Battle Royal
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Dear Fellow Investors:

When I was eight years old I caught the Pro Wrestling bug. Stan “The Crusher” Stasiak, Lonnie Mayne and Tony Borne were the big stars of the Portland, Oregon area wrestling scene. For years they wrestled at The Armory on NE Chautauqua every Saturday night. I was glued to the television set.

Once in a great while they would hold a “Battle Royal”. Twelve wrestlers would enter the ring and they would throw each other over the top ropes until there was only one wrestler left in the ring. The last man standing in the ring was the champion.

As investors, there is a great deal of wisdom to gain from a “Battle Royal”. This format was super entertaining for spectators, but only rewarding financially for the winning wrestler. There was only one winner and one paycheck. It is why one was not held very often, even though the crowd was the biggest at the armory when they did.

At Smead Capital Management we try to avoid industries or investment sectors which become a “Battle Royal”. Let me give you an example. Ford is led by a very effective and successful CEO, Alan Mulally. Ford has survived the worst consumer recession in 70 years and is enjoying the consumer confidence and lead time this affords the company. However, my wife and I will be looking for a new car for her in the next year and have visited numerous dealers. We have been shocked at how many wonderful automobiles there are today made by so many manufacturers. Here is a partial list: Ford (Lincoln Mercury, Volvo), GM (Chevrolet, GMC, Buick, etc.), Chrysler (Jeep, Plymouth), Hyundai, Kia, Toyota, Honda, Nissan, Mitsubishi, Subaru, BMW, Mercedes Benz, Volkswagen, Saab, Porsche, Lexus, Infinity, Acura and Tata (Jaguar and Land Rover).

It appears to us that the industry is providing car buyers too many choices. It could also mean a number of them could be getting thrown over the “top ropes” into bankruptcy in the next economic downturn. On top of the competition from makers of a very similar product, this is a labor intensive and capital intensive business with huge sales swings. These swings have as much to do with exogenous events like gasoline prices, economic growth and labor patterns as they do with corporate execution. It only makes sense that an executive from Boeing would be good at running a capital intensive business which bets the ranch every 5 to 10 years on a new product cycle.

The "Battle Royal" effect is why investors like Warren Buffett avoid technology companies as investments. If you are Cisco, Intel, Microsoft and Apple, you wake up every day knowing that 3 million of the smartest engineers in the world are devoted to inventing a new technology which destroys your monopoly and/or profit margins. Look at how disruptive Facebook has already been to the way we advertise products and use technology. This is the reason you don't see IBM making personal computers or hear the name Unisys or Burroughs or Digital Equipment very often.

Therefore, if "Battle Royals" are a bad thing in investing, what does a good thing look like? Corporate wrestling matches with as little as one or zero competitors are very preferable. We compare Starbucks to Coca Cola and McDonalds. Coca Cola makes the syrup and distributes it. They are the largest seller of beverages in the world. They have had one main competitor over the decades: Pepsi. In the land of anti-trust law it is nice to have one viable competitor.

McDonalds has spent the last thirty years wrestling with a few companies at a time like Wendy's, Burger King, KFC and recently with Subway. Their ability to provide fast food in a clean atmosphere has caused them to know more about what the customer for food and soda pop wants better than anybody else. Mickey D's brand recognition is maximal. They are the largest seller of Coca Cola products in the world and get their best profit margins from liquids. The fact that there are billions of people looking for food every day, allows their competitors to make some money along the way.

Starbucks makes the syrup like Coke and provides the product at the retail level like McDonalds. They sell an addictive legal drug (coffee) and they feature the beverages rather than the food. There is no other major worldwide gourmet coffee company. They don't have a Pepsi or Subway or Wendy's to compete with, and at the present time, there does not appear to be any major corporation which is even vaguely large enough to be a viable number two competitor. New product development for Starbucks is not labor intensive or capital intensive and this fast growing company produces all the free-cash flow it needs to grow its Seattle's Best brand, packaged-product business (led by Via) and expand the core brand around the world. None of the other coffee-oriented companies around the world provide enough national or international competition to Starbucks to really amount to "a hill of beans".

If you look into our portfolio, you will find numerous set ups similar to Starbucks. Disney dominates babysitting children and males (ESPN) with wholesome family entertainment. They get some competition in parts of their company, but have such dominant market share and mind space that there is profit for the others as well. We bet you can't name the number two supplemental health insurance company in the US behind Aflac. Home Depot has Lowe's, Walgreens has CVS and Wells Fargo has US Bancorp, but none of them face a capital intensive, labor intensive "Battle Royal" for the right to remain in the ring.

To create wealth by owning common stocks with long holding periods, you must avoid "Battle Royal" industries and sectors to succeed. We think you'd have to be lucky to have your company be the last wrestler standing.

Best Wishes,

William Smead

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