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MANAGEMENT

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Letter to investors, Q1 2021

Performance

The Master Account, in which I am personally invested alongside SMA clients, returned 6.8% net in Q1 2021, as reported by our fund administrator. As of December 31st, 2020, the top ten positions comprised approximately 68% of the portfolio, and the portfolio held approximately 14% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020	4.6%	18.4%
2021 YTD	6.8%	6.2%

ACML performance is net of fees and standard costs.

Serial acquirors

A class I enjoyed at businesses school was called "entrepreneurship through acquisition." It introduced the idea of a career path of entrepreneurship through buying an existing business, one with customers and revenues, as opposed to founding a brand new start up.

Having come from an M&A work background where the focus was on transaction mechanics and valuation, it was interesting to learn more about the process of locating small businesses, strategies to develop a pipeline of opportunities, and incentives to selling owners. We also discussed the very real post-acquisition challenges of managing a business, from customer dynamics that might not have shown up during diligence, to the nuances of handing cultural challenges under new ownership. These things are not easy.

In the public markets, many have tried the path of growing through serial acquisitions, or roll-ups as they are frequently called. The idea is simple enough and has clear appeal, if executed properly. In a fragmented market (one therefore theoretically lacking a major competitor), acquire smaller businesses (at attractive prices given the "arbitrage" in valuation between large public companies and small private businesses) and gain access to their steady cash flows and strong customer relationships (high switching costs). Then apply enterprise wide best practices and use the parent company's greater resources to spur growth and/or margin improvement and use the resulting cash flows to finance further acquisitions in a virtuous cycle of growth.

Unfortunately, in practice this is much harder than it sounds, perhaps because of the very real post-acquisition challenges of managing a business. Studies have shown that "the long-term stock price performance of roll-ups substantially lags that of several benchmarks,"[1] "M&As are value-destroying deals for the combined firms,"[2] and "acquiring shareholders receive negative or insignificant returns in the short run in developed capital markets."[3]

In contrast, Danaher Corporation is one of a handful of companies that has developed a highly effective playbook to grow consistently by acquisition and has compounded investors' wealth at very attractive rates for decades. The Rales brothers founded Danaher in 1984 and implemented the "Danaher Business System" (DBS), a comprehensive and deeply engrained set of processes adapted from Toyota's Lean Production and "kaizen" (or continual

[1] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=236530
[2] https://link.springer.com/article/10.1007%2Fs00187-015-0219-9
[3] https://link.springer.com/chapter/10.1007%2F978-3-030-23850-6_2

improvement) techniques to grow from an approximately $10m collection of manufacturing businesses to a $160bn conglomerate active in life sciences, diagnostics, and environmental solutions with revenues in excess of $22bn.

The brothers also own 15% of a smaller (approx. $6bn market capitalization) company called Colfax, with operations in welding equipment and orthopedic devices. Colfax is being built with essentially the same processes, dubbed the "Colfax Business System." We first invested in March of last year, but I wanted to provide an update in this letter (see section below) as Colfax announced it would split into two businesses, and I am excited by the opportunity presented by a Danaher-like business which is still in the early innings of its growth.

Discussion on a selection of portfolio positions with an average weight over 1%:

Positions with an average weight over 1% of the portfolio throughout the quarter were: Alphabet Inc., Amazon Inc., Brookfield Asset Management Inc., Burford Capital Ltd., CarMax Inc., Colfax Corp., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., IAC/Interactivecorp, KKR & Co Inc., Liberty Broadband, Naspers Ltd., Oaktree Acquisition Corp. B, Prosus NV, Tencent Holdings Ltd., Trebia Acquisition Corp., and Wandisco Plc.[4]

Colfax – update

Colfax was established in 1995 to reproduce Danaher's success of acquiring and improving good industrial businesses. By 2017 the business had three main divisions, Fabrication Technology (welding), Air & Gas Handing, and Fluid Handling. While the Fabrication business benefits from access to end markets with secular growth opportunities, the latter two were cyclical businesses, selling to customers in such industries as power, oil & gas, and mining. In 2015, Colfax installed Matt Trerotola, a Danaher veteran, as CEO and embarked on a major restructuring. In 2017 it divested its Fluid Handling business, in 2018 it divested is Air & Gas busines, then in 2019 it acquired DJO Global, which sells orthopedic products, from private equity firm Blackstone. Under Blackstone, DJO had been weighed down by debt which severely restricted its ability to invest in growth. Colfax saw an opportunity to apply its CBS process to an otherwise attractive business.

