Devonshire Partners

The Last Vestiges of Differentiation

Anybody who has listened to the Compounders Podcast or followed my writings knows that I am just a little bit obsessed with differentiation. That hyper-focus is present when my team and I are assessing businesses—both public and private—to invest in. It is also present when thinking about where Devonshire Partners sits within the extremely crowded and competitive US equity markets. The reality is that there are thousands of public and private equity firms competing for what appears to be a shrinking pool of alpha. Increased competition erodes excess returns. It doesn't matter what the asset class is.

Given all of that, how can an equity-oriented firm be—and remain—differentiated enough to generate excess returns? After spending 15 years in the public markets and watching the machinations that occur within small cap and microcap companies, my conviction has only grown that great investors who are willing to cap their assets under management and stick to the smaller end of the public markets can outperform over the long run. That is why Devonshire has a microcap opportunities strategy where we are pursuing a number of different avenues for putting capital to work, primarily:

1) Friendly PIPEs (private investments in public equities) where Devonshire would

provide growth equity to a company that has limited access to capital—or would provide capital to fix the balance sheet of a perfectly fine business with a bad balance sheet. As an example, we are in discussions with the management of a compelling business that went public as a SPAC and has a nasty piece of debt that is coming due soon. We are in position to provide a friendly source of capital that relieves the debt burden, takes pressure off of the equity, and gives the company the ability to invest in the business—in a transaction that would give us an almost controlling stake in the company.

2) Buying a large or controlling stake in a public company from a selling founder, CEO, or other large shareholder. I have seen multiple opportunities to do this as a public equities portfolio manager, and those experiences were highly influential in the creation of our strategy. We have found already, and will continue to look for, opportunities to provide liquidity to large shareholders who are ready to exit but don't have many outlets to do so.

3) Executing on a microcap take-private. Every quarter, we have dozens of meetings with microcap CEOs who quite frankly no longer see the benefit of being public. It is expensive and incredibly time-consuming. For example, I talked to a CFO recently who said he spends 50% of his time on things that only have to do with being public. Plus, most of these companies have limited access to capital or the cost of capital is prohibitive. We continue to have multiple, fruitful take-private conversations and are building relationships with companies we are interested in partnering with.

I spent two days recently at a microcap conference in LA and I believe I was the only private equity investor there. We are most certainly fishing in ponds that other private equity firms are not. That is inevitably going to lead to opportunities to put money to work in proprietary or non-competitive situations. We like our chances of generating more than satisfying returns for our investors whenever that is the case.

Differentiation and Edge

One of the best ways to differentiate yourself as an investment firm is to have an edge, loosely defined as some process or structure that helps generate abnormal returns. I think

the term edge is dramatically overused, especially in the public stock arena. Since Reg FD became a reality, the ability to develop an informational edge regarding large companies has diminished to such a degree that it is almost disingenuous for a manager to claim to have such an edge. At Devonshire, we firmly believe there is still an informational edge that can be attained when looking at microcap and nanocap stocks. The dwindling number of institutional eyeballs on these companies and the dearth of large check writers in this market cap spectrum almost guarantee that people who are paying attention can make better-informed decisions.

From our perspective, outside of the informational edge that exists in microcap, there are only a few sources of edge available in the public markets. The first is essentially a time arbitrage advantage that comes from having a stable and patient client base. If most market participants are maniacally focused on the next 90 days and next quarter's earnings report, a firm that truly can take a 3-to-5-year (or longer) time frame is going to have an edge. It might not show up immediately but the ability to benefit from the power of compounding—without getting shaken out by a bad quarter or client redemptions—will be a source of long-term outperformance.

The next source of edge is a mix of behavioral and analytical and is hard to quantify or validate as an allocator putting money to work with an asset management firm. The reason I combine them is that having one without the other is insufficient. What it really boils down to is a research and decision-making process that consistently leads to better outcomes than other firms can achieve. The competitive advantage here stems from some mix of contrarianism, effective data aggregation and ingestion, excellent communication up and down the organization, and the ability to act when the firm develops conviction. This is about people, process, and culture. Every firm tries to develop such an edge in a different way. By definition, very few can sustain such an edge over time, especially if there is a change in leadership.

Simply put, as a public equity manager, if there is limited room to establish an informational edge, you are left with very few avenues to consistently beat other firms and your chosen benchmark. Just ask any value manager or anyone who has to compete with the S&P 500

what the last 10+ years have felt like. They have had to be almost perfect to maintain their asset bases. These comments are not meant to be a condemnation of public equities. Most of my professional contacts are public equity managers—and they all feel this to some degree. I certainly did when I was in the seat. It is a shared reality.

In contrast, in the private equity world, there is another source of edge that essentially doesn't exist with most public companies. It is what I will call relationship edge, and it comes from the way firms and their principals represent themselves in front of owners, founders, and management teams who are selling a business. When you are buying shares of a public company, the stock doesn't know you or care that you own it. But what I learned very quickly is that in PE, relationships matter more than just about anything else. Success comes down to your approach, the way you treat people, the connection you build with all stakeholders, and how comfortable someone is with the idea that you will be their "boss" if you buy a majority of the company. The businesses we engage with represent the life's work of many of the people we interact with. Plus, we are not buying 100% and sending the sellers off into the sunset. We are typically buying 60% to 80% of the business with the hope that the management team is excited to stay on, continue to grow, and get a second bite of the apple that is a lot larger than the first. In such cases the relationship we develop with management really matters.

