April 11, 2024

Dear Client,

Banyan's equity composite gained 9.1% in the first quarter of 2024 versus the S&P 500's total return of 10.6%. Over the trailing three- and five-year periods, our equity composite compounded at 7.9% and 14.2% per year, respectively, while the S&P 500 compounded at 11.5% and 15.1% per year, respectively. For more details about our equity composite, please click here.

Niches & Profits

At Banyan, we own an exceptional group of companies that occupy diverse niches. Collectively, they make valves, hoses, and fuel systems for engines, water filters for utilities, gas pumps for gas stations, and computers for us all. They also insure risks, extend credit, process transactions, run lab tests, sell used cars, brew beer, play music, lay fiber, pay doctors, and supply dentists.

But none have their niches to themselves. Our companies compete daily to satisfy the consumers who nourish their niches, and satisfying consumers is hard work. Transforming inputs, usually available to all, into more valuable output requires a lot of costly energy. Workers earn wages for their efforts, equipment depreciates with use, and capitalists demand returns on their surplus.

Companies are hungry creatures, but consumer demand is finite. Rarely, then, can all occupants of a niche satisfy their appetite. The struggle for existence is therefore fierce. Many occupants die of malnourishment, and a hard life of break-even persistence awaits most survivors. Profits, much less big profits, are rare in the brutal jungle of commerce.

This is as it should be. Profits signal a market need. Demand is exceeding supply. Luckily, the world teems with smart people trying to get rich. These people, also called entrepreneurs, run to the scene in hopes of riches. They flood into the profitable line of business and supply rises. Their entry solves the market need, but the profits they were chasing vanish like a ghost.

Not all markets function this efficiently, however. Big profits, rather than being rare, are the norm in such cases. Such niches usually share two characteristics. First, the occupants have competitive advantages making it difficult, if not impossible, for new entrants (i.e., entrepreneurs) to compete effectively. Second, since new entrants struggle to survive, few companies occupy the niche.

Since there are few occupants of the niche, consumer demand can satisfy the appetite of all. As a result, the struggle for existence is not fierce, and profits rise to abnormally high levels. Whereas an influx of entrepreneurs would usually end the party, the competitive advantages of incumbent occupants keep the entrepreneurs at bay. Accordingly, abnormally high profits persist.

Despite their rarity, identifying companies operating under such conditions is not difficult. Look for persistently large profit signals that go uncorrected. Look for years of abnormally high returns

on tangible capital employed, in other words, which our companies have. Their weighted average return on tangible capital employed was 52.8% in their latest fiscal years, as shown below.[1]

Banyan's Equity Portfolio *End of Q1 2024*		
Stock	% of Equity Holdings	Return on Tangible Capital Employed
Cigna (CI)	11.1%	36%
Berkshire (BRK.B)	10.8%	9%
Vontier (VNT)	10.2%	83%
Markel (MKL)	9.3%	4%
Parker Hannifin (PH)	8.3%	81%
Carmax (KMX)	6.4%	7%
Apple (AAPL)	6.3%	205%
Amex (AXP)	6.1%	9%
Liberty Sirius (LSXMK/A)	5.7%	176%
Charter (CHTR)	5.3%	29%
Phinia (PHIN)	5.3%	22%
Labcorp (LH)	4.3%	29%
Danaher (DHR)	3.5%	61%
Henry Schein (HSIC)	3.3%	29%
Heineken (HKHHF)	3.0%	24%
Veralto (VLTO)	0.2%	160%
Fortrea (FTRE)	0.2%	21%
Weighted Average Return		**52.8%**

Think about this. Our companies earn 53¢ on every dollar employed in their businesses. If a normal return on capital is 10%, then every dollar invested in their businesses is worth $5. This degree of wealth creation has certainly attracted hordes of entrepreneurs over the years. Yet, our companies' big profits persist. They *must* possess formidable competitive advantages.

If anything, this understates the case. CarMax's niche is in a recession, which hurt its profits. Also, financial companies accounted for 26.2% of our portfolio, and their profits are best measured on equity since they use low-cost debt (i.e., deposits and float) to finance their businesses. Excluding these, our companies' average return on tangible capital employed was an even higher 74%.

On average, the market values this more profitable cohort at 19 times pretax enterprise earnings. They earn 74¢ of pretax enterprise earnings on each dollar employed in their businesses. Thus, each dollar employed is worth $14 of market value! This yawning gap between capital invested and market value should not persist. Yet, it does thanks to their competitive advantages.

Admittedly, financial data is backward looking, and competitive advantages can weaken with time. Abnormal profits then become normal, if not worse. Companies with competitive advantages that have stood the test of time are a great starting point, however. They are most likely to sustain their profits, and only sustainable profits can ***build permanent wealth***.

Sincerely,

Drew Estes, CFA, JD
Portfolio Manager

[1] Return on Tangible Capital Employed = Pretax Enterprise Earnings ÷ Tangible Capital Employed