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Wiedower Capital 2021 Interim Letter

Wiedower Capital invests in high-quality companies and CEOs that have industry tailwinds behind them and long runways for growth ahead of them. Research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. Qualitative factors are emphasized over quantitative, and the portfolio is concentrated with long holding periods. For a 5-page overview of my investing philosophy, see the Wiedower Capital Owner's Manual.

In the first six months of 2021, we invested in one new company (currently our smallest position) and sold zero holdings. This compares to full year 2020 when we made four new investments and sold two holdings. Things can change of course, but I will be surprised if any of our holdings are sold in the near future. All of the CEOs we are partnered with continue to impress me, and I believe their competitive advantages remain. If a company on my want-to-own list were to fall below my valuation threshold, I would most likely sell a little bit of several holdings to make room in our portfolio. That is how I designed Wiedower Capital's model.

Going forward, I think a reasonable expectation is around one buy and one sell per year. However, there will probably be periods of increased activity during market volatility, as well as extended periods of no activity. A big reason for this expectation of less activity is how much I love our entire current portfolio, which is not something I could have said a few years ago.

Building an investment process that is really in line with my personality took years, but the result has been fantastic. For the past year+, I have felt aligned with my investing in a way that I never did previously. Building my model to handle portfolio management was a big part of that. And I think the second biggest contributor was realizing that partnering with the best founder/CEOs in the world is what clicks with me. That is what gets me most excited about investing.

In my past several letters I have written about some of the great CEOs we are invested alongside. In my 2020 interim letter, I discussed what attracted me to Satya Nadella at Microsoft. And in my 2020 annual letter, I talked about some of the traits that got me excited about Jeff Lawson at Twilio.

Judging CEO quality is a subjective and fuzzy topic. I suspect investors are much more likely to agree on the qualities that make a great business (e.g., pricing power, high returns on invested capital) than the qualities that make a great CEO. In my 2020 annual letter, I said, "Even among high-quality companies with strong competitive advantages, it is rare that I get excited about a CEO and the company culture they have created." So, what is it that does get me excited about a CEO?

Of the ten companies we are currently invested in, nine are founder-led—with Microsoft as the lone exception. I think founder-led companies have intangibles that are extremely difficult to replicate. I remember doing my first few discounted cash flows many years ago and being surprised at how much of a company's value is determined by the long-term. It is not uncommon that a company's terminal value (10+ years into the future) is well over 50% of what the company is worth today.

If how a company will perform in 10-20+ years makes up most of its value today, then the most important factor when choosing companies to invest in is how durable their competitive position is. And if the long-term is what matters most to a company's value, then the only way a CEO can be truly aligned with you and me is if they are motivated to grow the business in the right way over the long-term.

This is why I like investing in the person who was there on day one to start the company with their own money and hard work in return for zero pay. Founders often have the vast majority of their net worth and reputation tied to the company. I believe the best founders are internally driven to see their own business succeed. They are motivated by something more important than money—many entrepreneurs view their business like it is one of their children. Building a business requires spending an enormous amount of time, energy, and money over many years. Thus, it is natural for that business to become a large part of the entrepreneur's personal identity.

In addition, a founder's knowledge of their own company is difficult to replicate. They were responsible—either directly or indirectly—for every hire at the company, including the board of directors. Founders were responsible for setting the company culture from day one. They were involved in getting the company's first customers and they are often still involved in getting the largest and most important customers. And they are the ones who have raised money and maintained relationships with investors.

For all of the above reasons, it is rare for founder CEOs to get fired from their own company. On the other hand, hired CEOs generally have much less of all of the above traits. It makes sense that a board of directors has less loyalty to a hired CEO than to the founder, which means the bar for firing a founder CEO is significantly higher than a hired CEO. Because of this, founder CEOs have more job security and are thus able to focus more on the long-term future of the company.

At some point, all businesses face serious competitive threats and can be at risk of disruption. Facebook launching the newsfeed and transitioning their wonderful desktop business to mobile were both highly debated internally. Amazon Prime was similar. Netflix transitioned to streaming, got rid of DVDs (and then brought them back), and started creating original content, which required billions of dollars in upfront cash. These types of decisions are much harder to make when a CEO has less buy-in from the board of directors, other executives, and investors.

When I look at most high-quality companies run by hired CEOs, what gives me cause for concern is not their near-term success. They generally have strong competitive advantages that are likely to stay intact in the near- to medium-term. However, I cannot help but wonder if they will be able to make tough decisions that hurt their short-term financials if that is what is necessary.

Hired CEOs generally own far less stock—that was gifted to them via options—and know they could be fired over short-term mishaps. This encourages them to focus on making as much short-term money as possible—usually through whatever their annual bonus incentivizes them to do. On the other hand, thanks to their large equity ownership, founder CEOs have more financial incentive to grow the business over the next several decades.

The big benefit of all this is that founder-led companies are often able to be more long-term focused. I want to see evidence of that in my research though. Adyen, led by its founder and CEO Pieter van der Does, is a prime example of a company that is very purposefully oriented toward long-term success.

Adyen does not give any short-term guidance to the market. They choose to grow revenue in a methodical way with Pieter being against the idea of mergers and acquisitions. Adyen could acquire smaller competitors and grow faster in the short-term. However, Pieter is obsessed with keeping Adyen's platform as simple as possible. Combining multiple technologies would make their platform more complicated, slower, and less secure.

Likewise, many companies are willing to do custom work for large customers. Not Adyen. They only want to increase their code base if it can benefit all merchants. Doing custom work for a large customer could increase near-term revenue, but it would result in a more complicated code base that could slow down future innovation.

Not surprisingly, Adyen is also very diligent in how they grow their employee base. Even today, with over 1,000 employees, every new team member meets with a board member before joining. This self-inflicted requirement forces them to grow slower than they could otherwise. They want to grow responsibly and profitably, not at the maximum pace possible.

