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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%
2018	(8.9%)	(4.3%)	(14.8%)
2019	(12.4%)	33%	24.2%
Compounded annual gain	4%	15%	7.9%
Overall Gain	36.6%	206.6%	84.2%

"If you have a 150 IQ, sell 30 points to someone else. You need to be smart, but not a genius"

Warren Buffett

Dear shareholders,

In 2019, NAV decreased by (12.4%) compared with an increase of 33% in the S&P500, including dividends. MSCI Europe increased 24.2% including dividends during the same period.

2019 was a bad year for us, both on an absolute and relative basis. Some of the underperformance was due to unforced errors made this year in several investments. This warranted some thinking, the result of which is the following disquisition.

Before we begin, I will say that as a partner on equal terms and with the same results, with all of my investable capital. It pains me if we don't get the right results, and I am doing my best to get there.

I will first discuss the structural reasons for the underperformance, then the specific mistakes made this year. Finally, I will close with some things we did right, and what will be done differently in the future.

In the 2016 annual report, we made a resolution to avoid selling prematurely (under normal circumstances), since in most cases we would have benefited more by waiting.

In the 2017 annual report, we discussed two types of investment situations we were looking for - great companies at a reasonable price, and reasonable businesses at a very low price.

As a result of the above, a dilemma arose in early 2017. We already had a number of investments that were below our new standards, and yet selling too early seemed like the wrong thing to do.

I decided not to rush and to let the investments mature as originally intended. That was a mistake. In retrospective I should have sold immediately and redeployed the money elsewhere. I even remember having exactly this conversation with Ronit two years ago, as she urged me to sell and move on. But the sale timing, while significant, was not the major issue.

Originally, we were willing to compromise on quality if it meant we would get a bargain price. However, in retrospective, there is no bargain price for some things.

The reason for this is mentioned in the 1989 Berkshire Hathaway annual letter:

"My first mistake, of course, was in buying control of Berkshire. Though I knew its business - textile manufacturing – to be unpromising, I was enticed to buy because the price looked cheap. Stock purchases of that kind had proved reasonably rewarding in my early years, though by the time Berkshire came along in 1965 I was becoming aware that the strategy was not ideal.

If you buy a stock at a sufficiently low price, there will usually be some hiccup in the fortunes of the business that gives you a chance to unload at a decent profit, even though the long- term performance of the business may be terrible. …"

Like others before me, for a time I tried my hand at catching bottoms. For this annual letter, I sat down to summarize my results investing in these types of situations over the years. The results were a mixed bag of profits and losses – especially in recent years.

Of course, I can point to years of personal success doing exactly this in the past. I can point out other investors who have done the same, such as Bruce Berkowitz of the Fairholme Fund. To cling to this would miss the point, which is that this is simply not an ideal (as Buffett would put it) way to invest as a whole – even if it can and has been successful in the past.

For a while I entertained the idea that if I paid less or maybe sold "at the right time", results would be superior. The problem is that for an inferior business, predicting future results is extremely difficult and so is determining fair value. What seems cheap today may prove to be expensive later, and knowing the "right price" to buy at is nearly impossible in practice.

There have been multiple examples of this over the years.

In early 2009, there were many opportunities to invest. Naturally, the lousy businesses lost much more value than the good and the great, which made it seem like buying the bad ones was a better choice. After all, if something went down 95% with the business substantially intact, it has to be better than something that went down "only" 50%. Right?

Wrong. In practice the better businesses grow stronger during downturns, so they are worth more on the way out. Weak businesses simply stay weak or get worse. This can be seen clearly in the case of Pra Group (PRAA) compared to Asta funding (ASFI). Both had near identical results from 1999 to 2008, but from 2009 to 2018 the two businesses completely diverged. PRA group's business grew 300%, and the stock rose 500%, while Asta funding's business stagnated and shrunk together with the stock price. Back at 2009, ASFI was trading at a quarter of the valuation of PRAA, with essentially the same financial results, size, and pretty much every other parameter.

The big difference was in the management, which built a high-quality business compared to a low quality one. For example, PRAA had its own in-house collection teams while ASFI relied on outsourcing. As tempting it is to point to the cheaper business as the better deal, it is just not the same business in this case. Sometimes quality dictates a lot in terms of results, and how quickly these are achieved. This quality difference was quite obvious for anyone reading both companies annual reports.

Another example is SL Green (SLG), owner of around 12% of the office space in Manhattan, New York. The company had an affiliate named Gramercy Capital Corp (GKK) which was a more leveraged and profitable entity in 2004-2007. Once the 2008 crisis was in full swing, GKK was harder hit than SLG. However, given that GKK's stock price took a much bigger hit the relative valuation was in its favor. Even so, SLG recovered very quickly and by the end of 2009 the stock price was almost back to fair value, delivering a 400-500% return in less than a year. In comparison, GKK limped on, eventually producing a 100-200% return over many years and after many changes in the business.

So not only that the better business grew stronger, it also got to fair value faster – and at a lower risk.

I say lower risk, because over the years I've seen very few high-quality businesses that got into serious trouble. The low-quality ones get there almost by default, and only about half of them eventually crawl out of the hole. A few never do, and many linger as zombies to lure investors to their doom. Even the cases that ended well took many years, and the end result was highly dependent on the entry price.

Investors who were lucky enough to buy these at the bottom made many times their money, while others sometimes lost theirs – it all depends on how bad it got before it got better, and how much time has passed. In the case of Enterprise Inns, it took 10 years until the business was eventually sold – for much less that its 2007 price. Sure, if you bought after 2008 you made some money – eventually.

