

Bryan Lawrence on the Investment Philosophy of Oakcliff Capital

We had the pleasure of speaking with Bryan R. Lawrence, founder of Oakcliff Capital, based in New York. The conversation took place in April 2021.

In the following wide-ranging interview, John speaks with Bryan about Oakcliff's investment strategy, Bryan's thoughts on resilient businesses, the value of having the right partners, the evolution of Oakcliff, the firm's opportunity set, Carvana as a case study of Oakcliff's approach, Bryan's thoughts on selling or trimming an investment, and much more.

John Mihaljevic, MOI Global: Bryan Lawrence is the founder of Oakcliff Capital, an investment partnership that invests in publicly traded securities. Bryan is also a member of Yorktown Partners, LLC, a private equity firm that invests in energy businesses, and he serves on the boards of several Yorktown portfolio companies. Bryan is a co-founder and trustee of Public Prep, which develops and manages charter schools in New York City. Bryan's analyses of U.S. government finances have been published by The Washington Post, and I'm sure the MOI Global community appreciates the insights and wisdom Bryan has shared with the community in the past.

Most recently, I'll just draw your attention to an [essay](#) of Bryan's that is available on the MOI Global website; it shares Oakcliff Capital's reflections after sixteen years in business. We'll get into some of those reflections and lessons learned, but Bryan, perhaps we could start with a simple question. How would you describe Oakcliff's strategy?

Bryan Lawrence, Oakcliff Capital: Before we do that, John, I want to say that I have such respect for *The Manual of Ideas* and the community you've built. When an issue arrives, it's required reading at Oakcliff, and you have done a terrific job organizing it. Thank you for having me.

As for Oakcliff's strategy, our objective is to be long-term investors in a concentrated portfolio of undervalued, high-quality businesses. We invest in high-quality businesses so that we can have a high degree of confidence in our estimate of long-term earnings power, intrinsic value, and margin of safety.

To get to that confidence, we spend a lot of time doing intense primary research with the objective of becoming the best-informed investor in anything that we own. We combine that research effort with a discipline of making infrequent decisions when the odds are in our favor. We consider ourselves productive if we make two new investments a year.

If you were to sit in Oakcliff's office, it would look like a library most of the time - a lot of reading going on - punctuated by conversations with competitors or customers or ex-employees of the businesses we own or would like to own. We talk with the CEOs of our younger businesses that are creating new products and markets, like Carvana and Cardlytics, to better understand their vision, but talking to management is only partially useful. CEOs tend to make optimistic public statements that avoid the issues they are facing, and Reg FD means that anything a CEO says to one investor has to be shared with all investors. So we spend less time talking to management teams and a lot of time talking with competitors, customers and ex-employees, where you are more likely to hear candid views about the bad as well as the good.

The businesses we look for tend to fall into three categories. We like two-sided markets, as they are difficult to establish but add a lot of value to both sides and to shareholders when they do get established. We like lowest-cost operators in fragmented industries where the cost advantage is

sustainable and the business has a long runway of market share gains. And we also like companies with pricing power, which generally means a product with either increasing or high utility relative to cost and an industry structure that allows the business to raise prices in excess of inflation.

Businesses in these categories tend to trade at high multiples, but we have been able to find some before they were obvious to other investors, which has been very profitable. We have also been able to buy shares in some when they have been experiencing selling pressure from other investors worried about some temporary misconception.

We are proud of our results. A dollar invested in our partnership in 2004 has compounded to \$14 today. For our limited partners, \$1 invested in 2004 has compounded to be \$8 today, compared to \$4 if they had invested in an index fund.

We have delivered these results while holding large amounts of cash. We hold cash when we can't find a great business at an attractive price and because we might find something tomorrow. Our cash has averaged 16% of assets but in market downturns has gone as low as zero. We are never going to use leverage at the partnership level because it can cause you to do things you don't want to do at exactly the wrong time. Why would we want to risk that, rather than compound capital at a decent pace and have ready money when others do not?

Also, our results have been tax-efficient because we sell investments infrequently and usually after a long hold period. More than 90% of the gains have been unrealized or long-term. Our confidence in our strategy is high, and we intend to keep doing what we do.