Finally, senior team members are promoted from within as opposed to hired from outside the company. Committing to only hiring from within requires building the entire company in a way that incubates future executives long before the company needs them. Internal development also significantly decreases the chances of hiring a senior employee who is not a good culture fit.

> "From the start, the focus has been on building the company with a long-term horizon. Growth of the team is measured, no short-term guidance is given to the market, and investment and innovation target the long-term. In that sense, sustainability – in the truest sense of the word – has always been key to Adyen's decision making." – Adyen 2018 Annual Report

As much as I care about founders who are internally motivated to grow their company in the right way, the rest of the employees also need to be incentivized to work towards that future. Businesses are really just groups of people who work together to sell something, generate revenue, and then spend that money to hopefully make more sales. The companies that reinvest their capital at the highest rates of return for the longest periods of time are the most successful. But again, businesses are just groups of people. And humans are—understandably so—selfish creatures. One of our most basic instincts is to do what is in our own best interest.

Because of this, I believe creating incentives that encourage employees to do what is both in their own best interest and the long-term interest of the company is one of the most important things a founder does. Yet, reading proxy statements makes it obvious that many founders—let alone hired CEOs—fail in this regard. And when I see a founder who does not think critically about something so important to their business, I cannot help but wonder what else they overlook.

Ideally, I like companies that pay a reasonable salary and no annual bonus, with the majority of pay coming from long-term equity. I believe it is extremely difficult to create annual compensation metrics that cannot be gamed in a way that is at least somewhat counterproductive to long-term value creation. The majority of a company's intrinsic value comes from the distant future, not near-term results. And incentivizing executives to achieve annual targets is often not conducive to that long-term success. I quoted Amazon's proxy statement in my last letter, but it is worth posting again.

> "Because of our executives' low salaries, the absence of an annual bonus program, and reliance on restricted stock units with long vesting periods, we believe that our executives' compensation is tightly aligned with our shareholders' long-term interests, and therefore that performance conditions on our stock awards are neither necessary nor, given the nature of our business, appropriate. As a company that relentlessly pursues invention across a wide range of opportunities, we believe it would be inappropriate to utilize a few discrete or short term financial or operational performance measures that may narrowly focus our executives on the success of only isolated initiatives, instead of on the long-term success of the Company as a whole." – Amazon 2019 Proxy Statement

To me, the above passage is so obviously true that it should not even have to be said. Unfortunately, Amazon's philosophy on compensation is also rare. Most companies take something that I believe is best when simple, and instead make compensation more complicated with worse incentives. Roku says it well too.

> “We do not pay our executive officers cash bonuses or have equity awards tied to either individual or corporate performance goals because we expect our executives to perform at the highest level regardless of possible bonus payouts or awards.” – Roku 2020 Proxy Statement

If a high-level executive at a public company requires an annual bonus to incentivize them to do an important part of their job well, they probably should not be there in the first place. Amazon—one of the world’s largest and most successful companies—pays their executives less than $200,000 each in salary, does not offer annual bonuses, and grants equity that does not start vesting for four years. That is how to incentivize long-term thinking. It is difficult for me to go from that and then get excited about a company that is 1/50th of Amazon’s size and pays much higher salaries, annual bonuses based on things like EBITDA growth, and grants equity that starts vesting immediately.

To be clear, I am not as strict on the reasonable salary + no bonus + long-term equity structure as it may seem. What I am strict about is leaders who realize how important incentives are and have put a lot of thought into it. I believe it is an extremely important aspect to business success that often gets overlooked.

Trupanion is an example of a company that has a unique approach to compensation. First, their annual bonuses are only 20% of base salaries, which themselves are very reasonable at $300k or less per executive. When a potential annual bonus balloons to 150%+ of what someone’s salary is, it is hard for that person not to be overly focused on that short-term incentive. However, bonuses that are capped at a small percent of salaries do not worry me as much. Trupanion also offers a small incentive to employees if they take their annual bonus in equity (with a two-year lockup) instead of cash. Even more interesting is how Trupanion does their long-term equity.

To determine equity grants, Trupanion first calculates how much they think the intrinsic value of the company increased that year. They do this by multiplying how much the company spent on acquiring new pets that year by their estimated return they will generate on those investments (as a reminder, I discussed Trupanion’s unit economics for each pet they acquire in my 2018 annual letter). Then, a small percent of this intrinsic value growth estimate (capped at 2.5%) is divided up among all employees, including executives. This is the most effective way I have seen of a company rewarding its employees directly on the unit economics of the business.

Trupanion’s proxy statement makes it obvious how much Darryl Rawlings, their founder and CEO, has thought through what culture he wants to incentivize. That is what I look for. Unfortunately, the compensation philosophy section in most proxy statements sucks. I could copy/paste a random company’s compensation philosophy into most other company’s proxy statement without even noticing. They pay salaries in the 50-75% range of their peer group (which is hand selected and changes whenever they want), annual bonuses are paid to incentivize short-term objectives (the opposite of what I want), and issue “long-term” equity (that starts vesting within 1-year). A proxy statement that does not have anything unique to say is a significant turn off to me.

As important as compensation and incentives are, there is much more to creating a successful company culture. Importantly, there is no right or wrong culture. Similar to incentives, I am more looking for a founder who prioritizes creating a productive culture for what they are trying to accomplish than I am seeking a specific type of culture.

As an example, walking around Trupanion’s headquarters has a distinct vibe to it: very casual, employees dress how they want, no shortage of tattoos and colorful hair, a ping pong table, free food, a daycare on site, and a ton of (surprisingly quiet) cats and dogs. I have not been to a Burford Capital office, but I suspect the vibe is very different—as it should be. Burford is full of lawyers who are allocating capital to other lawyers. That requires a more disciplined, structured environment.

