise debt or equity capital to grow locations if he truly has an edge. It is also possible his return on equity may diminish over time or as his business gets larger. Examples of businesses that have fit this prototype to some extent include Starbucks, Chipotle, McDonalds, Mastercard, Visa and Moody's.

Given the choice you would rather own Business B. Some in our portfolio have return on equity for 50-100 years above 50% and exhibit similar and even better characteristics to Business B.

Compounding

Albert Einstein reportedly said it. "Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it."

We are looking for businesses with predictable earnings, pricing power and organic growth. Let's look at two businesses with different compounding growth rates

Business A has a low return on equity and organic earnings growth of 5% for the next 10 years. Business B has a high return on equity and organic earnings growth of 20% for the next 10 years. Business A will compound over 10 years from $100 in earnings to $163 in earnings. Business B will compound over 10 years from $100 in earnings to $619 in earnings.

Currently, I an inclined to believe that Altria and Philip Morris will skew closer to the 5% earnings growth number and Mastercard and Visa will skew closer to the 20% earnings growth number. I certainly will not be 100% right on the exactly 10 year earnings growth of these companies, but directionally believe I will be correct. Both exhibit predictable earnings, high return on equity, pricing power and inflation protection. However, one appears to have the potential for acceleration in earnings growth based on a secular trend and the other group (tobacco) is at risk for secular decline. At some valuation (like 3-5x P/E), tobacco could be interesting relative to the earnings profile.

Over the long term, stock prices are driven by earnings power. In the above example, the high growth, predictable company will substantially outperform and justify a higher multiple.

Market Size

The companies in the portfolio current have very large total addressable markets. The market sizes of the companies are largely in the financial ($1 Trillion+ TAM) and Auto/Energy ($5 Trillion+ TAM) sectors. We are looking to find companies that have a defensible moat, consistent high ROE, historical and projected organic growth and a small penetration in its markets with pricing power.

Portfolio Construction

The portfolio construction will generally start with 10 positions that are 10% each. Over time, some names may grow to be a bigger portion of the portfolio if they perform especially well.

Think Different

The portfolio and positions will be quite different than a typical mutual fund, hedge fund and index fund. Many funds track the index and have 30-100 positions that are 1% positions. This often results in an index oriented investment result.

We also will look at new technology, large market sizes and new business models where the upside is 10:1, 100:1 and downside is low.

When it comes to new technology and new business models, the market, Wall Street Analysts, financial press, CNBC, Wall Street Journal, will sometimes get overly negative on a new technology company. We will try to 'look around the corner' and use the opportunity to get an attractive entry point. We will still look for competitive moats, high return on equity and other edges in these companies. These companies tend to be very special and only come once in a generation (Think GE, IBM, Microsoft, Apple, Amazon). At some point, they reach the desired fly wheel effect and build momentum where they are difficult to not own. The market does not always understand these companies and opportunities to buy present themselves.

Pipeline

We are always looking for companies that have predictable earnings and the potential for 5-20 years of organic earnings growth through a high return on equity. There are a number of companies, stocks and special situations that fit.

Low Turnover

I believe the below quote best represents the partnership today:

"The stock market is designed to transfer money from the active to the patient." – Warren Buffett

Gorav Khanna
Managing Partner
Columbia Heights Partners, LP