IRONVINE
CAPITAL PARTNERS, LLC

2012 Yearend Letter to Clients

January 21, 2013

To our investors and other interested parties:

Our accounts averaged returns of 2.40% in the fourth quarter, bringing our year to date totals for those accounts that have been invested with us all year to 15.30%. The S&P 500 fell -0.38% during the quarter and finished 2012 up exactly 16%. As is custom, we note that these returns are calculated after fees, and are presented on a total return basis.

We would categorize 2012 as satisfactory. While our performance lagged the major averages by a bit more than half of a percentage point, the rate of return our portfolio generated would result in a doubling of our capital base in less than five years. Moreover, we did this without the use of leverage, and with a cash hoard that averaged 28% throughout the year (calculated by averaging month end cash balances). Most importantly, however, is that all of our portfolio companies—whose number now stands at 13—continued to compound capital at attractive rates of return, are well managed, and remain reasonably priced.

Here we'll remind readers that we are business buyers, not market practitioners, and because so, we deliberately avoid the institutional imperative of being fully invested based solely on the fear of missing out—instead, we let the robustness of businesses and the prices where those businesses can be obtained, dictate our level of exposure at any given time. Naturally, this posture will result in us holding some cash during long stretches of rising prices. But prices can fall too. A value investor named Jean-Marie Eveillard once said, "I would rather lose half of our shareholders…than lose half of our shareholders' money." We find this quote particularly useful as we build our portfolio business by business, paying special attention to price, and ignoring all else.

You should all have received your individual account(s) performance under separate cover by now. If you haven't, or if you have any questions related to the data therein, please let us know. Additionally, if you would like to discuss our portfolio companies or investment process in greater detail—whether you are an investor or not—we would be happy to arrange a discussion.

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We recently made a sizeable investment in a company whose stock has grown quite out of favor with the masses. Some label it a 'value trap'. Others might defend our actions, classifying our behavior as contrarian. Whatever the case might be, we will allow time, operating progress and a stock price that will ultimately trade in line with underlying business value determine the victor.

This business is hated by many. It is made fun of at the water cooler and in comic strips alike. The CEO's job is often called for on a platter—similar to how heads were in Biblical days. We've read dozens of accounts of its imminent demise in the last two years. Below we highlight just a sampling of remarks we've heard directly or seen written about this business. I think these do an excellent job of summing up the consensus view:

- The business is in a slow, yet inevitable, decline
- They can't grow anymore
- They [the CEO and Chairman] don't care about investors
- I wouldn't buy that stock at any price
- I don't think so…It [the stock] hasn't moved in over 10 years!

In the past, we too have been guilty of such slander. However, late last summer, we commenced a thorough interrogation. Our work began by asking:

- Is this business really in decline?
- What if the decline—viewed as terminal in nature—is less severe than the masses expect?
- Better yet, what if isn't in decline at all? What if it maintains its dominant position?
- Or*, what if it increases its dominance and continues growing*?

The investor, philosopher, and great man Charlie Munger has on many occasions told crowds of students to "invert, always invert". What does that mean? It means that people—investors included—can make better decisions if they isolate the handful of things capable of sinking a hypothesis, and then try to disprove them.

An abbreviated account of four months' work spent trying to do just this [disprove the consensus] follows.

- Consensus viewpoint: The business is in a slow, inevitable, decline

Does a business with highly recurring revenues, a market share that exceeds 90% in its core segments, and stable gross margins that have averaged 80% since 2005 point to an organization in structural decline? After heavy investment in research and SG&A (this business expenses annually what others might attempt putting on their balance sheet and amortize over many years), adjusted operating margins at this company approach 40%. So far so good—but let's investigate their capital efficiency, or return on capital. This is without question the best measure of a firm's competitive advantage which we calculate two ways—using *total* capital, and *tangible* capital. Again, since 2005, returns on total capital have averaged 34%. Returns of 26% in 2012 appear low relative to the average, but a cash position that has grown from $23 billion (that's billion) at the end of 2008 to $63 billion in 2012 will do that to any calculation with total capital in the denominator. After removing excess cash, goodwill, and other intangible assets that require no investment to sustain daily operations (such as a plant or piece of machinery that suffers wear and tear with each use), this business generates returns on capital that exceed 300% on average and, in 2012, produced an astounding 529% return. In layman's terms, this means that for every dollar invested, this business spins off, on average, over $3 dollars in income *after taxes*. Working from operating income (an accounting term) to free cash flow (real world profit), we note that this business enjoys low capital intensity and, as such, free cash flow tracks operating income very closely. Looking at free cash flow as a percentage of tangible capital reveals that for every dollar of capital employed, this business spins off an average of $3.74 in free cash flow after everything—capital expenditures, interest expense, changes in working capital, and taxes. Do these economics imply a business suffering from a deteriorating competitive position? It wouldn't appear so.

