Columbia Heights Partners, LP

January 1, 2021

Dear Partners,

Columbia Heights Partners LP returned 36% for the year ended December 31, 2020.

Inception to date return since January 1, 2019 is 134%.

	Columbia Heights Partners, LP	S&P 500
2019	72.0%	31.5%
2020	35.9%	18.4%
Annualized	52.9%	24.8%
Total Return	133.8%	55.7%

This letter is on the longer side so I will address the structure below:

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Current Portfolio

The current portfolio holds 7 positions. The majority of the portfolio is invested in ***'high quality compounders'*** including Visa, Mastercard, S&P Global, Moody's, MSCI and FICO.

These businesses all exhibit characteristics consistent with my investment process.

I buy capital light businesses and a Warren Buffett quote below helps articulate the process.

"The best business is a royalty on the growth of others, requiring little capital itself." – Warren Buffett

Process

The investment process consists of a both quantitative and qualitative research.

Quantitative metrics provide discipline and include metrics such as EBITDA margin, Return on Equity, Sales and EPS Growth, Net Income Margin, Free Cash Flow Conversion and Capital Allocation.

Qualitative factors include pricing power, monopoly power, management quality, management incentives, top of capital stack, relationship with customers, ESG, 'eco system control' and operating leverage. I am looking for ***'scarce assets'*** with a unique brand, pricing power, dominant market position and network effects.

Quantitative Process

As articulated in the investor deck and prior investment letters, I rely on quantitative metrics and frameworks including the 50/50/50 (50% ROE, 50% Margin and 50% Growth). It is important to stick to these rules because it is easy to lower standards with an 'exciting' story. Some of the story stocks may even go up 5x, 10x or 100x!

An example of relevant quantitative metrics includes 50%+ Return on Equity, 50% EBITDA margins and 80%+ free cash flow conversion.

An example pipeline company in terms of high management quality and historical track record is Taiwan Semiconductor. However, it the busines has is capital intensive and has margins in the 20-40% range. This is clearly better than most businesses which do 5-20% margins, but I am looking for the best businesses in the world and 40-80% margins. Free cash flow conversion at Taiwan Semi is closer to 50% as opposed to the

80-100% of other businesses in the portfolio. I wish I could find a way to add this name to the portfolio, but it fails on these measures. If it came down to a PE of 1-5x or a meaningful change in the margin or free cash flow conversion (i.e. – the business somehow went asset light), it may merit a second look.

As Warren Buffett says the mistakes of 'commission' can sometimes hurt more than the mistake of 'omission. Berkshire's recent adventures in capital heavy airlines is an example of mistakes of 'commission'.

Qualitative Analysis

One key qualitative metric is 'Top of Capital Stack' businesses. I am looking for a business that might be a small part of the total value chain in terms of cost. These products tend to have a high utility and return on investment to their end customer.

This would also be something that is very high customer utility compared to price. Examples include a $0.20 Visa fee on a $100 Nike shoe merchant transaction, a 6bps Moody's debt fee on a $1 billion 4.5% interest rate bond issue, a 1bps MSCI or S&P Index Fee to an asset manager on a $1 billion Pension allocation or a $0.70 FICO consumer credit score on a $500,000 consumer mortgage.

These products and services may be needed by the customer to do a larger transaction and the customer might not have much power or incentive to dictate price. I am looking for companies that are 'price makers' and their customers are 'price takers'. Price maker businesses often have a 'tax like' characteristic to them.

Examples of businesses with high utility to relative cost may include Adobe PDF for $10/month, Microsoft Outlook/Office for $10/month, a critical $5 component on a $200 million Boeing Plane, a $1000 iPhone, a self-driving Tesla, a $10/month Docusign fee for a large mortgage company.

I prefer that the customer likes the product and appreciates the value they are getting relative to what they pay.

Every company I own has a CEO that owns between $100 million to $500 million of stock. I like this alignment of incentives. They will think twice before diluting shareholder capital.

Top of the Capital Stack

I am looking for 'top of the capital stack' businesses with 'pricing power'.

I am currently evaluating a 50/50/35 business (50%+ ROE, 50%+ Margins, 35%+ Growth). This company has a 20-year track record of stock buyback and has 80%+ free cash flow conversion.

The idea of 'top of the capital stack' is the idea that the company product is fundamental and first to be paid.

A simple example in most of our personal lives would be rent and shelter, food, property and income taxes and maybe even a mobile phone or car. Less important might indulgences like luxury items and extra travel.

Thought Experiment: The importance of runway

In previous letters I discuss return on equity in a restaurant busines and business quality across 5 business types.

I will now discuss growth runway.

Let's evaluate a business that earns $1.00 in 2020, trades at $20 in 2020, trades at a 20x P/E in 2020, a 20x P/E in 2040 and grows EPS at 25% per year for 20 years.

In 20 years, this business will be worth $1,735 per share. EPS will have grown from $1 to $87. The Net Present Value of the interim cash flows and terminal value at an 8% discount rate is $502. This implies the current stock price at $20 sells at a 96% discount to its Net Present Value.

At a 35% growth rate, the discount is 99%.

At a 30% growth rate, the discount is 98%.

At a 25% growth rate, the discount is 96%.

At a 20% growth rate, the discount is 92%.

At a 15% growth rate, the discount is 82%.

At a 10% growth rate, the discount is 62%.

The key point is that at 10-15% growth rates and long runway, the discount to fair value is 62-82%.

If a company can exceed the 15%, the discount to fair value gets to 90% and above very quickly! The golden rule is to find 15%+ growth and 20 years of runway. It is harder to find than you would think!

This shows the importance of finding long runway with growth. Over time, companies with low margin, low return on equity, low competitive edge and small markets will lose that long runway.

