BANYAN CAPITAL MANAGEMENT

January 29, 2018

It is more difficult for us to keep up with the S&P 500 in raging bull markets. Our job gets tougher as stock prices rise. Nevertheless, we were largely up to the challenge in 2017. Banyan's equity composite was up 17.5% for the full year while the S&P 500's total return was 21.8%. (Explanation of how composite is compiled)

We are pleased with our performance, but we are not satisfied. We remain on the hunt for attractive opportunities. Admittedly, they are harder to find in today's markets. To us, investing boils down to business valuation. When business prices are high, investing is difficult.

As we have said in the past, however, value is in the eye of the beholder. What is expensive to one investor looks like a bargain to another. Business valuation is an imprecise science, perhaps even an art. If someone tells you otherwise, run.

Once an investor estimates a business's earnings power, what will he or she pay for it? Or, as we prefer to say, is the "earnings power yield" sufficient given (1) the sustainability of the business's economics and (2) our opportunity costs? Reasonable minds can always differ here.

What's more, ***reasonable minds can always differ as to what a business's earnings power is to begin with***. In fact, investors cannot even know with certainty what a business truly earned in the past. The two most popular accounting proxies, net income and free cash flow, regularly fall short.

Consider the following two examples:

1. Tangible Assets & Depreciation – Depreciation is a non-cash charge reflecting the erosion of an asset's value, and the charge is based on the asset's historical price and useful life. If the asset's replacement cost is rising (falling), however, the depreciation charge will understate (overstate) the true cost of use. Furthermore, there may be no depreciation at all if the asset is idled. The mechanistic nature of depreciation fails to capture the nuances of reality and, thus, may cause net income to misrepresent what a business truly earns.

2. Intangible Assets & Amortization – Unlike tangible assets, the cost of creating an intangible asset is rarely capitalized and amortized over the asset's life. This has material distorting effects. If a business spends $1,000 acquiring a customer with an expected life of five years, for instance, the cost should be amortized at $200 per year over five years. Instead, a $1,000 expense is incurred in year one. This distorts both net income and free cash flows and makes growing businesses appear less profitable than they truly are.

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There are many such examples, but these are sufficient to make our point: There is nothing precise about business valuation. ***The two most important factors, earnings power and the multiple to pay for each dollar thereof, are both highly subjective***.

For this reason, we are baffled by many investors' "precision." We regularly see earnings estimated to the dollar five or more years into the future. To us, this is a form of pseudoscience and it is risky. The illusion of precision cultivates overconfidence, and overconfidence dulls the senses.

We prefer to recognize reality and proceed accordingly. We are conservative at every step, and we spend our time focusing on the knowable – a business's economics – rather than the unknowable – a business's "earnings" five years hence. In our humble opinion, this is a better way to preserve capital, which is the first step towards ***building permanent wealth***.

Sincerely,

Gary L. Watkins
President

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