With that being said, there are plenty of cultural characteristics that I do prefer to see in every company (barring unique circumstances). One of the biggest examples is a focus on developing talent from within the company as opposed to hiring from the outside. I believe the best executives need to have in-depth knowledge of how their company works. They also need to be respected by employees and the board. Those things require years of working inside the company. Mark Leonard from Constellation Software describes this dynamic well.

> "We nearly always promote from within because mutual trust and loyalty take years to build, and conversely, newly hired smart and/or manipulative mercenaries can take years to identify and root out. We incent managers and employees with shares (escrowed for 3-5 years) so that they are economically aligned with shareholders. In return we need and want loyal employees. If they aren't planning to be around for five years, then they aren't going to care much about the outcome of multi-year initiatives, and they certainly aren't going to forego short-term bonuses for long-term profits." – Mark Leonard, 2011 President's Letter

As Mark alludes to, I believe a culture focused on hiring from within is forced to think long term. Resources have to be dedicated to developing future managers and executives, and a good culture needs to be in place to keep those employees over many years. Many of the traits I look for in great CEOs and cultures are interrelated and reinforcing like that.

In the rare instance that I do look at a company that is not led by its founder, I pay close attention to how they handle CEO transitions. The four questions that I want to answer "yes" to are as follows.

1. Was the transition announced ahead of time?
2. Was it a gradual transition over 1-2 years?
3. Is the new CEO a longtime employee?
4. Did the old CEO stay on as a director?

Tyler Technologies exemplifies this perfectly. In 2002, a CEO transition was announced. Two years later, in 2004, the previous CEO became Chairman and the new CEO, John Marr, took over. Marr was CEO until 2016 when the current CEO, Lynn Moore, took over after a transition period and after having worked at Tyler since 1998. The previous CEO, Marr, is now Executive Chairman. To me, this shows an ingrained company culture over multiple decades of transitioning leadership as smoothly as they can. That goes a long way to maintain the company's success.

On a similar note, Darryl Rawlings at Trupanion has already announced he will transition to Executive Chairman in 2025. While I wish he were staying on as CEO for longer, I appreciate his forthrightness to tell shareholders far ahead of time. This also gives me confidence that he takes the transition seriously as the company will have spent years preparing for it when that time does come. To me, a CEO transition announced out of nowhere, especially an outside hire, is a major red flag.

> "If this company requires me to be in my desk 40 hours a week to succeed, I didn't succeed. In that case, I didn't build a company, I built a job." – Darryl Rawlings

This is why company culture is just as important as the founder. Over a long enough timeframe, all employees will eventually turnover, including the founder. But a strong culture that emphasizes customer care, product innovation, and capital allocation can continue to thrive.

Another trait I seek out in most company cultures is decentralization. I do not want to invest in a founder who tries to do everything. I want to invest in a founder who has built an incredible team around themselves and who trusts that team to do most of the heavy lifting. I believe humans work best when they are trusted and are given autonomy to make impactful decisions.

> "Being effective—changing things, influencing things, making things happen—is one of the fundamental needs with which human brains seem to be naturally endowed, and much of our behavior from infancy onward is simply an expression of this penchant for control." – *Stumbling on Happiness*

Humans desire control and autonomy. It is very core to our being. As I talked about above with incentivizing selfish behavior that also benefits the business, companies that are structured to take advantage of innate human behaviors should do better over those that are not.

When it comes to decentralization, Constellation Software is the best example I have seen. They are a $40-billion-dollar company that still makes hundreds of small acquisitions in the seven- and eight-figure range. They can do this because of how much independence is given to each individual business unit. Those units effectively operate as small entrepreneurial companies themselves.

I learned more about the benefits of decentralization from Mark Leonard's President's Letters than from any other source. Mark believes very strongly in giving employees control and constantly pushing decisions to lower levels in the organization so that more people are making impactful decisions. Mark has spent a lot of time discussing how Constellation Software is structured to empower as many employees as possible.

> "One of the fundamental beliefs at [Constellation Software] is that autonomy motivates people, and bureaucracy does the opposite." – Mark Leonard, 10/4/18 Investor Q&A

> "Our decentralized management structure allows us to have business unit management teams with strong customer relationships and deep market knowledge that are more focused and responsive than would be the case under a centralized management model. These teams provide our corporate head office and operating group managers with the ability to concentrate on issues such as capital allocation, identifying best practices, and helping recruit and coach high potential employees, while the [vertical market software] business managers concentrate on operating efficiency, and pursuing organic initiatives and acquisitions in our existing vertical markets." – Constellation Software 2018 Annual Information Form

Decentralization can have a secondary benefit that I seek out as well: frugality. When employees are part owners and they are given control over a segment of the business, they are more likely to treat it as their own and not waste money. When I hear about executives at a small company flying private, that is a big turn off. On the other hand, Mark flew economy for twenty years until he voluntarily stopped taking his salary.

> "This year I'll take no salary, no incentive compensation, and I am no longer charging any expenses to the company. I've been the President of CSI for its first 20 years… Cutting my compensation will allow me to lead a more balanced life, with a less oppressive sense of personal obligation. I'm paying my own expenses for a different reason. I've traditionally travelled on economy tickets and stayed at modest hotels because I wasn't happy freeloading on the CSI shareholders, and I wanted to set a good example for the thousands of CSI employees who travel every month. I'm getting older and wealthier and find that I'm willing to trade more of my own cash for comfort, convenience, and speed." – Mark Leonard, 2014 President's Letter

That is how a CEO engenders a culture of frugality. On a different note, Netflix is frugal in a non-obvious way. They do not waste money on mediocre employees, which I suspect is a problem at most companies. Netflix is known for paying very well and for having a rewarding culture—personally, professionally, and financially—but also a ruthless one. Average employees who could have cushy jobs elsewhere are routinely given generous severance packages and let go.