Mihaljevic: In your 2020 letter you talk about the resilience of businesses you owned going into the Covid crisis. How do you think about resilience?

Lawrence: We try to build resilience in multiple places. The first is that the high-quality businesses we invest in tend to be resilient themselves. If you take Charter as an example, we originally invested when there was a concern in the market about the ability of 5G wireless internet to replace cable internet. We did a lot of work on the physics and economics of wireless internet and thought this concern was overblown. So far, we have been proven right about cable having a wide moat relative to alternative ways to get internet into most US homes. Charter is the provider of internet to a little more than half of the 52 million homes its network passes and they are likely to connect more of those homes over time and to raise prices steadily on the connections they do have. This is a wonderful position to be in. You won't easily persuade a family to turn off its internet. Try to do it and see what your children say.

Going into the pandemic we felt we had a solid investment case for owning Charter as it continued to connect more homes and to demonstrate pricing power. People protest that their cable internet bills are too high, but with the average American watching more than four hours of video a day, that internet bill is maybe 60 cents an hour for the internet connection that allows all that streaming to happen. It's hard to find another form of entertainment that cheap, and this means pricing power for a long time to come, which makes Charter a great business we are happy to own at its share price.

What then happened with the pandemic is that the utility of Charter's internet connection to all those homes went from high to essential. One of the unsung successes of American business in the pandemic along with the rapid vaccine development – maybe this will be explored by historians – is that when so many Americans went home, it shifted the use of the internet from their broadband connections at work to their broadband connections from home. Yet, the connections to the internet from tens of millions of homes provided by Charter and other internet providers did not break. Gigabytes consumed per household went from 400 a month to 700, and yet the Charter network was able to

provide all of that.

We had a similar experience with Carvana. We went into the crisis with a lot of confidence in Carvana's unit economics and its customers were awarding it a Net Promoter Score of 82. The only Net Promoter Score we've seen higher than that is Tesla, which is almost like a religion. A Net Promoter Score of 82 in the used car business, which is not known for a great customer experience, is amazing and explains why Carvana's sales before the pandemic were growing so rapidly. We spent a lot of time studying the unit economics in markets they had entered early, like Atlanta, and could see they were already making money in places where they had local scale. What the pandemic then did was to make the idea of going to see five used car salesmen in person, which already wasn't high on the list of many Americans, become even less high on their list. And so more people are willing to try buying a car online, and Carvana's business grew stronger.

Glenn Greenberg, who is a very smart and experienced investor I worked with, would say that there are good surprise companies and bad surprise companies. There are surprises in life, but what you will find over time is that better businesses and management teams tend to have more good surprises than bad ones.

We also have sources of resilience at the partnership level. We keep large amounts of cash on hand when we cannot find attractively priced investments, and that cash serves as dry powder in a market downturn. In addition, our partners provide us with patient capital, which allows us to make rational, long-term investment decisions, especially in a crisis. Our patient capital began with money from the Lawrence family, and now comes from requiring new limited partners to have a three-year lockup on half of the capital they invest with us.

Our patient capital allows us to take advantage of opportunities other investors have to avoid because of the pressure they face to deliver short-term performance. We think that having great partners and patient capital is a competitive advantage that has been a key driver of our historical outperformance, and is especially important in a crisis when other investors are facing redemptions.

To modify Ben Franklin a bit, we think that the three best things to have in a financial crisis are a well-researched list of great businesses, great partners, and ready money.

Mihaljevic: You make this point about the value of having the right clients. That needs to be underscored, and I know some of our audience is already much attuned to that. But there's also a large swath of the investment world that believes AUM is a commodity and doesn't think about investors as partners. Why is that so important to you?

Lawrence: To start, thinking about clients as though they're some sort of commodity is morally wrong. It's their money, and it is our job to protect and grow it. Also, many of them are doing admirable things with their money. Endowments, foundations, and wealthy families funding things like medical research or need-blind admissions are not a commodity.

