ValueInvestor INSIGHT
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Value for the Money

Akre Capital's John Neff and Chris Cerrone describe what sets their "compounder" investment strategy apart, why they've made the few portfolio moves they have this year, how they're doing without Chuck Akre as a co-portfolio manager, and why they see mispriced value in American Tower, Moody's, Constellation Software and Roper Technologies.

INVESTOR INSIGHT

Akre Capital
John Neff *(l)*, Chris Cerrone *(r)*

Investment Focus: Seek companies with strong and profitable reinvestment runways when their stocks are fairly priced relative to their value-compounding potential.

Akre Capital's John Neff and Chris Cerrone learned about investing in high-quality companies from one of the style's foremost practitioners, Chuck Akre [*VII*, December 30, 2020]. As that approach has become increasingly common, says Cerrone, he believes the Akre rendition remains somewhat unique: "I think we emphasize more than others that investing in great companies and letting them compound over time doesn't really work unless you're disciplined about valuation."

That approach has consistently churned out market-beating performance. Over the past ten years the Akre Focus Fund has earned a net annualized 14.1%, vs. 12.8% for the S&P 500. Cerrone and Neff are finding quality at good prices today in such areas as software, asset management, credit ratings and wireless infrastructure.

In an environment with higher interest rates and less-accommodative monetary authorities, one of the best growth investors out there recently put out a video addressing the question, "Is quality stock picking broken?" Jumping right in, how would you answer that question?

Chris Cerrone: We've spoken many times with you in the past about what we try to do in bringing value to our clients. We're looking to invest in great businesses that have demonstrated high returns on capital and high levels of free cash flow, primarily due to benefitting from significant barriers to entry and pricing power. We want to invest alongside excellent management teams with histories of treating shareholders as partners. And we want to invest in businesses with great reinvestment track records and opportunities.

The last critical piece, which speaks to your question, is we have to be disciplined with respect to valuation, to have a good sense of a business's value and only invest when we believe the odds of compounding value at high rates of return over long periods of time are stacked in our favor. That version of quality stock picking we don't at all believe is broken. But quality investing in the absence of that type of valuation discipline has more to do with "collecting" than it does investing. We're not collectors of outstanding businesses at any price, we're investors in outstanding businesses when our discipline allows us to buy them at what we think are opportunistic valuations.

There are obviously many aspects of a company to consider, but would you say one characteristic stands out in separating the great investment opportunity from the good one?

CC: I would say maybe where we put more emphasis than some is on the extent of the reinvestment opportunity, both in terms of the absolute magnitude of the opportunity and on the ability of the management team to capitalize on it. Getting that wrong can really short circuit what might otherwise be a promising investment, while getting it right can really turbocharge shareholder returns.

John Neff: Bill Walsh, the former head coach of the San Francisco 49ers, used to say that when he was calling plays in critical situations he thought less about plays than he did about players. Putting that in an investment context, we think it can be useful to think about which CEOs are most likely to capitalize on tough times by taking advantage of the more attractive reinvestment opportunities that are likely to be present during those times.

One of the first CEOs that comes to mind for me is Andy Florance, the founder of CoStar Group [CSGP]. The company continues to evolve as the leading technology vendor to the commercial real estate industry, first in providing data, software and advertising tools that are de facto industry standards, and more recently in acquiring and building transactional online marketplaces like Apartments.com and Ten-X. We think it's an incredibly resilient business through real-estate cycles, and the company today has almost $5 billion in cash to reinvest in its business when others are pulling back. They've been very

disciplined about what they do and when, but this would be an environment where we consider Andy Florance and CoStar players to watch.

Describe generally how you think about valuation.

JN: The right price for us to pay is one that we expect will deliver to investors a return that at least mirrors the growth rate in economic value per share the business produces. If we project that a company over the next five years is going to compound its free cash flow per share at 15% annually, then a fair price to pay for that business is one that earns us 15% compounded as well. Arithmetically, that requires that the valuation multiple we pay to make the investment will at least be maintained over our holding period. So we always try to be conservative in what future valuation multiples we are willing to underwrite.

