

Classifying, Cataloguing, Collecting... and the Capital Cycle

This article is excerpted from a letter to partners of [Boyles Asset Management](#).

“The stamp collecting is important. ‘Even Darwin’s Journal was just a scientific travelogue, a pageant of colourful creatures and places, propounding no evolutionary theory,’ wrote David Quammen. ‘The theory would come later.’ Before that came a lot of hard graft. Classifying. Cataloguing. Collecting.”
-Ed Yong, “I Contain Multitudes: The Microbes Within Us and a Grander View of Life”

Warren Buffett has compared the investing process to investigative journalism, and it is that process of learning, collecting facts (and opinions), and trying to tie a story together into a theory about a business and its valuation that makes the effort an enjoyable one for us. The investing business is one in which the knowledge that a person learns on a given day may never be put to practical use; but it’s also one in which the lessons a person learns have the potential to be put to use continually throughout one’s career. Done correctly, the learning process is one of continuously classifying, cataloguing, and collecting information in a way that allows one to eventually connect the dots that lead to useful insights.

One of the things about which we continue to study and collect information is how the capital cycle has worked in various industries over time. The best treatments of the capital cycle that we’ve come across (though we’re open to other recommendations) are the letters of London-based investment firm Marathon Asset Management. There are two books containing the selection of letters we’ve read: 1) *Capital Account*, which covers the period leading up to and following the Technology, Media, and Telecom boom and bust of the late 1990s and early 2000s; and 2) *Capital Returns*, which covers the boom and bust leading up to and through the Great Financial Crisis that hit its apex in 2008. Ed Chancellor, editor of the collections of letters, provides a good summary to Marathon’s work:

“The key to the ‘capital cycle’ approach – the term Marathon uses to describe its investment analysis – is to understand how changes in the amount of capital employed within an industry are likely to impact upon future returns. Or put another way, capital cycle analysis looks at how the competitive position of a company is affected by changes in the industry’s supply side.”

So the key to capital cycle analysis is to focus heavily on the supply side within an industry, as opposed to the drivers of demand that normally get most of the attention. This dynamic is especially important in capital-intensive industries; and among companies that can be good businesses in the right part of a cycle, but that don’t have the wide-moat characteristics that are most desirable—and rare to find, especially at an attractive price.

While we enjoy the cataloguing and collecting of historical examples of things such as the capital cycle to help us navigate the future, the lessons that one experiences first-hand usually stick the best. And during the quarter, we exited our investment in Mastermyne Group Limited, which we have both followed and owned during the bottom portion of the current mining cycle. As we’ve followed it over the years, and had conversations with

management—from the tough times on through the tougher “darkest before dawn” times—we’ve gained a vivid example of how the capital cycle can unfold in the real world.

We bought shares of Mastermyne at various points from the middle of 2014 through December 2016, and sold the last of our shares in September. The average cost on our Mastermyne holding was approximately A\$0.24 per share, and our average selling price was approximately A\$0.53 per share, with dividends received pushing our average exit price up close to A\$0.55 per share. Our initial interest in the company was driven largely by a valuation that had the company trading at a discount to book value, a business that was still profitable, high insider ownership, and the mining services industry (especially underground coal mining, in Mastermyne’s case) becoming unloved. Companies throughout the industry were trading at close to 52-week lows, with many down 50-75% from the highest share prices they had reached during the boom that had peaked a couple of years earlier. As an illustration of how boom can turn into bust, the market cap of Mastermyne at its low point during 2016 was below its *net income* achieved in *each* year from 2011 through 2013.

As is often the case with value investors, we likely bought too soon, and sold too soon. The lack of interest from the investment community was evident last year as the stock price was trading in the range of A\$0.11-A\$0.23 per share from January 2016 through the end of September 2016, and the volume of shares traded was quite low. But just more than a year later, as there was some improvement and a little light at the end of the tunnel, the company was able to increase its share count by about 11% by issuing 10 million new shares of stock at A\$0.60 per share in a placement that “was heavily oversubscribed.”

Some new work, a better business pipeline, and some renewed interest in coal from China this year on the demand side helped lead to the improvement in the business. But the catalyst for the dramatic change in sentiment and stock price for Mastermyne has its roots in the capital cycle. While the company has a number of competitors in different areas of its business, it had four main competitors in underground coal mining services, which comprise its core. One of those competitors left the industry a couple of years ago early in the cycle due to problematic contracts; another started to shift away from underground work as conditions became difficult; and yet another is fairly small and has become less active in the tendering process for new work. But the last of the four competitors served as the key catalyst to Mastermyne’s improving fortunes, as that competitor, after a period of struggling, went into administration (Australia’s equivalent of bankruptcy) earlier this year. Besides the decrease in competition, Mastermyne was also able to take over the work that this bankrupt company had been performing for its key remaining project.

The word “compounders” is the term often used to describe the types of businesses we prefer to own: high-return-on-capital businesses with reinvestment prospects and competitive advantages that protect those high returns on capital. But, we firmly believe that almost everything can be a good value at one price and a bad value at another, and that the best opportunities often come by looking at things that are unwanted and unloved by most. So, we’re willing to venture into other areas and “non-compounder” types of businesses, especially when attractive prices are combined with well-incentivized management teams and conservative balance sheets to create situations in which significant upside might be available with little or no ultimate downside. We believe this mental flexibility can be an important advantage to us as investors. We hope that our experience with Mastermyne and observations about how the management team was able to navigate the extreme lows that followed an extreme boom will help us going forward. And while it would be nice to see the cycle starting to turn before investing in similar types of businesses, the market often re-prices things before one has a chance to see the turn. Or as Warren Buffett wrote in October

2008, about five months before the U.S. stock market hit its low, "...if you wait for the robins, spring will be over."