Columbia Heights Partners, LP

October 1, 2020

Dear Partners:

Columbia Heights Partners LP returned 12% for the quarter ended September 30, 2020.

Year to date returns are 27%.

Inception to date returns since Jan 1, 2019 are 118%.

	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%
Q3 2020	12%	8%	9%
2020	27%	6%	2%
Annualized	56%	21%	16%
Total Return	118%	39%	30%

Columbia Heights Partners LP is an investment partnership focused on long term investing. The partnership opened to outside investors in Q3 2020. I think about owning a stock certificate as being a part owner in a private business. Currently, the partnership holds 5 securities and less than 10% cash.

<u>Quality Businesses</u>

I look for 4 things in stocks:

1) Enduring Competitive Advantage
    a. High Return on Equity (over 50%), High Margins (over 50%), Monopoly Businesses, **<u>Predictable Earnings</u>**

2) Great Management
    a. Effective 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, a monopoly or duopoly business, was founded between 1860-1971, 15%+ EPS Growth since 2000, 51% EBITDA Margin, and most of the free cash flow returned to shareholders via dividends and stock buybacks.

The current portfolio represents a basket of stocks and companies that act as a **tax on credit lookups, tax on consumption and tax on debt issuance**.

I think of this as a 3-5% yielding portfolio of high quality businesses with 15-30% annual growth for the next 10 years as an attractive alternative to Treasury Inflation Protected Securities (TIPS), 30 year Treasuries, High Yield Bonds and the S&P Index Fund.

Relative Value in the Capital Structure of Visa

I am seeing some blue chip companies that have common equity stock yielding 3% and have EPS growth potential of 20% for the next 20 years. These same companies are issuing 20-30 bonds with yields as low 2% per annum.

$1 million invested in a 30 year bond yielding 2% will return in the year 2050 $1.81 million. This is likely to hardly keep up with inflation or most likely lose capital in real terms after inflation.

That same $1 million invested for 30 years in an equity growing EPS at 20% per annum will return in the year 2050 $237 million. Yes, that is $237 million

Yes, that is $237 million. That is not a typo. I have a few investors call me to say that must be a typo! This illustrates the power of compounding over long periods of time. The equity returns $237 million versus $1.8 million in the same company's bond.

The equity will protect against inflation. If EPS growth slows to 10% per annum, the same equity will return $17 million. This is still an almost 10x premium to the corresponding bond.

This capital markets inefficiency in pricing the bonds of companies like Alphabet and Visa versus their equities is as wide as I have ever seen.

It is rare to find companies that can compound for 10-30 years at 20% and target large market sectors.

Thought Experiment: '4 Businesses'

To provide some context on how I think about investing we will do a thought experiment on 4 business types below:

Business 1

Business 1 generates cash flow of $1 million in year 1, $1.3 million in year 2, $1.7 million in year 3 and $2.2 million in year 4. This business has $0 in capital expenditures during all 4 years and returns all the capital to shareholders in the form of either stock buybacks or dividends. Over 4 years, shareholders receive $6.2 million in cash dividends.

This is clearly a good business growing free cash flow at 30% compounded with 100% free cash flow conversion.

Companies that exhibit similar characteristics include Mastercard, Visa, Moody's and S&P Global. Select software companies also look like Business 1.

Business 2

Business 2 generates cash flow of $1 million in year 1, $1.3 million in year 2, $1.7 million in year 3 and $2.2 million in year 4. However, the capital expenditures to grow the business (for example opening more stores in the case of a retailer like Chipotle or Starbucks) is $0.5 million in Year 1, $0.65 million in Year 2, $0.85 million in Year 3 and $1.1 million in Year 4.

This business generates $3.09 million in free cash flow and dividends over the first 4 years.

This is also a good business as it grows cash flow from $1 million to $2.2 million in 4 years. However, this growth requires $3.1 million in capital investment to be put back in the business. Business 1 gets to the same result without the capital expense.

Apple, Google, Microsoft, Amazon, Facebook look like a hybrid between Business 1 and Business 2. Starbucks and Chipotle look like Business 2.

They are clearly more capital intensive than years past because of large capital expenditures in the cloud build out. Historically, the management teams have been fantastic capital allocators, but I gravitate towards companies with lower capital expenditure profiles. Google's capital allocation has resulted in some questions from investors on side projects. Amazon, for the first time, seems to be generating massive amounts of operating cash flow ($20 billion in Q2 2020!). Jeff Bezos will likely make a high return on capital investment with that money, but it is by no means a guarantee.

Taiwan Semiconductor is another example of a company that has historically had a very high capital expenditure and consistently high growth and return form that capital expenditure.

Business 3

Business 3 is a business that generates cash flow of $1 million in year 1, $1.05 million in year 2, $1.1 million in year 3 and $1.16 million in year 4. This business is growing slower than business 1 and 2 but also has no capital expenditures.

This business generates $4.31 million in free cash flow and dividends over the first 4 years.

Altria and Philip Morris are examples of Business 3.

Business 4

Business 4 is a business that generates cash flow of $1 million in year 1, $1.05 million in year 2, $1.1 million in year 3 and $1.16 million in year 4. This business is growing slower than business 1 and 2. This business also spends 80% of annual operating cash flow on capital expenditures. Capital expenditure cost is $0.8 million in year 1, $0.84 million in year 2, $0.882 million in year 3, and $0.926 million in year 4.