There is, however, a distinction which is important. Some clients add more value to an investment firm than just the fees that they pay. Patience from our clients has helped us make rational, long-term investment decisions during periods when the market prices of our businesses have not reflected their underlying value. Clients who see a relationship with an investment manager as an opportunity to make money over the long term, with an option to add more money in a downturn two or three times each decade, are the opposite of a commodity.

There's also a lot of evidence that clients can be their own worst enemy. The Wall Street Journal ran a story in 2009 describing a study that Morningstar had done on the difference between returns

reported by investment managers and returns experienced by their clients. The story highlighted the best performing mutual fund of the 2000s, Chris Heebner's CGM Focus Fund, which compounded 18% annually during those ten years. But Morningstar calculated that Heebner's clients lost 11% annually.

The reason for this was that Heebner's great returns were volatile, and clients able to realize daily liquidity frequently sold after the fund had performed poorly and bought after it had performed well. The result of their market-timing was a negative 29% compounded return relative to the value that Heebner added. That is an astonishing result and one that we want to avoid for our clients.

Heebner's clients made those poor decisions because of deep forces in human psychology. Many people are driven by fear of loss when share prices are declining and by fear of missing out when they are increasing. These fears frequently overcome rational thinking. Anyone who has beaten the market picking stocks - and this includes Warren Buffett himself - experiences volatility in short-term results. Many people do not respond well to volatility.

We are trying to recruit partners who think about investing the way we do. That is why we ask that new limited partners agree to a three-year lockup on half of the capital that they invest with us. They can use the other half for liquidity or portfolio balancing, and they can take 6% out each year of the locked-up capital, but we want them to put an investment with us into a psychological place that is long-term.

Over the long term, we believe that we will deliver good returns to our partners. We think that what we own today is discounting a gross ten-year IRR in the high teens, and if clients add in the downturns, they may see even higher returns. In the next downturn, we will reach out to existing clients and allow them to invest additional capital entirely with no lockup. We will limit capital raised to an amount that we can invest profitably and give priority to existing clients. Given our concentrated portfolio, it's important to not let assets under management get in the way of investment returns, and we will be loyal to our existing clients.

How great would it be to reverse the astonishingly bad experience of Heebner's clients? We are working hard to generate returns over the next sixteen years like we have seen over the past sixteen, and we will be proud if we succeed. We will be even more proud if we have generated returns higher than our own for clients who add money in the downturns.

Mihaljevic: I know Oakcliff started in 2004 with a \$6 million investment by the Lawrence family. That family capital has grown to more than \$175 million invested in Oakcliff, so you are quite aligned, if I may say, with all the limited partners. How has Oakcliff grown and what is its relationship with Yorktown?

Lawrence: We set Oakcliff up in 2004 to invest money I had made as a banker at Lazard and money coming out of Yorktown, a private equity firm started by my father and his partners that invests in energy companies. The Oakcliff strategy was a good way to diversify family concentration in private equity and energy.

The inspiration was really Shelby Cullom Davis's example. He started investing in the late 1940s with maybe \$200,000 of his family's money. He never accepted any outside capital and compounded that money by investing in stocks to more than \$800 million by the time he died in 1994. It was something like a 19% annualized return for almost fifty years. We have compounded at 17% gross since inception compared with his 19%, but he used margin compared with our preference for cash on hand. I am proud of our results so far and we have another three decades to see if we can match his record.

The \$6 million of family capital we started with grew as my family, people affiliated with Yorktown

(general partners of the firm, CEOs of our businesses), and others who knew me added capital. People would read Oakcliff's letters, have confidence in what we were doing, and invest. By the end of 2020, the total amount invested was \$62 million, we had distributed \$50 million and there was \$290 million still in the partnership.

We are very aligned with our limited partners. John and I each have well more than half of our net worth invested in Oakcliff. Our objective is to compound at attractive rates over the long term and we are excited by the returns we see on Oakcliff's investments from here.

In 2013 I began spending time on Yorktown to see if I could help them recruit a new generation of investors and develop a renewable energy investment strategy to add to their expertise in upstream and midstream investing. They have recruited three talented new investors and have made a series of renewable energy investments, the early results of which are promising.