> "Managing people well is hard and takes a lot of effort. Managing mediocre-performing employees is harder and more time consuming. By keeping our organization small and our teams lean, each manager has fewer people to manage and can therefore do a better job at it." – Reed Hastings, CNBC

Being known for paying really high salaries does not sound like frugality, but it is in Netflix's case. Out of every company I follow, Netflix generates the highest revenue per employee. Part of that is the type of business they are in, but another contributor is their lean culture.

As Mark Leonard mentioned above, decentralization results in better customer relationships because the employees interacting with customers also have power to make decisions. Customer obsession is a trait I look for in all cultures. Some CEOs bring up competition on a regular basis, which I find as off-putting—especially when it is to bash those competitors. Other CEOs, even when prompted by an analyst question about competition, just say something nice, and then turn the question around to talk about their customers. Talking about competitors too much is a sign of a culture that is not as focused on solving customer problems.

At Shopify, all executive hires are required to do customer support when they start. Tobi Lütke, the founder and CEO, still has his own customer support account and takes calls every once in a while. The last time I visited Trupanion's headquarters, Darryl's desk (he did not have an office) was in the middle of the customer service department. I doubt that is a coincidence. At Twilio, new employees build a product using Twilio's APIs, even non-technical employees. This helps to ensure that all employees understand how customers use Twilio. Adyen is internally structured to innovate cooperatively with customers.

> "The Adyen organization is divided into workstreams, which are comprised of product, technical and commercial staff. These workstreams work with our merchants in a co-creative manner and are thus able to efficiently prioritize. Company-wide strategy is set on the basis of these workstreams' objectives at a yearly basis, and almost always subject to change, ensuring that we keep our speed and agility while we grow the team." – Adyen 2019 Annual Report

Lemonade talks about their net promoter score—a way to measure how much customers like a company—on a regular basis. Tim Bixby, Lemonade's CFO, has said that net promoter score is Lemonade's second most important internal metric. Their overall net promoter score is in the 60s and 70s, which is impressive in its own right, but especially for an insurance company. Even more impressive is that their net promoter score is in the 40s and 50s for customers who have had their claim denied. So, customers who get denied for the one benefit they pay Lemonade for—covering insurance claims—still have a better opinion of Lemonade than most other companies' customers have of them. That is incredible.

And of course, the OG of customer obsession is Amazon.

> "We seek to be Earth's most customer-centric company. We are guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking." – Amazon 2020 Annual Report

> "We are firm believers that the long-term interests of shareholders are tightly linked to the interests of our customers: if we do our jobs right, today's customers will buy more tomorrow, and we'll add more customers in the process, and it will add up to more cash flow and more long-term value for our shareholders." – Jeff Bezos, 2001 Letter to Shareholders

Being the CEO of a public company is not equivalent to being the CEO of a private company. While most skills overlap, running a public company does generally require the CEO to communicate with a significantly larger base of investors.

I am still surprised how often I research a new company and find how little they do to help new investors get familiar with them. They do not write shareholder letters. Their annual reports are the bare minimum that is legally required. They are not super helpful on quarterly conference calls, and their investor relations website barely has anything on it.

Two companies that put a lot of effort into investor relations are Netflix and Trupanion. Both companies write great shareholder letters, have informative investor relations websites, and are open and forthright on their conference calls. Reed Hastings, Netflix's founder/CEO, and Darryl Rawlings, Trupanion's founder/CEO, both have been very consistent in their long-term vision for their respective companies and have spent a lot of time explaining that to Wall Street.

I think the return on investment from writing high-quality shareholder letters is enormous. If an investor asks me about researching Constellation Software, the first thing I say is how valuable the annual letters were to me. These companies turn a largely variable cost of investor relations into more of a fixed cost (here I am mostly referring to time cost, less so monetary).

Public company management teams spend a significant amount of time answering similar investor questions. On the other hand, Netflix and Trupanion answer these introductory-type questions through their shareholder letters and investor relations websites. They may spend more time upfront creating letters and a helpful website, but once finished, those are fixed costs and available to every investor in the world. Alternatively, most public companies experience this as a variable cost—answering the same question by many investors every year.

As an example, investors should not be asking Trupanion management about how they calculate unit economics because Darryl explains it in-depth in his annual letters. Meanwhile, other management teams probably get asked relatively basic unit economics questions on investor calls constantly. What a waste of time answering the same questions over and over when management can answer them once and for all through public writings. When I finished reading Mark Leonard's letters, I only had a handful of questions that needed further answering about the company.

I also find that clear written communication often correlates highly to clear thinking. And when a leader is not great at communicating their vision to the public, I see that as a bad sign as to how good they are at motivating employees, attracting the best new talent, and getting other investors excited. Being a good storyteller is an important part of being a successful founder and company leader. Founders need to tell their vision to the world. It helps to attract both potential employees who want to help make that vision a reality and long-term investors who are aligned with that vision.

Darryl travels to Omaha and gives a presentation about Trupanion after the Berkshire Hathaway meeting every year. He wants long-term investors, and he smartly figures that Omaha during Berkshire weekend is a good place to find them. Anecdotally, I have heard numerous stories about both Trupanion and Netflix putting effort into directly reaching out to large funds that are known for being good, long-term investors. I think there is a lot of value in attracting a high-quality investor base that is focused on the long-term.

One cultural characteristic that I seek out, but unfortunately rarely find in our investments, is great corporate governance. When I say that, the main things I look for are a single class of shares, a different CEO and Chairman, annual director terms, and high equity ownership on the board.

Especially with companies that have IPOed in the past five or so years, it has become the norm for the founder to be both CEO and Chairman, have complete control via a super-voting class of shares, and staggered three-year terms for directors. These things are not deal breakers—we are invested in numerous companies that fail on at least two of those—but they do irk me. I just think it is a good look for founders to have a little more oversight as opposed to being granted complete control from the day they are public.