This business generates $0.86 million in dividends over 4 years.

This business is what I call a capital destruction machine.

General Motors, many auto companies, many oil companies and many industrial and commodity and steel businesses exhibit similar characteristics to Business 4. These businesses tend to have low margins, low return on equity and low competitive moats. I think it would be fair to say that most of the companies in private and public markets look like Business 4: Mediocre growth and mediocre return on capital.

Many industrial or other businesses that have been purchased historically by private equity and levered also exhibit similar characteristics to Business 4. The stability and low cost of debt have generated high IRR for the private equity sponsors, but these were not necessarily high quality businesses.

Choosing between the 4 Businesses

As a long term investor, I gravitate to business 1.

I am looking for high return on equity, high organic cash flow growth, low capital intensity and shareholder returns via dividends and buy backs.

Business type 2 and 3 can be good investments, but business 2 is capital intensive and certainty of future returns on capital can be uncertain.

Business 3 tends to have high free cash flow conversion, but growth is low and terminal valuation multiples put a lid on potential upside. Business 3 and 4 also run the risk of becoming 'value traps'.

I have studied many businesses since the 1960's that have looked like Business 4. It is unclear to me why capital markets have even allocated any capital to companies like Business 4 (Alcoa and GM) since the 1960's.

GM in the 1920's - 1940's may very well have looked like Business 1 or 2, but that competitive and technical and scale advantage eroded over time as the industry matured. It is remarkable how resilient Moody's and S&P have remained since the early 1900's to the 2020's.

Which of the 4 business types would you prefer to own?

I did not address ' Business 5' - businesses that exhibit -$1.0 million in cash flow in year 1, -$1.5 million in cash flow in year 2, -$2.0 million in cash flow in year 3, and -$3.0 million in cash flow in year 4. In addition, some of the current high valuation stocks have $1-2 million capital expenditures in per year in year 1-4.

I choose to largely miss out on these companies. The management, sell side investment bankers, short term hedge fund holders and various other market participants are sometimes incentivized to prefer these companies spend more capital when targeting a 'huge' market. A small fraction of these 'bets' will be immensely successful (even 10-100x), but investors should proceed with caution as many could fail.

I recently read a letter that compared the amount of capital raised and burned by Uber to the total amount of since inception cash burned by Amazon, Microsoft, Apple, Oracle, Facebook and Google. The point was something to the extent that the combined $5 trillion market cap+ of the 'FANG' stocks was created on very little original venture capital and cash burn. It was likely in the range of $100-$500m of total capital.

Uber in fact has raised and spent10x+ more than those companies and burned it. In addition, Uber has no profits to show for this and a 'relatively small' market cap of $50 billion.

It is very difficult to find companies that are 'capital efficient'. Shopify has burned $30 million since inception and is now a $100 billion annual GMV, #2 in online in commerce and has a $100 billion market cap. Some Series A/B business plans by 26 year old Stanford MBA students are burning that much in one year. Uber was likely burning that much in one week at it's peak cash burn! No thanks! This is not meant to pick on Uber specifically, but just the importance of cash burn and capital efficiency.

Another example is the total capital spent by various self driving technology software companies. It is early to tell who the winner will be, but it is likely that the losers may spend billions of dollars for a project that does not ultimately work or generate a meaningful return of revenue or cash flow.

It appears that Comma.ai has 2nd position in the self driving software business with a capital raise of $8 million. Cruise, Waymo and Zoox have likely all spent many billions and may be behind Comma.ai. Tesla may be in the lead, but has likely spent much more than Comma.ai. At the very least, we can agree the dispersion of capital spent and results is likely to be very high with a difficult to predict ultimate winner.

In conclusion, I feel strongly that if I find the 5-10 businesses out of the 500 businesses in the S&P that look like Business 1 and combine that with a 5-20 year time horizon with moderate price discipline, we will out perform the S&P. The majority of the S&P 500 businesses look like Business 4 or even the loss making Business 5.

Pipeline

The bar to enter the portfolio remains high. I currently have a number of companies that I am evaluating with high return on equity, high margin, high cash flow margins, free cash flow conversion and sensible capital allocation.

50% / 50% / 50%

I recently came across a business with 50% return on equity, 50% annual growth and 50% margins. This is a potential business to add to the portfolio, but currently the valuation is 200x P/E. It is also not a 'top of the capital stack' or 'tax or toll collector' business but it is close.

I will keep tracking if the valuation gets compelling. It will probably not make it into the portfolio but I will keep an eye out for the new holy grail of 50%/50%/50% ROE/Margins/Growth at reasonable valuation, top of capital stack dynamics and a long runway of growth. This company does not buy back stock yet and it remains to be seen their capital allocation strategy in the future. Also, the company capital spent on R&D seems to be remarkably efficient.

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

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Books I am reading or read recently:

Mao: The Unknown Story by Judy Chang
Story of Civilization by Will Durant
Sapiens by Yuval Noah Hariri
Homo Deus by Yuval Noah Hariri
100 Baggers by Christopher Mayer
Am I Being Too Subtle: Straight Talk From a Business Rebel by Sam Zell