It's important to Yorktown's limited partners that we realize good values on existing Yorktown partnerships. They have entrusted their capital to us, and we are working hard to deliver good results. I serve on the boards of several Yorktown companies and am working on maximizing their value. As those values are realized, Yorktown will be a declining percentage of my time.

Mihaljevic: One thing that struck me is your investment in Carvana, which I know you've held for some time. It's done extremely well. I'd like to explore how you got to the point where you found yourself investing in Carvana because I have to admit, as a value investor I have often found myself on the wrong side of change while investing in a business I thought was extremely cheap. Talk to us a little about the process by which you evolved into the investor you've become.

Lawrence: The market is not doing a good enough job looking out five years or more. There are a couple of problems. One problem is that many people in the market are not doing the work required to understand businesses. Index funds and ETFs are now half of the US stock market, and they buy and sell mechanically. There are some mutual funds that do terrific work, but the average mutual fund has 185 investments in it, and I just don't believe that the manager of a fund with 185 investments has time to understand each one of them.

Another problem is that the value of a business with a strong customer value proposition and great unit economics but negative free cash flow is suspect to a value investor. A value investor says, "Well, if it's so cheap, it should have great cash flow today." But what if those negative free cash flows represent the rational decision by management to reinvest in the business to gain scale?

We thought Carvana was the lowest cost operator in a fragmented industry run by an exceptional management team. You could see the customer delight - a Net Promoter Score of 82 and just 2% of people returning the cars. You could see unit economics for early cohorts that were profitable. Markets entered in 2013, 2014, and 2015 were profitable or nearing profitability when we made our initial investment. You could do that work, and you could also do the work to understand the short thesis that had many investors on the sidelines.

The short thesis on Carvana was that different people affiliated with the father of the CEO used captive insurance companies to buy Carvana's finance paper, to pay above market prices for that paper to goose Carvana's sales and thus enhance the value of their Carvana shares. But you could look at the financials of these insurance companies and see how that Carvana finance paper was performing on their books. These insurance companies have to report their financials to the states because insurance companies are regulated by states. That Carvana paper was performing exceptionally well. It turns out if you sell quality cars for prices lower than competitors and if you have the scale to turn away people who can't put money down, your loans will have lower frequency of

defaults, lower severity, and therefore lower losses.

Carvana loans continue to perform at cumulative losses that are well below what people expected when the loans were originated. So based on the unit economics, on the customer value proposition – was management making a rational decision to try to grow to cover the entire country? We believed they were.

Today, Carvana is showing signs they are right that an enterprise at scale in the used car business can digitize and automate a lot of the process of selling a car and create a vertically integrated model that amortizes fixed costs across greater volumes. If they are right, they will use that scale to deliver cars more cheaply and conveniently than the 30,000 dealers who make up the industry. If that happens, you have a company that will dominate a large industry.

The process we used to analyze Carvana wasn't different from traditional value investing. It was just looking out, not at today's free cash flows, but at the prospect that management is right about decisions to invest today to have great future cash flows. With a bunch of cross-checking, you can put yourself in management's shoes and see if they're making rational decisions. Same tools, different perspective. Look five to ten years out but be careful about your assumptions. Trust management if research suggests they are trustworthy, and then work hard to verify that trust.

Mihaljevic: It's an interesting point because it's not dissimilar from what John Malone has done for a long time, which is to not show a ton of current period profits and to make the government his partner in that sense in terms of keeping taxes low. Value investors seemed to understand the John Malone approach well. But when it comes to companies like Carvana, they seem to miss what's essentially quite a similar approach to reinvesting in the business.

Lawrence: There's some truth to that. They're different, but in both cases the value of a business with high reinvestment opportunities is high. You must do the work to make sure that when management claims reinvestment opportunities are high, they actually are high. You must look for reasons to be confident as you trust management but verify what they're saying.

An interesting thing over these last two or three years for Carvana is that there have been a couple of moments, one at the end of 2018 and then one in the spring of 2020, when people lost faith. That provided opportunities to buy more because cross-checking showed that nothing had changed about Carvana's value proposition in late 2018 or March 2020. If anything, the value proposition in March 2020 was enhanced by the pandemic.