With that being said, Facebook is one company that I think founder control is justified. Even though I disagree with a lot of the negativity surrounding Facebook, the reality is they do get a lot of shit from the public and from politicians. I would not want the board to overreact during some politician's publicity tour and try to throw Zuckerberg out.

Trust is a very important part of finding CEOs who I want to invest in. I do not want to invest even $1 of Wiedower Capital's money into a CEO who I do not trust. As much of my CEO analysis focuses on assessing their character as to their management abilities. I want CEOs who are kind. I want to invest in good human beings who are trying to make the world a better place. There is nothing wrong with wanting to make a lot of money, but I need to believe they are motivated by more than that.

In poker, a tell is when a player's behavior may give a clue about the strength of their hand. A player who is normally calm but suddenly gets nervous could be bluffing. However, some players get nervous when they have a really strong hand. Tells are not universal and they rarely tell the whole story. However, they can be helpful hints that add up to a more complete story. Likewise, a lot of my CEO analysis is looking for tells—small things they say and do that add up to me forming an opinion on what kind of human being they are. I am looking for CEOs who are independent thinkers, intellectually honest, humble, and obsessed with learning.

A big part of seeking these traits out is just paying attention to what leaders talk about. I find that people usually give themselves away by what they do and do not talk about. Some CEOs talk about company culture all the time. Others almost never do. When I notice either of those, I take note because it is usually not a coincidence.

The Atlassian co-founders discuss culture in many of their shareholder letters. HEICO starts every conference call by thanking their employees. Pieter van der Does talks about Adyen's hiring process in every letter. Darryl Rawlings writes about and discusses his company's unit economics more than just about any other leader I have seen. Mark Leonard has written nineteen letters that dive deep into decentralization, incentive structures, hiring insiders vs outsiders, and how to create a capital allocation machine. Reed Hastings wrote a book, *No Rules Rules*, about Netflix's culture. Satya Nadella wrote a book, *Hit Refresh*, about how he wanted to improve Microsoft's culture. Tobi Lütke talks about encouraging entrepreneurship all the time.

Likewise, Jeff Lawson at Twilio regularly discusses how to encourage developers. He even wrote a book about it, *Ask Your Developer*. Lawson also talks about company values more than probably any CEO I have seen. He has written letters, made presentations, and given interviews about Twilio's ten principles that guide them.

> "Culture is what you feel when you walk into work every day. You don't have to write it down. Every company has it… Values are written words that are like handles on the culture. They allow you to guide it… Values that aren't representative of [the company] are just empty words on a wall." – Jeff Lawson, Invest Like the Best

Nowadays, pretty much every moderately sized company does some sort of charitable giving, but it is clear that some founders take it more seriously than others. In 2015, Twilio used 1% of their equity to start Twilio.org as a way to support their philanthropic goals. In 2019, Twilio founded WePledge, a way for employees to donate 1% of their time and/or income to do good, with matching contributions from Twilio. Twilio open-sourced this endeavor and got Atlassian, Okta, and Zoom to join them. Similar to Twilio.org, Okta for Good was funded with

Okta's equity. Both Todd McKinnon at Okta and Jeff Lawson at Twilio talk about their charitable endeavors on a regular basis.

In 2015, Mark Zuckerberg and his wife Priscilla Chan announced the Chan Zuckerberg Initiative with a pledge to donate 99% of their wealth over their lifetime. In the future, I suspect society is going to look at Zuckerberg very differently than how he is viewed today. Ultra-wealthy tech billionaires get a lot of hate—and certainly some of it is justified—but frankly, I think the world is lucky to have the group of powerful tech billionaires that we have.

On that note, Jack Dorsey, founder and CEO of both Twitter and Square, donated 28% of his net worth in April 2020 to fund COVID relief. That is incredible, but also not too surprising. Dorsey has consistently donated his wealth to charities over the years and has also given portions of his company equity back to his employees multiple times.

> "I am so grateful [for my wealth]. But a big part of gratitude is [action through giving back] … I want to give out all my money in my lifetime. Selfishly, I want to see the impact… When you build something like Twitter or Square, the greatest value is seeing someone else use it. That's what drives us. It feels electric… That electricity is the same I feel when I give." – Jack Dorsey, Yang Speaks

Daniel Ek, founder and CEO of Spotify, has mentioned that he probably will not still be CEO of Spotify in 5-10-years. He said he is still young and wants to make a bigger difference in the world via healthcare that saves lives. I do not love that he is leaving Spotify sooner than I would prefer, but I have a lot of respect for someone so wealthy who wants to dedicate their time to something that will have a bigger positive impact on the world (not that providing entertainment to hundreds of millions of people via Spotify is not valuable—it is).

> "I have a responsibility to do more than what I'm doing. Maybe this comes back to the Swedish roots, like you're not supposed to be a billionaire in your thirties. You're not supposed to be the 0.01%, no matter what it is you've accomplished." – Daniel Ek, Fast Company

Because I look at a lot of mid- to large-cap founder-led businesses, it is not uncommon that the founder/CEO is a multibillionaire. In these cases, I look for leaders who voluntarily take very little pay. This has nothing to do with whether these founders are worth it or not—the leaders of our holdings would be difficult to overpay with how much value they bring.

There are plenty of incredibly rich founders who continue to pay themselves millions every year. I think the ones who do not are less likely to be greedy and more likely to be shareholder friendly. I also think it is inaccurate to claim that a salary, bonus, and/or equity grant changes a billionaire-founder's behavior for the positive. And giving them money for something that would have occurred anyway makes no sense. I roll my eyes when companies claim in their filings that the incredibly rich founder who owns a ton of stock needs more annual equity grants to "create long-term alignment."