I look for large markets, low penetration, growth runway, high return on equity and competitive moats. Examples of very high return on equity and huge runway could even extend to concepts like the US Constitution, US or Global GDP in 1776, Bitcoin's 8 Page White Paper by Satoshi Nakamoto and many of our leading companies either historically and today (like GM in 1920 or Visa in 1990). The S&P Index and MSCI Index have long runway and growth given the market size and adaptability of the indices.

A quote from Charlie Munger comes to mind about how difficult it is to find businesses that can maintain a long runway:

"Over the long term, the companies of America behave more like biology than they do anything else. In biology, all of the individuals die, so do all of the species. It's just a question of time" - on businesses inevitably getting "clobbered." – Charlie Munger

Macro Thoughts and Money Printing

I am paying attention to macro policy, interest rate policy and inflation. I believe owning businesses with high pricing power is one defense to unpredictable macro events.

Governments are printing currency to fund large budget deficits. I am not sure how it ends, but I would like to be hedged against an adverse outcome of inflation or currency debasement.

For example, in years past a $1 million 10-year Treasury at 5% provided $50,000 in income to a retiree. Today, that same retiree needs $10 million of 10-year Treasuries. I don't know if this is a 10x inflation over 10 years, a 35% annual inflation over 10 years, currency debasement, inter-generational theft or some combination thereof.

I need to be cognizant of inflation risk and protect the portfolio accordingly. Solutions include equities with pricing power and Bitcoin. A lot of the top companies have returned 35% a year since 2010, but so has the number of 10-year treasuries required to generate the same $50k of income. Does that mean the equity return was not real 35% annual growth? I don't know the answer, but probably somewhere in the middle and the return was driven by both real growth and a macro tail wind.

The prospective returns of Gold, Bonds and Equities have all been impacted. A fascinating example from 2600 years ago below might help articulate where we might be headed.

Athens: 594 BC

Lyn Alden has an investment strategy blog that brings up an interesting example of high debt levels and currency devaluation.

“In the Athens of 594 B.C., according to Plutarch, ‘the disparity of fortune between the rich and the poor had reached its height, so that the city seemed to be in a dangerous condition, and no other means for freeing it from disturbances seemed possible but despotic power.’ The poor, finding their status worsened with each year- the government in the hands of their masters, and the corrupt courts deciding every issue against them- began to talk of violent revolt. The rich, angry at the challenge to their property, prepared to defend themselves by force. Good sense prevailed; moderate elements secured the election of Solon, a businessman of aristocratic lineage, to the supreme archonship. He devalued the currency, thereby easing the burden of all debtors (although he himself was a creditor); he reduced all personal debts, and ended imprisonment for debt; he cancelled arrears for taxes and mortgage interest, he established a graduated income tax that made the rich pay at a rate twelve times that required of the poor; he reorganized the courts on a more popular basis; he arranged that the sons of those who had died in war for Athens should be brought up and educated at the government’s expense. The rich protested that his measures were outright confiscation; the radicals complained that he had not redivided the land; but within a generation almost all agreed that his reforms had saved Athens from revolution.

-“The Lessons of History”, Will and Ariel Durant, 1968

The Bad News and the Good News

The bad news is we could be headed to US Dollar currency debasement, fiscal deficits, higher taxes, lower growth, asset inflation, some degree of social discontent, some degree of China and US geopolitical tension with asset flows slowly moving from the United States, Europe and Japan to China.

The good news is technological innovation in terms of deflationary automation and robots, climate change (Tesla), financial innovation and inclusion (Bitcoin), Genetic and Biotech Progress, poverty alleviation and real per capita GDP growth in China and India could lead to a more balanced and prosperous world overall over the long term.

Pipeline

Companies in the pipeline that I am evaluating that may or may not make it into the portfolio include Adobe, Atlassian, HDFC Bank, ITC India, Red Bubble and Adyen. I suspect none of the names will make it in the portfolio, but I will continue to study them.

Concentration

The portfolio remains concentrated in 7 names with target low turnover and 10 year+ holding period.

My under writing for each name includes a prospective annual return ranging from 15%, 19%, 20%, 25%, 29%, 35% and 100%. The portfolio annual return ranges over 10 years are base case of 25%, bear case of 18% and upside case of 62%. Range of 10 Year MOIC's are 4x, 4x, 6x, 9x, 13x, 17x and 1000x. There is uncertainty but I think I have optionality to the upside with strong underlying businesses with dominant positions in their underlying market.

Technology and International Investing

Currently I do not own any international equities. Some are in the pipeline including Adyen, but it has a high valuation. I will continue to look at both domestic and international equities, but I am not sure I will find international equities that fit my criteria.

I believe most of the portfolio has a technology element and international element. One name is very heavy on the technology side.

I did an analysis of 30 software companies to see if any fit my criteria and it had a surprisingly high dispersion where most companies passed on none of the profitability criteria whereas a few others passed on many criteria and came close to working. Ultimately, the valuations were priced high and I need to do more research. I will continue to keep an eye out on the international and technology side, but time will tell if I find any attractive investment opportunities that fit the investment framework.

Quotes

"The best business is a royalty on the growth of others, requiring little capital itself." – Warren Buffett

"Over the long term, the companies of America behave more like biology than they do anything else. In biology, all of the individuals die, so do all of the species. It's just a question of time" - on businesses inevitably getting "clobbered." – Charlie Munger

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

Book Recommendations

The Lessons of History by Will Durant

The Great Bridge: The Epic Story of the Building of the Brooklyn Bridge by David McCullough

The Gene: An Intimate History by Siddhartha Mukherjee

Damn Right!: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger by Ric Lowe, Janet C. Lowe, Margaret A. Lowe

Thinking, Fast and Slow by Daniel Kahneman