Long Product Lifecycle: A Predictive Attribute

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Regular readers are familiar by now with Horizon Kinetics' focus on qualitative attributes that may be predictive of outperformance. Consistent with the Firm's long-term value investing philosophy, identification of these traits has been central to our research and investing process since the inception of the Firm. Fundamental research is generally required to identify these characteristics. This is a time-intensive process, which contrasts with the quantitative screens that can be used to identify groups of stocks with similar price to earnings ratios or sector classifications. However, the long-term performance of companies described by these predictive attributes suggests that the effort is worthwhile. Recent commentaries have highlighted owner-operators, dormant assets, spin-offs, bits & pieces, and scalability. This month's discussion will center around long product lifecycles.

Companies with short product lifecycles face a constant challenge: they must develop new products or reinvent themselves regularly or risk losing market share or profitability. Consider computer hardware manufacturers or video game developers, for example. As new technologies or games come to market, prior versions quickly become obsolete, or at least fall in popularity. Therefore, continuous investments in research, product development, and marketing are required just to stay in place, much less to increase market share or profitability. Witness the experience of BlackBerry (formerly Research in Motion Ltd.). In a matter of years, the BlackBerry corporate arc descended from dominance of the smartphone for business use to a brand struggling to maintain market relevance, as Apple Inc.'s iPhone and smartphones powered by Google Inc.'s Android platform have overtaken the BlackBerry's share of the retail and business segments. This short-lived market dominance is not atypical of technology companies; accordingly, Horizon Kinetics tends to avoid long exposures to such stocks. Though there are periods when this aversion results in underperformance relative to the broader markets, often over an extended time horizon (as, rather dramatically for us, during the 1999 to mid-2000 technology bubble period), our experience has been that companies based on long lifecycle products are more appealing. While these businesses may still have variable revenues and earnings, as all businesses do, the greater likelihood that their products will still be in demand tomorrow contributes to more predictable long-term results.

Jarden Corp. ("Jarden" or "JAH") is a holding company whose brands include the household names Coleman, Oster, Marmot, First Alert, Mr. Coffee, Bicycle and also Bee playing cards, and Crock-Pot, among others. Many of these brands have been prominent for generations; 14 have been in continuous use for over a century. Jarden has made investments in the brands but is able to benefit from the fact that they are long-standing, easily recognized brand names—efforts to increase visibility for an existing, trusted brand are frequently less costly than those to establish a new one. Furthermore, while some portfolio components (K2 skis and snowboards, for example) may be sensitive to economic conditions, many are not. For instance, many people consider their morning coffee to be a key part of their morning routine—if a household's coffeemaker breaks, it will most likely be replaced even in a weak economy. As a measure of the value the company places on its brands, it acquires almost

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exclusively products that occupy the #1 market share in their category. It is very difficult to competitively displace this type of consumer brand. Jarden's brands represent #1 market positions in 23 categories, including fishing, coffee makers, blenders, smoke alarms, and playing cards.

In addition to adding new product lines to the portfolio and making the necessary investments to maintain or expand the market share of their brands and the long-term profitability of the company, Jarden management's assertive advocacy for shareholder (as opposed to executive officer) returns predates their own tenure. The current management team, headed by Martin Franklin (Executive Chairman) and Ian Ashken (Vice Chairman and Chief Financial Officer) has been in place since June 2001. Immediately preceding that date, as outside private equity investors, they had proposed, in a letter to the Board of Directors, to take the company private. Their letter of criticism and proposed action so impressed the Board that they invited Mr. Franklin and Mr. Ashken to join rather than acquire the company, and to manage it. Which they did. Aside from divesting poorer products, they undertook a series of leveraged acquisitions of the class of consumer products companies that now characterize the portfolio, deploying the cash flows generated by mature brands to pay down the debt. The company has also actively repurchased shares. These actions have contributed to the annualized book value per share increase of 30% witnessed since 2001.

DreamWorks Animation SKG Inc. ("DreamWorks") is the producer of animated children's content, including successful franchises such as *Shrek* and *Madagascar*. (One should not fail to note that "SKG" is an acronym for founders and principal shareholders Steven Spielberg, Jeffrey Katzenberg and David Geffen. This is as qualitatively significant as any other objective assessment metric.) The stock price of DreamWorks tends to fluctuate with the box office success of its latest theatrical release—in late 2012, the tepid audience response to *Rise of the Guardians* triggered a stock price decrease, while the above-expectations performance of *The Croods*, released in late March 2013, contributed to a stock price recovery. This is an entirely normal phenomenon, since investors clearly view the value and prospects of DreamWorks as direct outcomes of the success or failure of the company's most recent release. If box office receipts were the only source of revenue from a film, DreamWorks would certainly not appear in a commentary on long product lifecycle. However, there is an entirely different and far more important dimension to the long-term value of its proprietary content. Once a film has been produced, it is an asset that exists in the film library—practically speaking, forever. Additional revenues may then be generated from the library as, for instance, from DVD and streaming sales, or television broadcasts, at very little incremental cost. A successful film may form the basis of a franchise, including subsequent theatrical releases and television series—for example, there are now three *Madagascar* movies as well as a television series based on a subset of the characters. The characters may be licensed for merchandising, or for use in other entertainment venues. DreamWorks recently signed several agreements based on the use of their characters in theme parks in Macao, Russia and mainland China.