> "Due to Mr. Bezos' substantial stock ownership, he believes he is appropriately incentivized, and his interests are appropriately aligned with shareholders' interests. Mr. Bezos has never received any stock-based compensation from Amazon." – Amazon 2019 Proxy Statement

I know Bezos is unfathomably wealthy, but I believe that same basic statement should be in the proxy statement of every company that is led by a billionaire founder/CEO.

Independent thinking can show itself in all sorts of ways. Most companies have similar compensation structures. Most companies do not have great corporate governance. Most companies do quarterly conference calls the same way. Most CEOs do not write helpful shareholder letters. Most companies do not have investor relations websites that actually help outsiders understand the company. Most companies give quarterly guidance. Most companies do not have explicit capital allocation frameworks.

I want to invest in CEOs who do things because they are best for the long-term health of the company, not because they just accepted something as the norm. When researching a new company, I keep my eyes open for things that make me think “hmm, that’s not how most companies or CEOs do things.”

Darryl Rawlings was the first to show me how open and honest a public company CEO can be. He writes the best shareholder letters that I am aware of. Each year, he publishes a 15-20+ page deep dive into Trupanion: what they are doing good at, where they are struggling, how they internally make decisions, where the industry is heading, and much more.

Darryl’s 2019 letter was especially interesting as he walked through an entire discounted cash flow analysis for Trupanion. This demonstrated how well Darryl understands the underlying dynamics of his business, and it also showed what key metrics he pays attention to that drive intrinsic value the most. I would expand more on this letter but Darryl’s introduction to the discounted cash flow is better than what I could say.

> When we are making strategic decisions, or choosing how to deploy our discretionary cash, we use a 15-year discounted cash flow model to determine the value we expect to create.
>
> This 15-year discounted cash flow model informs what we believe is the intrinsic value of our company and how it changes over time. These changes, when positive, result in value creation. Building and using our DCF model not only keeps us honest about our value creation per share, but it also reinforces the importance of our key metrics and informs our decision making.
>
> Said another way, our model is a tool to help track our progress as well as chart our future. Our model does not determine our destination, nor does it reflect our aspirations. Our aspirations are to outperform our model! Rather, it acts as a compass, helping us navigate and plot our course.
>
> Our metrics, how they have trended historically, and our conviction around how they will trend in the future, are the building blocks of our intrinsic value model. For me, using the past as a guide is the single best method for trying to predict the future. If the past was consistent and predictable, then one can reasonably expect it to be a useful forecasting tool.
>
> We believe all companies should be valued on future cash flows. To accomplish this task, one needs to build a DCF model. When an informed investor builds such a model for Trupanion, we believe they will better understand how and why our business is differentiated. Absent this exercise, one is only speculating as to how best to value a company.
>
> There is no such thing as the perfect DCF model, but I am confident that when it comes to our business, our interpretation is well thought out and defensible. Our goal is to be transparent to our shareholders, employees (who are also shareholders!), Territory Partners, veterinarians, and members. We share what we believe are our key metrics and how they impact our intrinsic value.

I wish more public CEOs ran their companies this way. Rawlings was the first to show me this ability to be so open as a public company CEO, but Mark Leonard at Constellation Software was the one who cemented intellectual honesty as a core part of what I look for in a founder.

Leonard is so straightforward and rational that it has made the idea of investing in most CEOs basically impossible. He single-handedly significantly raised my bar for what I consider high-quality management. And now, I do not want to invest in a CEO who lowers the overall quality of management in our portfolio. Thus, for me to invest in a new company, I have to believe the leader is on the same tier as the amazing CEOs I am discussing in this letter. That is rare.

Both Rawlings and Leonard seem to not be able to help themselves in talking about what their companies are bad at. It is kind of ironic, but I get excited when a CEO talks about and shows an ability to objectively analyze mistakes they make. I do not find this trait often. To me, many CEOs come off as more polished versions of the stereotypical used car salesmen. No company is even close to perfect, so when a CEO seems to only talk about how amazing everything is going, I struggle to trust them.

Along with this, one big tell I seek out is a CEO who says "I don't know" and/or gives a lot of nuanced answers to questions. An important part of my early research on a new company is watching interviews or speeches the CEO has given. As a group, public company CEOs are very well-spoken, and they know how to give the "right" answers. Communicating well and being a good salesperson are common and important traits among successful leaders. But when a CEO seems to have all the answers, I am suspicious. The world is grey—not black and white. And the future is uncertain. Giving nuanced answers with "ifs", "ands", or "buts" is a hint to me that someone understands this uncertainty and their own gaps in knowledge.

Tobi Lütke at Shopify and the Collison brothers at Stripe routinely impress me with how rationally they approach questions. Listening to these three on conference calls or in interviews also makes it obvious how well read they are. More and more the past couple years I have become very attracted to founders who may be described as autodidacts—they are obsessed with learning across a wide range of topics.

Charlie Munger's book *Poor Charlie's Almanack* is one of the most important books I have ever read. It ingrained in me the value of lifelong learning and trying to get a little smarter every day. Over years and decades, small but constant knowledge improvements can result in a worldview that is far more robust than would be otherwise. While becoming more knowledgeable is enjoyable in its own right, I believe it is also very valuable for leaders who are building evolving businesses in a constantly changing competitive landscape.

I pay attention when leaders talk about what books they are reading or have read. Todd McKinnon at Okta regularly tweets his thoughts on books he is reading. Both Mark Leonard and Tobi Lütke have talked about their love of *Thinking, Fast and Slow*—another one of the most impactful books I have read. Studying psychology and cognitive biases has meaningfully helped my understanding of how humans work, and I think it is a topic worth studying for leaders. Lemonade made Dan Ariely, a top behavioral economist, one of their founding members.