We get asked a lot if rising interest rates have materially changed our valuation framework, and the answer is no. We don't tend to underwrite multiples in the future that have been meaningfully challenged by a 4% 10-year Treasury. We never drank the Kool-Aid that 1% was going to be sustainable, so with the benchmark rate at 4% – essentially a 25x P/E for no growth – our valuation outlook hasn't materially changed.

Ultimately we're looking to underwrite mid- to high-teens rates of return. The wider the variance in our upside and downside cases, the higher the IRRs we'll require. When we're confident the range of outcomes is more narrow, the acceptable IRR might be slightly lower.

You're rarely that active in buying and selling, which appears to have been the case so far this year as well. What does that say about your general assessment of the current opportunity set?

JN: We've actually been very productive in terms of looking at new ideas, but overwhelmingly that work has deepened our appreciation of what we already own rather than resulted in our buying something new. But we do believe the few additions and subtractions we've made have improved the quality and prospective growth of the portfolio.

What made cloud-software company Snowflake [SNOW] make the cut as a new position?

CC: We agree with the big, simple idea that private and public enterprises are likely to continue to embrace cloud computing, so there's a tremendous tailwind behind software vendors like Snowflake that provide to cloud customers products and services that are unique and value-added.

ON QUALITY:

Quality investing in the absence of valuation discipline has more to do with "collecting" than it does investing.

The company's platform allows users to more effectively warehouse, organize and analyze not only their own data, but also data shared by and with others. Previously, sharing meant data sent from one entity to another, so the provider lost control of it once they sent it out and the recipient got control of data that became more obsolete as time passed. What Snowflake does is basically poke a hole through the firewalls between the data belonging to companies on its platform, allowing them to share data in a way entirely defined by the data provider. Control remains very much in the provider's hands, but the data shared is always up to date.

Snowflake has been successful in building out vertical-specific networks that become more powerful and valuable as users join the network. The company is now also opening the platform to third-party app developers, which should extend the functionality available to users and reinforce the network effects of being part of the platform.

The CEO, Frank Slootman, and CFO, Mike Scarpelli, have an outstanding track record in enterprise software, most notably at ServiceNow and Data Domain, and have been very deliberate and articulate in laying out a competitive-advantage road map for the company. That's important given the concern that one day the giant cloud providers may try to disintermediate them, which we think would be very difficult to do.

While the company came public in the fall of 2020 at $120 per share and the stock relatively quickly went above $400, earlier this year it traded back down near the IPO price and we built a small position. The business is just turning free-cash-flow positive, but this is one where we expect the growth rate to be faster than what is typical for us. Even assuming multiple contraction over our holding period, we were able to underwrite a shareholder IRR above 20%. [*Note*: Snowflake shares closed recently at around $135.]

Describe the reasoning behind two recent portfolio subtractions, Dollar Tree [DLTR] and SBA Communications [SBAC].

CC: Dollar Tree is a business we owned for more than 10 years, the first half of which was tremendous from a shareholder perspective and the second half of which wasn't. We talked earlier about how critical management's reinvestment decisions are. In this case the company's purchase of Family Dollar in 2015 completely changed the trajectory of the business. We were quite patient, but after years of underperformance and turnover in management, we concluded this was on the shortest leash from a quality, management and reinvestment point of view when it came time to raise cash.

JN: The rationale was a bit different for SBA. The fundamental quality of the business – cell towers – is very high. But the valuation just became very full. The stock traded at a significant valuation premium to American Tower, which we'll speak in more detail about later, despite SBA's growth potential being comparable to

American Tower's and its debt leverage being higher. So this wasn't a quality, management or reinvestment issue, we just thought the IRR wasn't sufficient for it to keep its place in the portfolio.

You generally only hold 20 or so stocks at a time, but there often seems to be a thematic element to a number of your ideas. Is that the case today with asset-management firms KKR [KKR] and Brookfield Asset Management [BAM]?

CC: Yes. Over the past 20 years there has been a meaningful shift in institutional investors' portfolios away from publicly traded stocks and bonds and into alternative asset classes, including private equity, private credit, infrastructure and real estate. Allocations to alternatives have gone from single-digit percentages in many cases to 30% or higher. There are also new categories of investors, such as insurance companies and the high-net-worth channel, which are just now accelerating their interest in alternative assets. We expect total assets under management for alternative managers to grow at 10% or better over the next five or ten years, a big wind at the back for investment managers like KKR and Brookfield.