Today CFX comprises 2 segments, ESAB (fabrication/welding), and MedTech (orthopedics).

ESAB is the second largest player in the $30bn global fabrication technology industry. Its major competitors are Lincoln Electric and the welding subsidiary of ITW. 30% of sales are from selling equipment and almost 70% of sales are from selling consumables, which generates a stream of repeatable revenues. The company provides a suite of software products to help customers manage maintenance programs, comply with extensive documentation & certification requirements, and monitor weld quality including tracing weld operators and part numbers in order to correct errors. This positions ESAB as a solutions provider and not simply a materials supplier, which increases customer stickiness. While welding might at first sound like a cyclical industrial business, a large proportion of ESAB's sales are directed towards more attractive general fabrication, infrastructure, healthcare & laboratory, renewables and defense industries. Furthermore, 50% of sales are to emerging markets which benefit from secular growth drivers, and the company has acquired capabilities in the faster growing programable robotic welding segment.

MedTech derives 75% of sales from Prevention & Recovery, which largely comprises knee, ankle, and wrist bracing in which it is global leader with leading industry brands such as DonJoy and Aircast. 25% of sales are from surgical reconstruction, with a focus on extremities, such as "reverse shoulder" implants in which it is global leader, with further products in knees and ankles etc. MedTech will benefit from the industry tailwind of a 70% increase in the number of joint replacement procedures over the next decade, driven by an aging but active population. Most procedures currently take place in hospitals, but the proportion of procedures taking place in ambulatory surgical centers (ASCs) and outpatient settings is expected to increase to approximately 50%. This works to MedTech's advantage as its bracing products are deeply penetrated into ASCs, and its digital solution are integrated into many workflows, which help ASCs manage insurance reimbursement and remote patient monitoring. These existing

[4] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.

relationships should help MedTech compete more effectively in reconstruction against large and well-managed companies, such as Stryker and Zimmer Biomet.[5]

Earlier this year CFX announced its intention to split its 2 businesses, as they have little overlap with each other. ESAB, which has been managed by Colfax for many years, will stand on its own under existing leader Shyam Kambeyanda. At MedTech, current DJO CEO Brady Shirley, who is a Stryker veteran with 26 years industry experience, will remain as President, but will be joined by Colfax's current CEO, CFO and head of business development, who will continue to apply their CBS expertise. Importantly, Danaher/Colfax founder Mitch Rales will remain as Chairman of the Board for both ESAB and MedTech. He will step down from the board at Fortive (a larger Danaher spin out) in order to free up his time to do so, and I read this as a strong indication of his commitment to the success of the future Colfax businesses.

Based on management comments, I estimate that Colfax can grow to a \$25bn business, from approximately \$6bn today. ESAB had 2020 revenues of \$1.9bn with 16% EBITDA margins. MedTech had 2020 revenues of \$1.2bn with 18% EBITDA margins. With mid-to-high single digit organic growth, combined with diligent application of the CBS process, including operational improvements and acquisitions, management are aiming to grow *each* business to \$3bn in revenues, with 20% EBITDA margins for ESAB and 25% margins for MedTech. These businesses can convert 90% - 100% of EBITDA to Free Cash Flow. Working through the math, this implies future combined FCF of approximately \$1.3bn, compared to approximately \$200m today. The publicly listed comps trade at around 20-30x multiples, implying a \$25bn+ value. Even if this takes 10 years to achieve, our investment could still compound at 15% IRR from today's market cap of \$6bn.

Much of the thesis relies on an assessment of management's ability to live up to their comments. For this I believe it is worth discussing some of the Danaher Business System, as it is central to the Colfax story. Danaher was established in 1984 to buy businesses and improve them. The initial businesses were of variable quality and included one called Jacobs Engine Brake, which suffered from low productivity and poor quality control. The Rales brothers hired an engineer and former green beret named George Koenigsaecker, who had previous work experience in Japan, to manage the business. As the story goes,[6] frustrated by the issues at Jacobs, he brought in two of the architects of the Toyota Production System to overhaul the company. This was such a success that the company rolled out Lean manufacturing and kaizen (continuous improvement) processes across all their other businesses. DBS has evolved over time beyond the manufacturing floor, and encompasses all aspects of business including supplier, customer, sales, corporate, and even investor relations functions.