There are more than 30,000 dealers of used cars across the United States. Rather than going for scale and automating the process of selling someone a car and getting them insurance and financing, those dealers are small and have labor-intensive costs that are not easily reduced. Now as those individual dealers try to develop an online alternative, they do not have the scale to succeed. That was pretty evident in March 2020. We didn't know how many units Carvana would sell for the next six or nine months of 2020, and we did not know how much capital they would need to raise to get through the pandemic, but we knew that the pandemic was likely to make people much more accepting of buying a car online, and that has proven to be true.

Mihaljevic: Fascinating. Bryan, you've talked about the volatility inherent in equity markets, sometimes more, sometimes less, but it's something that benefits your long-term fundamental approach. Another aspect to that seems to be the environment for investing that we're in with almost half of the stock market owned by passive investors. Plus, there's a large swath of active investors who act more like renters than owners. Tell us about what that does to your opportunity set.

Lawrence: I am amazed that the market is as volatile as it is, and I don't think the volatility is decreasing. You see movements in share prices that don't seem to mean anything. It makes me feel good about Oakcliff's strategy. As fewer people compete, how could that not be good for what we're doing? The market, as you just said, is half robots, and a lot of the remaining half is renters. That can be dangerous for investors with a short time horizon. The actions of an index fund or an ETF do not dampen volatility. As prices go up, they have to buy more, and as prices go down, they have to sell. I suspect, going forward, that volatility will increase. How could that not be good for someone who's done the work?

At VALUEx in 2019, one of the presenters estimated that of the \$80 trillion of assets out there - equity assets across the stock markets of the world - maybe 1% would fit the category of actively-managed, concentrated value investing. He defined actively managed, concentrated value investing as having even a single 5% position and annual turnover less than 30%. So, of the \$80 trillion, maybe \$800 billion was managed in this way. More than one-third of that was Berkshire Hathaway. It remains puzzling to me after sixteen years of doing this that you can have these results that are much better than the market if you do this type of work and yet, the number of people doing the work is small and appears to be shrinking.

Maybe that will change, but human psychology is what it is. Most investors respond irrationally to volatile share prices and are better off investing passively to lower their fees and not experience the anxiety of deviating from the performance of the indices.

Of course, if too much of the market is invested passively, the share price of each publicly traded business will become less tethered to its intrinsic value and volatility will increase. Maybe this index and ETF trend will be revealed to be a mistake. There's this old expression: It's not bad ideas that get you, but rather good ideas taken to extremes. The opportunity for what we do is just enhanced by the growth of passive investing.

Mihaljevic: I'm curious about how you think about selling a position either in part or a whole. If there is truly so much market volatility, I assume some of it is to the upside, and sometimes it's not necessarily warranted by underlying fundamentals. How do you think through when to trim a holding?

Lawrence: It's a great question. For everything we own, we develop a set of projections about what we think the business will do in terms of cash flow available to shareholders over the next ten years. All the work we do, all the reading, the cross-checking, and the thinking boils down to these projections. They are, by definition, uncertain because they're projections. But they're our best attempt to make a conservative assumption about what the business will do for shareholders in cash per share over time.

We apply multiples for each business five and ten years out, and we discount those values back to today. If we see a ten-year IRR of over 20%, we're likely to be buying more of something, and if we see an IRR of under 15%, we're likely to be selling down something. We don't like to transact because transactions result in taxes when we sell something. If we're going to buy something new, we must be sure it's a good idea. The burden of a new idea is higher than something that we've owned for a while. If something that we've owned for a while is starting to discount an IRR less than 15%, we're likely to trim it. We do that reluctantly. But if we're doing our job right, we've got things in the portfolio, new or otherwise, where the IRR is more favorable than that. We make these decisions slowly, but we make them.

Mihaljevic: Bryan, we are having this conversation here in April 2021, roughly a year after the market crash of 2020. It's a completely different market environment. In some ways, it seems overheated. How do you invest in this environment?

Lawrence: There are obvious places of market excess. Someone will write a great book about SPACs. I nominate Michael Lewis; except he's probably working on the GameStop book right now. There are areas of clear overvaluation, companies that have no earnings, poor unit economics, and no evidence that their lack of earnings reflects reinvestment in attractive projects for the future. Many such companies are being valued by the market too richly relative to their likely future cash flows, and the results for their owners will be disappointing.