What stands out about these two companies in our minds is their own compounding mindsets. Unlike some competitors, they retain the vast majority of their earnings and reinvest it alongside their clients' capital. We expect that to be an incremental driver of shareholder value.

The market seems quite concerned that rising interest rates will negatively impact these companies' money-raising abilities and their investment returns.

CC: You should expect fund raising to slow in certain areas, specifically those thought of as fixed-income substitutes. But there are a number of asset categories, such as distressed debt, where fund raising may be enhanced. Many alternative asset classes have historically provided quite resilient performance in these kinds of market environments.

With respect to higher interest rates crimping returns in private equity, the math works out that you only need a slight decline in purchase valuations in order to offset higher costs of borrow. As an illustration, a buyout with a purchase price of 9x EBITDA, leverage of 6x net debt to EBITDA, an average cost of debt of 6.5%, annual EBITDA growth of 7%, and an exit multiple of 8x, would generate an IRR of 22%. If you hold all of the other assumptions the same, if borrowing costs increase 200 basis points, from 6.5% to 8.5%, the rate of return would decline from 22% to 20.5%. To get back to 22%, the purchase multiple would only have to decline from 9x EBITDA to 8.8x EBITDA. We don't consider that type of adjustment in private-market valuations to be unreasonable.

ON NEW IDEAS:

Our work on new ideas has overwhelmingly deepened our appreciation of what we already own.

In the past you've been willing to hold cash in some volume when net inflows were strong and you couldn't put the money to work as productively as you'd like. What's your cash balance look like today?

JN: We've long described the three best "shock absorbers" for equity investors as owning exceptional businesses, paying reasonable valuations for them, and building cash when reasonable valuations are hard to come by. There's been no change in our thinking on that front.

We don't consider cash a drag, not because of the returns we can make on it – which in recent years have been quite minimal – but because of the behavior it promotes. Morgan Housel talks about the positive benefit of cash in his book, *The Psychology of Money*, in the way it helps prevent you from ill-timed sales of your stocks during a bear market. We think investors who are willing to hold or accumulate cash when valuations are frothy are more likely to behave better during tough times when opportunities abound. By "behave better," we mean sell less and/or buy more.

Today our cash position is around 4%, and it would probably be even lower if we weren't being careful about meeting redemptions without having to sell anything. We've had to be defensive out of prudence, but we'd rather be playing offense now than defense.

Update us on your investment case today for long-time portfolio holding American Tower [AMT].

JN: As is typically the case for us, it starts with the quality of the business. American Tower is the largest independent U.S.-based owner of cellphone towers. It leases antenna space on its multi-tenant sites primarily to wireless communications and data providers. The tower is the point where digital signals from the core optical network are transformed into analog radio signals that connect to wireless devices, and vice versa. That transformation between digital and analog is fundamental to wireless connectivity, making cell towers a bottleneck business for wireless data and communications.

Due to the physics of radio frequency, signal propagation and spectrum reuse and handoff, multi-tenant towers offer the ability to create wireless-network coverage and capacity more cost efficiently than any other method. That was the case ten years ago and is very likely to be the case 20, 30, 40 or more years from now. For economic and regulatory reasons, you can't just put these towers up willy nilly, making each tower something of a geospatial monopoly. And driving all this is the secular growth of wireless data consumption at 30-40% per year globally. That drives long-term demand for more cell towers, more tenants per tower, and more equipment per tower. American Tower already has AFFO [adjusted funds from operations] margins of over 40%, and adding

more tenants and equipment is done at a roughly 90% incremental margin.

Given that they have long-term "hell or high water" leases that have built-in annual pricing escalators, I would be hard pressed to think of a business that has more top-line visibility than this one. The company reports in its 10-K what are called "future minimum rental receipts expected from tenants with non-cancellable operating leases." That number at the end of 2021 was $61.4 billion, which is the equivalent of 6.7 years of last year's annual revenues.

Is the ongoing rollout in the U.S. of the fifth-generation [5G] mobile network an incremental positive?