> "[Learning] is really my core value. I believe that the job we all have in life is to acquire knowledge and wisdom and then share it. I just don't know what else there is. This is the bedrock of my belief system."
> – Tobi Lütke, The Observer Effect

Lütke and the Collison brothers are extremely impressive when it comes to being learners. It can be mind boggling to witness the sheer number of topics those three can talk intelligently on. I do not believe that can be faked. My takeaway is that they are curious people who enjoy broadening their knowledge. The type of people who are obsessed with self-improvement are the type of leaders I want to invest alongside. After watching one interview with Patrick Collison, I wrote down the following note as my main takeaway.

> Patrick is extremely intelligent. He's up there with Elon Musk in terms of the most impressed I've been by someone's raw intelligence and with how wide and deep his breadth of knowledge is. Patrick also comes off as very thoughtful, genuinely humble, and intellectually honest.

That is the type of CEO who gets me excited to invest alongside. As much as I love investing, there are a small number of CEOs who tempt me into wanting to go work for them. They are smart, kind, obsessed with creating a great company culture, and they lay out a future vision of the world that I want to see come true. If I had to give up investing tomorrow and was forced to get a job, the companies I follow would be the first ones I consider going to work for.

Just as important as anything I have talked about thus far—probably more so—is the CEO's capital allocation skills. In very simple terms, the success of any business is determined by their ability to allocate capital. A company sells something, earns revenue, and then invests that capital however the leaders and culture best see fit—hiring employees, marketing, a new office, R&D, investments, etc. Just about everything a business does can be boiled down to allocating capital. The companies that invest money at the highest rates of return for the longest periods of time are the most successful.

For my portfolio management model, the quality score for each company is made up of 16 individual metrics. Some of these metrics—say economies of scale—are nice to have, but they are not required. We own a few companies that score low on economies of scale, and that is ok if their competitive advantage is strong in other areas.

The capital allocation metric is not like that. Out of all the companies in our portfolio and on my want-to-own list, the lowest capital allocation score is 4/5. If I believe a company is just average (or worse) at allocating capital, I have no interest in trusting our money to them. Looking at every company in our portfolio and on my want-to-own list, the capital allocation score is the metric that has the highest lowest number. I believe that is an accurate representation of how important I view capital allocation.

Many companies I look at are growing fast and have not yet reached profitably. In these scenarios, capital allocation is usually relatively simple: shovel all revenue back into organic growth. And I am perfectly ok with that. Often, that is the smart thing to do—as long as the unit economics of the business are healthy. If a company's returns on capital are more than what it costs them to acquire that capital, then investing capital creates value. Thus, growth is good. The book *Valuation* determined that for companies that have high returns on capital, the single most important driver of shareholder returns is revenue growth (particularly organic revenue growth).

With that being said, I still need to believe that growth is pursued in a disciplined way with a focus on maintaining profitable unit economics. Leaders who seem to pursue growth at all costs are a major turn-off. It is possible to reinvest all revenue to grow quickly while also being frugal.

I previously talked about Darryl Rawlings' obsession with Trupanion's unit economics. They have operated close to breakeven for at least the past nine years while they funnel most excess cash back into acquiring more pets at 30-40% returns. I appreciate Darryl's desire for reinvestment and growth—but balanced with a healthy balance sheet and not going too far in the red.

Lemonade has mentioned how they were turning away two-thirds of their home insurance applications the first several years they were in business. In 2020, Lemonade finally released a pet insurance product after having customers request it since the company was founded in 2015. This type of methodical growth—as opposed to growth at all costs—gives me confidence that a founder is focused on good capital allocation that maintains healthy unit economics.

> "we got requests for pet insurance the first week. A lot of our customers have pets… We wanted to have pet insurance and it took a lot to resist coming out with that product immediately. But we knew we needed to improve our renter's insurance, our homeowner's insurance, our condo insurance. If we

allowed ourselves to get distracted by meeting every need our customer had and tried to meet it at the exact time they had it, we wouldn't be serving our customers." – Ty Sagalow, In Practise

> "grow as fast as we can add healthy business… customer satisfaction needs to remain high" – Tim Bixby, Dave Lee on Investing

> "The last thing we want to do is grow fast but create tail risks that would come back and destroy our business in the future." – Daniel Schreiber, Voices of Wall Street

As companies become more successful and profitable, they have more capital allocation decisions to choose from: mergers and acquisitions, share repurchases, dividends, how much debt to raise, and how much organic reinvestment to maintain. When looking at more mature businesses, I like to see a clear capital allocation philosophy. Look at the below two quotes from Tyler Technologies… and then notice that they were written 14-years apart. Tyler has a very consistent capital allocation philosophy that has been maintained by their culture for a long time.

> "we will continue to reinvest our cash in ways we believe will maximize shareholders' investment in Tyler… we will continue to invest in our software products to keep them competitive so that we may sustain this growth over the long-term… Second, we will selectively use cash to add growth through acquisitions… Finally, we will at times invest our cash in Tyler through stock repurchases." – John Marr, 2005 Shareholder Letter

> "Tyler builds shareholder value through investments in research and development that allow us to improve and expand our solutions; through strategic acquisitions that broaden our capabilities and expand our addressable markets; and by the opportunistic repurchasing of Tyler stock." – Tyler Technologies 2019 Annual Report

And Tyler has stuck by their promise to only repurchase their stock when it is "opportunistic." Many mature businesses buyback stock every year—which is fine—but I love seeing repurchases that are very lumpy. A company that does large buybacks during market corrections can add a lot of shareholder value over time. In the fourth quarter of 2018, Tyler's stock fell 25%, and the company spent $147 million to repurchase its shares. That was more than Tyler had spent on buybacks in the prior four years combined. Likewise, the only time HEICO bought back its shares in the past 14-years was during the 2009 collapse.

Companies that maintain a healthy balance of cash and debt are more able to take advantage of these opportunities—and others—when they do occur. HEICO, on every quarterly conference call, updates their debt to equity, net debt to EBITDA, debt maturities, working capital ratio, days sales outstanding of receivables, and inventory turnover rate. Most likely, that reflects their internal focus on these metrics.