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In addition to continuing to produce new content, DreamWorks has been adding to its library through acquisition. In 2012, DreamWorks acquired Classic Media, a portfolio of characters including *Where's Waldo?*, *Transformers Animated*, *Rocky & Bullwinkle*, and *Olivia*. As the number of distribution channels expands, so too does the demand for content. If there is a key statistic for valuing DreamWorks, it is not the success of its most recent film, but the growing size and value of its film library, which can continue to generate earnings for generations. While any investor can readily find the company's most recent revenue or earnings figures on a financial market website, one cannot screen for the number of titles in the DreamWorks library.

AutoNation Inc. ("AutoNation") is the country's largest automotive retailer. In addition to operating new and used vehicle dealerships, the company has a finance and insurance business, as well as a parts and service segment. Though it is not necessarily the case in urban centers such as New York City, in most parts of the country travel by automobile is the norm and owning a vehicle is a necessity. Though new car models are introduced annually, and sales levels vary depending on the economic environment, it seems highly unlikely that automobiles will be rendered obsolete any time soon; AutoNation can be said to benefit from a long product lifecycle. Furthermore, the company engages in a strategy to have representation across all major automotive brands within a given market; this serves to mitigate fleeting trends in brand preferences. It has also begun to re-brand its local dealerships under the AutoNation umbrella brand; it remains to be seen whether this additional strategic thrust will be successful.

The automobile market was severely impacted by the global financial crisis. Light vehicle sales totaled 10.4 million units in 2009[1], compared to 16.9 million units in 2005. In 2012, light vehicle sales totaled 14.4 million units—significantly recovered, but still below the 2005 level. Nevertheless, AutoNation has reported steadily increasing sales and earnings per share (EPS) since the 2009 trough.

The EPS trend has been aided by the company's share repurchase strategy. The company has now retired $7 billion worth of shares at an average price of $17 per share—59 million shares were retired between February 2008 and February 2013 alone, which amounts to 33% of the original share base over the five year period. There are few precedents for a public company engaging in a quasi-going-private strategy on this scale. AutoNation recorded EPS of $2.52 in 2012, which is nearly 74% greater than its earnings per share in 2006 (when light vehicle sales were over 16% higher than they were in 2012). Though the share repurchases certainly contributed to the EPS increase, acquisitions of dealerships throughout the financial crisis were also a major factor.

[1] Source: Bureau of Economic Analysis

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Automobile sales is a highly competitive industry, as evidenced by low profit margins—in 2012, AutoNation generated 81% of revenue through the sale of new and used cars, yet this activity only accounted for 35% of its gross profit. The parts and service segment alone, with only 15% of the company's revenues generated over 40% of its gross profit; together with finance and insurance, these two divisions produced two-thirds of AutoNation's gross profit. The parts and service segment also contributes to the long product lifecycle characteristic of AutoNation's business. A consumer is not likely to purchase a new vehicle very frequently; however, a vehicle requires regular service. While car sales are cyclical, car usage is much less discretionary, irrespective of the economic environment; therefore, owners must have their car serviced regularly to keep it in working condition. As mentioned above, the service and parts division generates far less revenue than does the core auto sales operations, yet contributes higher gross profit. This business has been weak for the past several years due to poor trailing light vehicle sales—the core customers for the service and parts division are those who have made purchases in the past 1 to 5 years. However, as car sales have begun to normalize, it seems reasonable to expect parts and service revenues to increase on a slight lag. During the company's fourth quarter 2012 conference call, management stated that "2012 was the trough" and "service and parts is the foundation of our business." Not only does AutoNation stand to benefit from a normalized auto sales environment, but it also stands to achieve higher profitability due to the shift in revenue mix going forward.

Due in part to the persistent demand for their offerings, many companies with long product lifecycles are able to steadily compound book value, even in difficult markets. In spite of their long-term return potential, many of these companies are currently trading at attractive valuations, providing a margin of safety for investors with a sufficiently long investment horizon.

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