- Consensus viewpoint: They can't grow anymore

How many businesses have been able to grow revenue at a 9.2% compound annual rate for the last seven years? Not many, but this business is one of them. Computing this same number over a four-year period—incorporating the effects of the Great Recession—reveals a resilient 5.1% average annual growth rate. Moreover, this business is fighting the law of large numbers that makes growing off a $60 billion revenue base (in 2008) tough. After the heavy investment in research and marketing that we note above, operating income has still been able to grow faster than revenue and, due to an envious negative working capital position and truly global business driving a low cash tax rate, cash flow from operations and free cash flow have grown at 10% and 12%, respectively over the last four years. Note that these are absolute numbers. This business is also a consistent cannibal of its own shares, retiring 2-3% of its float on a net basis after issuing shares to senior employees for compensation. Thus, on a per share basis, this business has grown free cash flow per share at an annual clip in the mid-teens over the past four years. Is this business struggling to grow? It doesn't appear so.

- Consensus viewpoint: They [the CEO and Chairman] don't care about investors

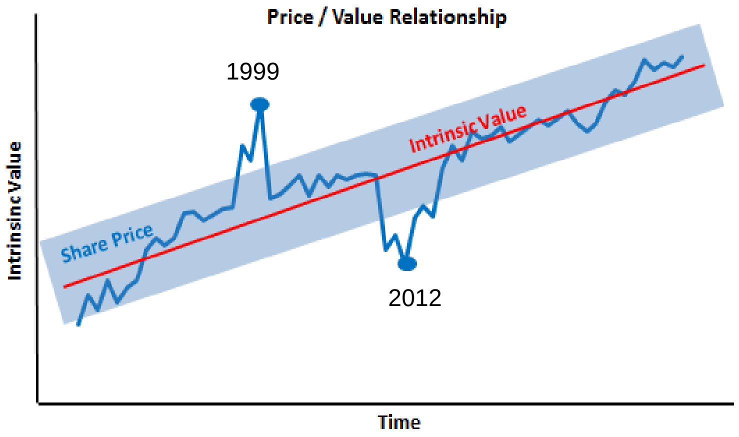
This was one of our largest indictments of the company before embarking on our search for answers. A careful study of history disproves our original thinking. Since 2005, this business has bought back over $100 billion dollars of its own stock on a gross basis (ignoring shares issued for compensation). Investors are better served computing *net* buybacks, however, which takes into consideration how much of the company's equity the board has given away to employees in the form of stock compensation. The two can differ materially and some businesses that I won't call out in this letter are guilty of leading us astray. Using this yardstick, the business has bought back a still-very-impressive $80 billion worth of stock. In addition to substantial share repurchases, the company has also returned over $68 billion dollars to investors in the form of dividends since 2005. In aggregate, close to $150 billion dollars in capital has been returned to shareholders over an eight-year operating period—an amount equal to 65% of today's market capitalization. You might be mumbling 'hang on…here is a business with a dominant competitive position that has 40% operating margins, requires almost no capital to run the business, spins off and then returns huge amounts of cash to investors….it must be trading at a valuation in the stratosphere.' Read on.

- Consensus viewpoint: I wouldn't buy that stock at any price
- Consensus viewpoint: I don't think so…It [the stock] hasn't moved in over 10 years!

These statements had a profound influence on us with respect to just how depressed investor sentiment towards this business has become. First, these 'never, ever' views are widespread—particularly amongst retail investors. But more broadly, they travel deep into the psychological wirings, thinking, and actions of the majority of humans that have capital invested in markets *where prices can be so readily obtained and acted on*—including highly paid portfolio managers. I think a question is worthwhile: Would you, the reader, opt not to purchase a highly profitable apartment building at a price that yielded you 15% on your cash investment because you feared that in one month you might not be able to sell it at a higher price, knowing full well that in five or ten years its value would be appreciably higher? This would be folly calculus. Are you shocked to learn, then, that many investors behave precisely this way much of the time?

Let's return to our business. Suppose I were to tell you that in 1999, this business generated $10.8 billion in operating earnings before depreciation and that this number had grown to nearly $31 billion at fiscal yearend 2012? This reads like a stock you would want to own—*but at what price?* You see, in 1999, the market was willing to pay a very high price for this growth potential. However, in 1999 at 42 times earnings, the underlying *business* could have performed spectacularly (and did), but the *investment* was highly likely to disappoint (and did). Fast forward 12 years, and the price to value relationship has done a complete 180. The business is larger, more competitively entrenched, and more profitable, yet the stock is shunned—often times for the sole reason that it hasn't moved in over ten years. More than a decade of price stagnation, in concert with tremendous business progress, has resulted in a price today of just 7.4 times that $31BB (and growing) in earnings. And after incorporating the company's substantial cash position, its asking price falls to just 5.2x 2012 operating earnings before depreciation. Of course, not all of this cash is accessible without becoming subject to an egregious payout to Uncle Sam due to his poorly founded repatriation tax laws. But you get the point.