Burford Capital funds its investments in three different ways: equity from the public company balance sheet, debt, and outside capital in the funds that Burford manages. Each of these sources has pros and cons. Investing directly from the balance sheets means Burford's shareholders get all of the upside, but this cash is limited. If Burford only had access to their own equity, growth would be much slower. Using debt and outside capital allows Burford to invest in more lawsuits, but that also gives up some of the upside. In this regard, interest expense on debt is cheaper than outside capital where Burford only earns management and performance fees. However, debt levels must be managed as to not cause risk to the overall company.

Burford refers to these three sources of capital—balance sheet, debt, and outside capital—as the three legs in their capital stool. Management often discusses on conference calls and in their semi-annual reports the balancing act of optimizing the pros and cons of those three legs.

> “Our funding sources [are organized] by expected return, risk, and life of the assets we originate. We use our balance sheet and certain dedicated funds to provide capital for higher risk, higher return, longer-lived assets such as those created in our legal finance business. We typically use dedicated funds, in which our balance sheet is an investor, to provide capital for the kind of lower-risk, lower-return, shorter-lived assets that typify complex strategies activities. And we use still other dedicated funds (without balance sheet investment) for low risk, low return, very short-lived assets, such as post-settlement and law firm receivables financing.” – Burford Capital 2020 Annual Report

> “In planning [our debt] issuance, we have purposely constructed a set of laddered maturities with an overall weighted average maturity [4.4-years] well in excess of the expected weighted average life of our legal finance assets [2.3-years]. We have also sized these issues so that any single year’s maturity amount is significantly less than our historical annual rate of legal finance asset realizations, which we believe protects against a liquidity shortfall when these bonds become due should we not refinance them.” – Burford Capital 2020 Annual Report

Finally, mergers and acquisitions can be an important part of capital allocation. Burford Capital has acquired three companies in their 12-year history and all three have been homeruns. Mark Zuckerberg at Facebook made one of the best acquisitions of all time, Instagram, and two others that I believe will ultimately prove to be very financially beneficial as well, WhatsApp and Oculus.

Satya Nadella, in his seven years running Microsoft, has made several big acquisitions that I am a fan of—Mojang (the company behind Minecraft), LinkedIn, GitHub, and ZeniMax Media (the company behind a few of the largest video game franchises in the world). Nadella also disposed of Nokia, a poor use of resources that was not core to Microsoft’s business. Likewise, Jack Dorsey at Square has impressed me just as much with his divestitures—Caviar and an Eventbrite investment—as his acquisitions—Weebly and Credit Karma Tax. There is a lot of value in focusing a company on its core operations and getting rid of distractions.

The above companies—Burford Capital, Facebook, Microsoft, and Square—occasionally make acquisitions to expand their business in ways that would be difficult to replicate organically. Other companies—such as Constellation Software, HEICO, and Tyler Technologies—use acquisitions as a core part of their business model. Frankly, it is probably not fair to even compare Constellation Software’s success with M&A to other companies that do not focus so much on it. Constellation Software has successfully acquired and integrated hundreds of small software companies while still maintaining high returns on invested capital. With serial acquirers, I want to see an entire company culture that is built around acquiring businesses at strict hurdle rates.

On the opposite end of Constellation Software is a company like Adyen. Pieter van der Does, Adyen’s founder and CEO, is vehemently opposed to acquiring other payments companies. Pieter believes that one of Adyen’s biggest competitive advantages is their single, clean code base. They have never done an acquisition and they do not do any custom coding for clients. If they build something, it is made available for to all their merchants. Pieter is one of the most long-term focused founders I follow. In his eyes, acquiring another company could increase short-term growth, but their code base would immediately become more complicated and slower. Thus, growth over the longer-term would be negatively affected.

> “If you measure success over seven years, [organic growth] is faster. If you measure success over one year, then it’s a lot slower.” – Pieter van der Does, 2020 Capital Markets Day

Importantly, not every CEO we are invested in has all of the traits that I just spent 15-pages discussing. No company is perfect, and no leader is perfect. With that being said, I only want to invest alongside CEOs who overwhelmingly impress me. There are tens of thousands of public companies in the world, and we are currently invested in ten of them. It is perfectly ok if I do not want to entrust our capital to the majority of CEOs that I look into. We only need a handful.

Thankfully, those who do achieve the bar I am looking for often make it obvious. The best CEOs continually impress me the more I learn about them. For example, it is rare that a CEO has really thoughtful opinions on how to best incentivize employees for long-term success, but then seems to be growing at all costs with no regard for prudent capital allocation.

The CEOs we are invested in seem to check almost every high-level box I look for because so many of the traits I discussed—like being kind, humble, and intellectually honest—are correlated. How good a CEO is at running a company and allocating capital is extremely important, but just as important for me is being confident that they are good human beings who will do right by small outside shareholders like us.

A large part of my investing philosophy is finding the best trustworthy founder CEOs who are running companies I understand, and then trusting them to do what they say they are going to do. When I find someone like that, and we can invest in them for a reasonable price, I intend to hold for a long time.

Travis Wiedower

Appendix 1: Historical Results*

Period	Wiedower Capital	S&P 500
2015	-11.91%	-1.37%
2016	19.19%	11.95%
2017	22.28%	21.82%
2018	-18.61%	-4.39%
2019	-3.36%	31.48%
2020	36.99%	18.37%
H1 2021	13.02%	15.25%

Cumulative	56.35%	130.67%
Annualized	7.29%	14.07%

* Started February 24, 2015. Wiedower Capital results are net of fees and are based on a model account that has been active since inception. The model account pays fees as a non-qualified client, which is currently 2% per year. All accounts are managed the same, but individual account results may vary from the above results based on different fee structures and minor position size differences. S&P 500 results include dividends.