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VMCH Corporation - Annual Report

VMCH Corporation performance (in USD)

Year	Annual percentage change in Per-Share Book Value (NAV) of VMCH	in S&P500 with Dividends Included	in MSCI Europe with Dividends Included
2012	24.8%	16%	19.9%
2013	27.7%	32.4%	25.9%
2014	(2.7%)	13.6%	(5.6%)
2015	(1.4%)	1.3%	(2.3%)
2016	6.1%	11.9%	(0.4%)
2017	5.5%	21.8%	25.5%
Compounded annual gain	9.3%	15.7%	9.6%
Overall Gain	71.1%	140.8%	74.0%

"Time is on your side when you own shares of superior companies." – Peter Lynch

To the shareholders of VMCH,

In 2017, NAV increased by 5.5% compared with an increase of 21.8% in the S&P500, including dividends. MSCI Europe increased 25.5% including dividends during the same period. Our 6-year annualized return to date was 9.3%.

It seems that the past few years were not so kind to value as they were to growth – what was expensive just became even more expensive. We underperformed significantly this year despite the overall good business performance of our portfolio companies. We would expect this to reverse at some point, as it has in the past.

For example, Amazon just went from a P/E of 200 to 300 in one year, contributing to the general sense that profits and valuation do not matter if you keep growing revenues (but not profit). At the same time, one of our holdings that is part of the S&P500 was and remained among the least expensive in the entire index, while growing net profit faster than almost any other company.

The reason we invest with an eye on valuation and not simply chasing growth, is that in the long term there is almost a 1:1 relationship between profits and returns. The more you pay, the more you need the future to be just perfect to make a profit, and the less you get to enjoy that profit if it materializes. More so for companies that are growing without making profits.

Here at VMCH Ronit and I think that cash flows and profits still matter, and at some point, the market will come back to its senses. We do not rely on the market alone though – last year we resolved to extend our average holding period, and this year we made another determination that has to do with risk management.

Risk management means that we are resilient to whatever the market throws at us, and are thus ready to exploit opportunities. To do that, we focus mostly on knowing what we buy and having a margin of safety to protect us from being wrong. Potential investments generally fall into the following categories:

1. Great companies at a reasonable price.
2. Reasonable companies at a bargain price.
3. Bad companies ("cigar butts") at a ridiculous price.

Great companies are great investments because there is more than one way to make a profit. Usually, these companies grow *while* paying dividends and buying back shares. That means that time is on our side – a year goes by, and higher profits are all but assured, which usually leads to a higher share price. Hence sitting on such companies, even at higher valuations is quite profitable.

Let us take the case of a company we hold in our portfolio that is engaged in the otherwise boring business of car insurance. However, with a top-notch business model and management, the company makes a return on equity of over 50%, compared to around 10% for the industry. For the past ten years, they managed not only to grow the business 10% annually, while paying out almost all the profit in dividends each year, adding around another 6%. That means that the value of the shares increased at a clip of about 16% every year – with that amount of growth, a low price is not critical to success.

Theoretically, even if someone was to buy shares in the company ten years ago for the lofty valuation of 30 P/E (which we wouldn't do), and sell it in today's more reasonable valuation of around 15 P/E, he would still make a reasonable annual return of around 10%. This shows that such companies have inherent margins of safety that are not so much part of the valuation but a part of the business itself.

Next in line are the reasonable companies. A reasonable company might have a great business, but no more growth. Or maybe it has a lot of potential growth, but not a lot of profitability in the business. At any rate, holding such a company for extended period of time would be much less profitable than a great company that is both a great business and grows at a healthy pace.

So why invest? Because occasionally, some of these companies are available at a very low price. When price normalizes, we make a hefty profit. Historically we were satisfied with an initial return of 20%, or 5 P/E. This has not proven to be conservative enough, since in some cases, there are setbacks and cyclicality that might lower the value further. Some performed well at the end, but not before providing us with the opportunity to buy more at much lower prices.

As a result of the above, we no longer consider buying such companies for anything less than a 3 P/E or equivalent. Such a price should better compensate us for the lack of other return drivers, provide a much bigger margin of safety and higher returns.

As for "cigar butts" (as Buffett buts it), our take is that we only buy the ones we cannot realistically lose on. It might be achieved by buying certain debt securities, or other instruments that make sure that even if the business goes under, there are enough assets to provide a cushy return. Generally, we do not invest in such companies unless there is an unusual opportunity.

Ideally, we would like to have as many great companies as possible in our portfolio, and supplement them with some reasonable businesses at a bargain basement price.