The chart on the following page is one we like to show clients to help them better understand how we address valuation. The red line represents business value (something we refer to as intrinsic value). It moves steadily upward and to the right with time as corporate worth increases. The steepness of the red line is driven by how quickly a business is compounding capital—or, as we explained above, how high its returns on capital are. The blue line represents the price the market is willing to pay for a business. As you can see, prices can fail miserably at times to approximate economic reality. Our circle of competence is in buying high quality businesses run by outstanding management teams at reasonable prices. Graphically, we demonstrate this with the portion of blue shade that falls under the red line.



Rarely do we find outstanding businesses selling far below the blue shaded area—businesses we feel can compound capital at attractive rates of return long into the future, trading at substantial discounts to intrinsic value. We believe this to be the case today with this investment.

In our second quarter letter to investors this year, we wrote 'We value businesses just as we would a bond—by discounting a conservative estimate of the coupons we expect to earn over its life. Unlike most bonds, however, equities, if chosen wisely, don't have fixed coupons or maturities—*their coupons can grow into perpetuity*. Today's yield, plus a conservative estimate of tomorrow's 'coupon growth', provides us with an estimate of the forward return we hope to realize over our holding period. This is a useful analytical tool—equity yields allow us to compare new investment opportunities to those of the businesses we already own stakes in (in addition to Treasury yields, and the yields in other risk assets such as high yield credit or mortgage products).' Applying this exercise today, we observe the following:

- Cash in the form of US Treasury Bills yield 0%
- The 10-Year Treasury yields 1.83%

- The 30-Year Treasury yields 3.02%
- Investment grade bonds yield 2.7%
- Junk bonds yield 5.7%
- Bond yields are fixed
- The earnings yield on the S&P 500 is 7%
- Our business equity yield is 13%
- Adjusting for cash, its equity yield is 18%
- Equity yields float

Most would agree that this business appears to have superior absolute and relative investment characteristics. Without first knowing the name of the business, I would bet many would salivate at the opportunity to own it.

The business is Microsoft.

Investing requires us to manage our way through an uncertain future. There are varying degrees of uncertainty associated with different businesses. Competitive threats always exist, but we feel confident we've disproved the consensus view that Microsoft is a business in terminal decline. Importantly, the risk we took—and by risk, we mean the likelihood of Microsoft's value being permanently impaired—is limited to a large degree by the depressed price we paid for the business. That is, at a price of just 7.4 times 2012 free cash flow (5.3x net of cash), the future could diverge materially from our conservative assumptions *and we still don't believe we'll lose money*. The odds are heavily stacked in our favor. This, by definition, is the margin of safety Ben Graham urged investors to demand in his original writings, and it's at the core of our philosophy and how we conduct our operation.

Note: This letter is a reprint from July 30, 2012 while Matt Barnes was employed at McAdams Wright Ragen Inc. Ironvine Capital Partners, LLC was subsequently created and commenced managing client assets in November 2013. The Ironvine Concentrated Equity Composite was created on December 1, 2013, with an inception date of April 1, 2012. A review of the performance record for compliance with the portability requirements of the GIPS standards was completed by an independent accounting firm. The verification and performance examination report are available upon request.

Important Disclosure Concerning Performance Information:

Data used in this letter to compute average performance for the second quarter includes three (3) accounts that were being managed for the full quarter, and two (2) accounts being managed for the full year to date. At the end of the second quarter, there were 11 additional accounts being managed using this strategy but not included in the performance data because the inflows occurred during the quarter. These portfolios will be included in subsequent quarterly performance data. In the second quarter, account level performance was -0.48%, -0.38%, and -0.65%, respectively. YTD, account level performance was 9.59% and 9.69%, respectively. All performance figures reflect the deduction of fees. In both the second quarter and YTD periods, two of the manager's personal accounts were included. In these instances, the performance calculation adds back commissions paid then deducts a model fee of 1%. All portfolios have, and have had through the stated reporting periods, similar compositions in the positions held. The average was computed by summing the performance of each portfolio and dividing it by the number of portfolios managed for the full period. The data is strictly for illustrative purposes and is by no means indicative of or a guarantee of future returns. These performances figures have not been audited.

Equity index information is provided for informational purposes and is not directly comparable to your own account performance, which may differ substantially from any index shown. The S&P 500 in an unmanaged index based on the prices of 500 large-cap, publicly traded US companies, and cannot be invested in directly. The S&P 500 is more diversified, in terms of number of holdings and market sectors, than individual portfolios advised by MWR and does not contain non-equity assets, such as cash or fixed-income investments. We caution you that there are a number of significant differences between your own portfolio and the S&P 500 Index and that comparison is therefore appropriate only for limited purposes. MWR-advised portfolios typically contain cash equivalents in varying amounts at different times, in addition to equity securities. Diversification does not ensure against market loss and there is no guarantee a diversified portfolio will outperform a non-diversified portfolio.