This example illustrates the main problem – if a cheap price is the only hope of the investor to make a profit, time is of the essence. When to buy and when to sell becomes critical and in my experience, is mainly a function of **luck, not skill**. Certainly, some have had good result with it for a time, but their luck invariably runs out. Not to say that a low price can't help, but cheap things have an annoying tendency to become even cheaper in too many cases, for too long. Great businesses have the opposite tendency – they tend to get more and more expensive. Better catch them early!

Another advantage of the superior business is free cash flow. It would seem like the cheaper the business, the more buybacks it can make of the stock. This is often deceptive, as the low-quality business often directs cash towards debt reduction, pension plans, capital expenditures, working capital, lawsuits, and plugging various holes in the business. And the cash never seems to be quite enough – hence the cashflow is in a sense **not free**.

In contrast, a good business generates free cash, which goes towards dividends and buybacks. The higher the ROIC, the more excess cash a business tends to generate, and the higher the valuation can be. Add in good management and a bit of growth and results can be amazing.

The last advantage of the good business I would like to mention is the ease of identifying one. This might seem odd, but we all know a good business when we see one – clients are happy, sales increase, management is thrifty, debt is low and shareholders get paid. The business is seen by many as "necessary" and is such in reality. Few if any can compete with it on equal terms. You don't need to be a genius to know one when you see one.

In contrast, a bad to mediocre business is often impervious to analysis and projection. Sales might go up – or not. Competitors might lower prices. Regulators are looking for issues. The CEO might make a stupid acquisition, or buy back stock at a high price. All of these risks again make valuation difficult. Identifying whether the negatives are really "priced in" is quite hard in such cases, in contrast with a great business that has one or two temporary issues, such as Coca Cola, American Express or SL Green in their respective histories. The worse the business, the smarter one needs to be to value it.

All of which leads me to the quote at the start of this disquisition – investment analysis should be always reducible to a simple thesis. As impressive as a long, detailed and well researched investment pitch can be, it is not by being smarter that we are going to make profits. It is mainly by buying a few great businesses at reasonable prices, then sitting on our respective bottoms and just saying no to the rest. Sounds easy, but is not. There are plenty of things coming at us and saying no to 99.9% of them is no small feat. But that is what is expected of us.

As mentioned before in our 2017 annual letter, time is a great friend of the great business – we can get growth, dividends, and an increase in the share price over time at a low risk. This is in practice superior to buying super cheap junk, then trying to resell it for more while time is working against us. Hopefully we have demonstrated that clearly enough in practice as well as in theory.

Now to address some specific mistakes made this year:

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"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."

Warren Buffett

We identified a number of very cheap assets - SandRidge Energy Inc. (SD), Resolute Forest Products (RFP) and Contura Energy Inc. Warrant 2023 (CNTWW). SD and RFP had great management teams at the helm – with Carl Icahn and Prem Watsa respectively controlling the businesses and calling the shots. Contura had a more mediocre management team, which seemed acceptable considering the company was newly formed after a 2016 bankruptcy, with the senior bondholders now in charge.

Unfortunately, in SandRidge Carl Icahn refused to sell the assets. He paid 17$ per share and received offers at 13$ (we paid around 9$ per share, less than half the PV-10 NAV). Since it would be many years until anything happened, and the company would not gain much value in the meanwhile, we had to sell at a loss (6.7$ per share). It would have been a mistake to remain considering that the company was not liquidating, contrary to previous indications.

RFP encountered tough pulp and lumber markets in late 2019, which reduced cash flows from 300M$ to 50-100M$. It will be a while until the company is able to pay out generous dividends as it did in 2018. In the meanwhile, the valuation moved from cheap to ridiculous, costing us a lot on paper.

However, the biggest mistake this year was buying the warrants of Contura. The company itself was leveraged to the price of high-quality metallurgical coal, and we added additional leverage with the warrant. Unlike the other two, here it ended up a near total loss, although we retain a small position still as the warrants expire in mid-2023.

Overall the "bottom fishing" group had cost us much in terms of performance this year. It is my own fault entirely. It is also something that is fixable.

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“The definition of insanity is doing the same thing over and over again and expecting a different result”

Albert Einstein

And now to the good news.

As we change the way we select investments, our results would change as well. Starting today, we would require all of our investments to be of superior quality. We would not consider inferior businesses with superior managements, as was the case with RFP and SD. We would implement our own version of Buffett’s punch card system and will not shy of holding cash until we find something great.

The clear preference would be towards businesses that are growing, high ROIC while being reasonably priced. These should have a durable competitive advantage (moat) and good management teams. Currently around 80% of our portfolio is in this category, compared to only around 35% a year ago.

The other group of companies that we would find desirable in our portfolio are certain low risk situations, without major growth prospects but with strong downside protection. These are toll road-like businesses, where nothing spectacular happens but the cash keeps coming in. Currently 13% of our portfolio is in this category, compared to around 6% a year ago.

Of our top 5 holdings, 4 are in businesses we have held (profitably) for years and are very familiar with. The fifth business is a more recent addition, with the same superior characteristics as the others (more on that in the portfolio section). These top 5 holdings are currently around 2/3 of the portfolio.

As you can see, we made significant changes and would expect different results going forward.

Ronit and I would like to thank you for being patient and understanding during this transition. Your support means everything to us, and makes it that much easier to do our job to the best of our ability.

To better days ahead!

Eduard Gorban Ronit Ezr