What we own right now is discounting a gross ten-year IRR going forward of somewhere in the high teens. We're pretty confident in that. It's eleven companies. We are very focused on increasing our understanding of those companies, and we have confidence in what we see. The question now is how to add a twelfth or thirteenth from our watchlist, and whether to subtract any based on new information or an increase in their market price.

Another consideration is that all the money being printed to support all this borrowing may not result in a happy outcome. If you look at the central bankers' playbook, the last time debt levels were this high was right after World War II. There's a pretty clear precedent where central banks can use their powers to suppress rates on government bonds and get inflation going so the real rate of return on government bonds goes negative. There's an interesting paper by Carmen Reinhart from 2011 examining what the U.S. government did to knock down its indebtedness after World War II. It achieved negative real interest rates on government bonds of about 3% annually. If you do that for ten years, the U.S. government can knock its debt-to-GDP down by 30%. In a world where inflation is encouraged and bond returns are suppressed, it is not clear that inflation will stay under control. You want to own things that can outrun inflation.

One thing we've been thinking about a lot is whether we own those sorts of businesses. Two examples we do own are Cardlytics and TransDigm. At Cardlytics, if someone advertises a product that costs \$100 and is willing to spend a percentage of that \$100, and next year, that product costs \$110 and they advertise at the same percentage, Cardlytics revenues will go up, yet it has no need to reinvest in its business. TransDigm has pricing power such that it should be able to continue raising prices in real terms. We think about each of our businesses this way.

We're giving this a lot of thought. It's a strange environment. We have confidence in what we own, but it is amazing to me that as we sit here today, you can look back twelve months and feel what that felt like as the market collapsed and compare that to SPAC mania. I'm confident that twelve months from now, things will feel different again.

We continue to find attractive investments despite this strange environment. In January we invested 10% of our capital in Basic-Fit, which is a low-cost gym operator in Europe disrupting a fragmented industry. We think that other investors do not understand the quality of Basic-Fit's business and are overly focused on the pandemic's temporary closure of gyms in Europe. The company has scale economies in procurement and technology that allow it to build and operate gyms for much less than its competitors. From studying how the low-cost gym industry has developed in the U.S., the U.K., and Germany, it is clear that a large player (like Planet Fitness in the U.S. or Pure Gym in the U.K.) can use scale economies to generate high returns on capital behind a wide moat. If you have scale that makes you the low-cost provider, and you build gyms across an area that all members can use, you make it impossible for a competitor to enter because there is not enough revenue to support two players given the fixed costs of running a gym. It turns out that low-cost gyms are similar to cable systems if you achieve local scale and density.

Basic-Fit has two million members currently and earnings power of €3/share, but we think membership will grow to ten million by 2030 due to increasing gym usage in France, Spain, Belgium and the Netherlands, market share gains in those countries from higher-cost operators, and expansion

into new countries. If that happens, by 2030 the company should have about €10/share of earnings power and will have generated nearly €50/share in free cash flow, which we hope to see distributed as dividends or buybacks. We purchased shares for approximately €30, which means a ten-year IRR in the mid-20s if we are right about the business.

The market will continually change, but the intrinsic value of great businesses is likely to grow over time. This is because the factors that make a business great tend to be durable and make that business grow. Of course, all businesses are subject to change, and some great businesses will be eroded by new developments. At Oakcliff we watch closely for signs of that happening. We focus on learning as much as we can about a short list of great businesses, stay disciplined about how much of them we own at current share prices, and have cash ready for lower prices in the future. That is our strategy. We think we will have continued good results going forward and would like to add clients who understand what we are doing.

Bryan R. Lawrence is the founder of Oakcliff Capital, an investment partnership which invests in publicly-traded securities. Bryan is a member of Yorktown Partners LLC, a private equity firm which invests in energy businesses, and he serves on the boards of several Yorktown portfolio companies. He is a co-founder and trustee of Public Prep, which develops and manages charter schools in New York City. His analyses of US government finances have been published by The Washington Post.