We manage a concentrated portfolio, which means that there is not necessarily much correlation with the markets at any particular period. In any market index there is a wide distribution of returns for each constituent of the index, which means that in a market that provides a 10% return there are specific stocks that provide a 100% return or a -50% return in that year. Since we buy only a few out of thousands of potential stocks, we do not fully participate in the return or the risk of the general market.

What we do participate in is the financial performance of our own portfolio, which I'll be happy to discuss in the shareholder section. But before we do that, let us discuss a recent success story of ours, the investment in Strayer Education (STRA), and a less than successful investment, Altisource Portfolio Solutions S.A.

Altisource is a provider of real estate services, a capital light business model that experienced tremendous growth since it spun off Ocwen Financial. Ocwen would buy mortgage related assets, and Altisource would manage those assets for a fee. All went well until the regulator decided to investigate Ocwen for mishandling the management of the assets they acquired and the share price collapsed in 2014.

After investigating further, I determined that the regulators had essentially no case – the company performed relatively better than almost any of their competitors in managing the assets, and were only singled out because they managed one of the highest default rate portfolios in the industry – a fact that was also making huge profits for both Altisource and Ocwen as they modified the mortgages and mostly kept people in their homes. The complaint rate coupled with big profits were attracting regulatory attention.

As a result, I decided to invest. Soon after, the regulators decided to punish the company in an unusual manner by preventing them from investing further in their main line of business, and sending in a team of investigators that sat inside Ocwen's offices for two years – and the company paid for it. The regulators also effectively removed Ocwen's Chairman and founder.

This highly unusual action (these investigations historically ended with fines and some business practices modifications) meant that Altisource had now a declining revenue stream from Ocwen instead of a growing one. The stock went down even further to levels that did not make sense considering that there was a predictable and virtually guaranteed revenue stream for over 10 years forward. I decided to buy more shares at that point, since I believed that the regulatory investigation would not uncover anything special and at some point, growth will resume at Ocwen after the company is cleared.

I was not wrong that the company would be cleared. After about two years of investigation sitting around in Ocwen's offices, essentially nothing was found and the regulators moved on. The stock price climbed on the good news. Before the company could go back to business, multiple local regulators sent notices that they are suspending the ability of Ocwen to do business in their state. This is the second time something highly unusual happened without any good explanation to back it up – a federal regulator had just spent two years going through everything and found nothing, and now others are coming back with the same allegations. At this point Ocwen went to court, but the damage to Ocwen and its business was already done, affecting our investment in Altisource.

Altisource had good management, and they succeeded in expanding the non-Ocwen business of the company, preserving most of the cash flows. But growth never returned and it is unclear if it would ever return, considering that at some point Ocwen seemingly lowered the level of working relationship with Altisource, which means they would not necessarily get to benefit from any future business at Ocwen. In addition, building new business is a slow, risky proposition and we are not in the business of investing in start up businesses.

The lesson to learn here is that we should avoid businesses with high level of regulatory scrutiny, because the business will lose value even if no fault is found.

3 years after we first became investors, I decided to sell at a loss. Selling was not an easy decision, but at the same time we had the opportunity of investing in a great business at a bargain basement price, a once in a decade opportunity (more on that in the next section of the report). I would just mention here that we are talking about a business with around 30% ROIC, growing at 10-15% annually, trading at a price to earnings of 6 – an amazing bargain. And it is getting better every year.

This year we exited our investment in Strayer Education. Strayer has proven to be a very good investment, returning around 100% in 3.5 years of ownership, which is 20% annually. Strayer is a for-profit university. The for-profit education industry experienced a boom and bust cycle, with most of the industry disappearing except several players who were not complicit in the wide scale abuse of the federal funds directed to higher education. Strayer is one such company.

The company was acquired at the P/E of 10 with the expectation that once the cycle is over and growth resumes, the shares would be repriced to a higher multiple. The company indeed returned to growth in 2017, and the stock was repriced to a more suitable P/E of 20. The company deserved a 20-25 P/E because it had an ROIC of 30-50%, plus the potential to double profit only on higher utilization of the current infrastructure with zero investment. I could have happily sit on the shares for many years, enjoying the growth and good returns.

So why the decision to sell? In late 2017, management made the decision to merge with another company of similar size. The other company does not grow, and that lowers the overall growth rate. The merger makes some sense for both companies, but it makes less sense for long term holders at this price. There is also some risk at combining two large businesses, and we may yet return to invest in the company if it is attractive in the future.

Before we part, a few words regarding the market in general. Ronit and I still see a lot of opportunities in the current market, mostly in traditional industries such as real estate and manufacturing. We have a lot on our plate to look at as we go into 2018, and we both would like to thank our shareholders for placing their trust in us and taking part in our journey.

Eduard Gorban Ronit Ezr