DBS is integral to the way Danaher conducts its business, from defining high level core values to providing comprehensive processes and tools to enable employees to execute on strategic plans, with an emphasis on Lean manufacturing, Growth, and Leadership. DBS lays out 5 core values: "The best team wins" - Danaher emphasizes employee selection and leadership development. "Customers talk we listen" - focus on identifying and solving for unmet customer needs. "Kaizen is our way of life" – continuous improvement, eliminate waste. "Innovation defines our future" - drive breakthrough ideas for technology, products, solutions and processes. Finally, "we compete for shareholders" – deliver best-in-class results to consistently attract and retain loyal shareholders.

Danaher deploys these core values through a set of results-driven practical processes and tools, which are applied rigorously and unemotionally. For example, when integrating a new acquisition, Danaher undertakes a comprehensive assessment of managerial talent both at the interview stage, and a few months post-acquisitions after observing managers in operation to sort those who are unlikely to succeed or to fit with the Danaher culture. Danaher creates a three to five-year strategic plan at each operating company. The goal is to identify true breakthrough opportunities for performance and competitive advantage. This is monitored through a Policy Deployment process, where the long term targets are broken down into annual objectives that would need to be achieved along the way. Specific processes improvements required to meet these targets are prioritized and are tracked against specific, quantifiable targets. The appropriate DBS tools (there are over 50) are deployed to address the improvements, and

[5] Source Colfax internal analysis, investor day presentation

[6] The book "Lessons from the Titans" by Scott Davis, Carter Copeland and Rob Wertheimer has a great chapter on the evolution of the Danaher Business System

progress is measured monthly and annually. Any shortfalls are highlighted and tackled through a formal Problem Solving Process. As with most things DBS, the Problem Solving Process has a comprehensive set of tools designed to get to the root cause of an issue, and a variety of tools to map out potential solutions.

There is an extreme focus on process, with the overarching goal to identify standard work and maximize workflow through repeatable and measurable functions. The company weeds out people who do not conform to this world view[7] and goes to some lengths to train employees. For example, new managers are required to undergo a 2-3 month DBS immersion program before they are allowed to start their jobs. This involves several "kaizen events," which typically take place at the manufacturing floor and involve a specific target such as halving the floor space required. There is accountability at the highest levels. The belief is that having the president of the company "put on jeans and work boots and get involved with a broom on the shop floor can be powerful in setting expectations."[8]

Furthermore, DBS emphasizes measurement, through the following 8 core metrics:

- Financial: Core Revenue Growth, Operating Margin Expansion, Cashflow / Working Capital turns, Return on Invested Capital
- Customer: Quality, On-time delivery
- Talent: Internal Fill Rate, Retention

The Talent metrics are a good example of how Danaher tangibly applies its "the best team wins" core value, as managers, even good operators, who fail to internally develop their team are eventually shown the door. As an example of the way numbers drive processes at Danaher, the former head of logistics at Leica Biosystems (acquired by Danaher in 2006) described in an interview[9] his experience with the Operating Margin Expansion metric and the need relentlessly to cut costs by 5% a year, every year. After a few years of successive 5% improvements, he ran into an issue when dealing with a 3rd party logistics (3PL) partner. The 3PL company operated at sub 5% profit margins, so attempting to negotiate better terms to achieve the 5% margin improvement eventually became untenable. Under pressure from his superiors who would not accept failure to cut costs, he eventually used Danaher's version of Value Stream Mapping[10] and Dynamic Pricing tools to overhaul the entire process of working with this 3PL partner, to reduce costs by 50%.

During Larry Culp's tenure as CEO from 2001 to 2014, Danaher reinvented itself and transitioned from cyclical industrial businesses to more stable, higher margin and faster growing businesses in the healthcare, dental and testing equipment industries. The company learned that its DBS operating improvements had greater impact on businesses with higher gross margins and a big spread between gross and operating margins, as there was more opportunity to take out operating costs. Moreover, a focus on companies with better growth meant less need to resort to layoffs, which would cut people the company had taken the trouble to train. Finally, steadier businesses suffered less during a recession, which would otherwise reverse hard won margin improvements. As a result, Danaher found it could support more debt at cheaper rates to accelerate acquisitions and be more highly rated by the market, which was of enormous value to shareholders over time.