The Devonshire approach is distinctly non-coastal, despite that fact that we are located in California. That approach tends to resonate with sellers who operate businesses outside of the coasts and who care about things other than just price. The valuation will always be a major component of every transaction, but I have already witnessed many occasions where we have quickly ingratiated ourselves with the sellers. As a tangible example, I interviewed the CEO of one of our portfolio companies about why he decided to sell to Devonshire. It turns out that he really liked Shahzad and thought he could work with him for a long time. He told me that going into the process, he was focused 100% on price but, as he started to better understand what his life was going to be like post-transaction, things like demeanor and enthusiasm regarding the company's growth opportunities became just as important. A friend of mine who is a very successful independent sponsor told me that there are a lot of jerks in private equity. I can't vouch for that, but we certainly want to be the antithesis of any

such people. That is not going to matter in every deal, but our goal is to develop the best relationship with management of all the players in the process—with the hope that even if we aren't offering the highest price, the relationship is what seals the deal.

Relationship edge is one that builds and compounds the more investments you make and the longer your brand is out there. The extreme example of course is Warren Buffett of Berkshire Hathaway, who often gets the first call when a business is available for sale. We are not going to develop that kind of cachet overnight. But if we employ a consistent approach, we firmly believe we can build a sustainable edge in private processes. And on the public side, we are playing a long game where we are building relationships with public company management teams who invariably don't have a lot of conversations like the ones we are having with them—at least not on a consistent basis. My impression from my discussions is that very few investors are calling these executives to express the desire to make a strategic investment in the company. That differentiates Devonshire and hopefully, over time, allows us to develop a sustainable relationship edge.

Trying to live in the now—and five years in the future,

Ben Claremon
Partner

Our general public service announcement is as follows: we are interested in expanding our network of all the stakeholders in this industry. So, feel free to reach out to me and Shahzad (skhan@devonshirepartners.co) if any of the above resonates with you. For anyone with access to deal opportunities, please see our private company deal criteria below. As a reminder, Devonshire is willing to pay referral fees to anyone who brings us deals. Also, we are happy to chat with people even if they don't have a deal right now that fits the below criteria.

General Criteria

Founder-led or family-owned-and-operated companies with EBITDA of between $2-$10

million that have 10+ years of operating history.

Industry Focus

All industries except for metals & mining, natural resources, biotech, banks, and insurance companies.

Investment Type

We are open to buying minority or majority interests as a result of owner liquidity events, succession planning, management-led buyouts, and spin-offs.

Recommended Podcasts

We listen to a lot of podcasts at Devonshire. We know that there are far too many great podcasts out there for anyone to consume all the content. As such, like with our investments, we try to be highly selective in our recommendations. Below we have highlighted an insightful Invest Like the Best podcast and included a shameless plug for Devonshire content. We hope you enjoy these episodes.

External Content

It is not a secret that the private equity world is obsessed with roll-ups and platforms. The basic idea is that the consolidation of fragmented competitive bases is a way to professionalize the entire industry and a wonderful way to take advantage of multiple arbitrage. Buy a platform company for 9x EBITDA using leverage, make follow-ons at 4-5x EBITDA and get to a size where someone else will pay 15x for the platform. What possibly could go wrong? In an insightful and sobering interview with Alex Sloane and Matt Perelman of Garnett Station Partners, Patrick O'Shaughnessy dove deep into why it is so hard to get a multi-unit franchise roll-up right. The part that was most interesting to me was where they discussed what makes roll-ups go wrong: too much leverage, not integrating the companies well, not respecting companies' culture, and focusing on EBITDA and not free

cash flow. On that latter point, the following discussion of the flaws associated with believing adjusted and pro-forma EBITDA numbers really resonated with the Devonshire team:

The other problem is people, we've found, they fool themselves with this sort of adjusted EBITDA, run-rate EBITDA, pro forma EBITDA nonsense. In a world of zero rate and with leverage, perhaps you could sell these things like the hot potato to the next buyer. But people forget, in part, the Trump tax cut—they capped interest deductibility at 30% of EBIT.

So you look at some of these consolidations, and you say, how much of that adjusted EBITDA actually turns to cash flow? Okay, how much leverage did you put on this business? Now rates went up by 500 basis points. Did you buy caps and swaps on the debt? If you did or you didn't, what is your tax rate?
How much actual cash flow is there in these businesses? And that's what sort of scares us about some of these consolidations, is how much of the EBITDA that you're underwriting actually turns into cash flow. And we're very focused on that, in part because of our roll-up experience. But also, again, we're students of history.

When you look back at some of the failed roll-ups, I think a lot of it was believing the pro formas and the run rates. And when you're acquiring things and when you're in super acquisition mode, you can always have those adjustments. The problem is when you say, 'Wait a second, what do I actually own? How much of that is real?' And can I maintain the culture at each of these local businesses in order for those cash flows to persist and grow?

You can find the full interview here: https://joincolossus.com/episode/the-art-of-franchise-investing/

Internal Content

During the last quarter, Ben Claremon had the opportunity to appear on the Talking Billions podcast, where he discussed Devonshire's microcap opportunities strategy in depth. For anyone who hasn't heard our perspectives on the why the microcap space is so compelling at the moment, this podcast represents a good overview of the philosophy, approach, and

differentiation (there's that topic again) of the strategy: https://www.talkingbillions.co/episodes/ep-96-ben-claremon

If you would like to follow us and the Devonshire journey on a more regular basis, please subscribe to the Compounders Substack and the Compounders podcast, which can be found on Apple, Spotify or wherever you listen to podcast.