As the late venerable Clay Christiansen noted in his essay "The Big Idea: The New M&A Playbook," there are two reasons to acquire a company.[11] The first more common one is to boost current performance by attempting to cut costs. While "the second, less familiar reason to acquire a company is to reinvent your business model and thereby fundamentally redirect your company. Almost nobody understands how to identify the best targets to achieve that goal, how much to pay for them, and how or whether to integrate them. Yet they are the ones most likely to confound investors and pay off spectacularly."

Colfax today, following its purchase of DJO and prospective split, has successfully redirected its growth prospects in a somewhat parallel setup to Danaher under Larry Culp. It is using the DJO business, with its strong positions in

[7] Interview with Larry Culp https://southeasternasset.com/podcasts/ge-larry-culp-on-lean-manufacturing-culture-and-covid/
[8] HBS case study on Danaher Corporation 9-708-445, quote from former Danaher CEO Larry Culp.
[9] Interview with https://inpractise.com
[10] https://en.wikipedia.org/wiki/Value-stream_mapping
[11] https://hbr.org/2011/03/the-big-idea-the-new-ma-playbook

bracing and shoulder reconstruction, as a platform to expand into new verticals such as foot and ankle reconstruction and has already executed 6 bolt-on acquisitions in the last 12 months.

Moreover, CBS implementation has already begun to bear fruit. At the March investor day management disclosed:
- Core Revenue Growth: doubled from 2-4%
- Margin Expansion: from 19% to 22% (EBITDA)
- Innovation: the percentage of revenues from new products ("vitality" score) increased from 7% to 11%. The number of new products launched increased from 8 to 32
- Continuous improvement: backorders reduced by 56%, held orders improved by 29%
- Talent: 20% improvement in associate engagement

I believe our investment in Colfax has the potential to compound at attractive rates for many years. We are aligned with successful operators who have established highly effective processes for growth via acquisition. As founder Mitch Rales said "the real game here is thinking about the next 10 years and what we can do by compounding off of a very small base… I just think it's a lot easier to move the needle off of these bases and double the size of the business in the years to come than it is for a larger scale company."

Hims and Hers (formerly Oaktree Acquisition Corp) – exit
We were stopped out of our HIMS (formerly OAC) position. As mentioned, trading in post-merger SPACs can be extremely volatile and irregular, so I had set a trailing stop loss to protect any profits. While I like the team and board that Hims has assembled and am intrigued by their approach to the potentially massive telehealth opportunity, I have not yet developed enough conviction on their competitive position. The original idea was as low risk SPAC trade, the current operating business is in my "too hard" pile.

TREB and OACB – New positions
I initiated positions in 2 SPACs, Trebia Acquisition Corp. (TREB), backed by Bill Foley who has a good track record of value creation for shareholders, and Oaktree Acquisition Corp. B (OACB), another Oaktree vehicle. Both positions were initiated at prices fractionally above Net Asset Value. The likely downside if they fail to complete deals or if they announce deals the market dislikes is NAV ($10/share) less some fractional friction costs, while the upside could be meaningful. Some of the froth has come out of the SPAC market, so results may be subdued, nevertheless, I believe this is a reasonable lower-risk use for some of our large cash position until I find more long-term investments.

Exor, Liberty Broadband – trims
Exor once again became a 20%+ position which I trimmed for portfolio management reasons. As I detailed in my Q2 2019 letter on non-ergodicity, I like to be mindful of the risks of over concentration.

Liberty Broadband completed its merger with GCI, thereby collapsing one layer of the double discount to Charter Communications, presenting a good opportunity to trim that position as well.

KKR – add
On February 1st, KKR closed its previously announced acquisition of Global Atlantic, one of the largest fixed rate and fixed annuity providers in the US. The benefit to KKR is that it will both consolidate GA's operating earnings and generate fees from investing GA's insurance "float." KKR recently updated the market on the value of GA's assets, reporting a 25% increase to $90bn. This has positive implications for both the management fees that GA will generate for KKR in the future (management expected $200m in incremental fees from the transaction, it seems clear that this will be an underestimate) and insurance operating earnings. KKR is firing on all cylinders and I believe the stock can double over the next 5 years. I therefore added to our position.

Samer Hakoura
Alphyn Capital Management, LLC
April 2021

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