JN: Yes. The company recently highlighted how the big three mobile carriers in the U.S. – Verizon, AT&T and T-Mobile – spent roughly $30 billion per year deploying 4G, but for 5G that spend is running at around $35 billion annually. A key feature of 5G is the use of higher-frequency spectrum bands than have ever been deployed previously. That higher-frequency spectrum has a lot of capacity, but not the range that lower-frequency spectrum does. Higher-band frequencies also cannot penetrate as well rain, foliage and buildings. 5G thus requires tower networks to become more dense, both in the number of towers and in the equipment on each one. The network upgrade for all this in the U.S. is unequivocally good for towers.

Are opportunities outside the U.S. equally bright?

JN: There have been some areas such as India that have had growing pains. But for the most part AMT's international expansion has been very successful. It has also allowed American Tower to remain more tower-centric rather than dilute the business quality with less attractive reinvestment into things like fiber. As of the end of 2021, 80% of its towers were outside the U.S., in countries such as India, Brazil, Mexico, Germany and South Africa. Countries are at different stages of development, but in all cases are on similar or even accelerated growth trajectories toward wireless. We think the global scope here enhances the reinvestment runway substantially.

On the subject of reinvestment, what's your take on the company's $10.1 billion acquisition a year ago of data-center company CoreSite?

JN: Investors have questioned both the strategy behind the acquisition and its price tag. CoreSite's 28 datacenters are highly interconnected and host a disproportionate number of cloud on-ramps. AMT believes that we're going to see cloud on-ramps proliferate from the core out to the edge, meaning closer to end users in order to reduce transport costs and improve latency. They believe wireless towers will have an important role to play in making up that network edge and that the big cloud companies like Amazon Web Services and Microsoft may be significant future tenants on their towers. The jury at the moment is still out on that, but we think the concept makes sense and could open up a significant new area of growth for the company.

INVESTMENT SNAPSHOT

American Tower
(NYSE: AMT)

Business: Owns, operates, develops and maintains multi-tenant communications towers used primarily to provide to end customers the wireless services of global wireless carriers.

Share Information (@11/29/22):

Price	**217.22**
52-Week Range	178.17 – 294.40
Dividend Yield	2.7%
Market Cap	$101.13 billion

Financials (TTM):

Revenue	$10.45 billion
Operating Profit Margin	30.3%
Net Profit Margin	27.8%

Valuation Metrics
(@11/29/22):

	AMT	S&P 500
P/E (TTM)	33.0	19.1
Forward P/E (Est.)	44.3	17.8

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Vanguard Group	13.0%
BlackRock	7.7%
State Street	4.6%
Cohen & Steers Capital	2.9%
Wellington Mgmt	2.6%

Short Interest (as of 11/15/22):

Shares Short/Float	0.8%

THE BOTTOM LINE

While its shares are often expensive given its growth profile and the predictability of its business, rising interest rates have impacted the market's enthusiasm for the company's stock and created opportunity, says John Neff. Given its profitable runway for reinvestment, he believes at the current price he can underwrite a roughly 13% IRR on the shares.

Sources: Company reports, other publicly available information

American Tower's shares are rarely inexpensive. Describe how you're looking at valuation with the stock price now at just over $217?

JN: Businesses with this kind of visibility tend to be expensive because investors like predictability. But the company is organized as a real estate investment trust and even though it isn't a dividend play like most REITs, its shares still tend to come under pressure when interest rates are rising. That has been the case this year and is certainly a factor in creating the current opportunity.

The stock price has bounced back some, but just a few weeks ago when the shares traded below $200 we could underwrite this at a mid-teens annual return. That's now more in the 13% or so range, which we still consider very attractive for a company with this combination of business quality, management and reinvestment opportunity. As of our reporting at the end of September, this was an 11% position for us.

Turning to another long-time Akre Capital holding, describe the upside you see today in Moody's [MCO].

JN: Let me start by talking about the less well known Moody's Analytics side of the business. Under the mantra of facilitating "better decisions" by its financial and corporate customers, it provides software, data and analytics in areas like credit underwriting, compliance and regulatory reporting, and know-your-customer (KYC) systems. They have products, for example, that can identify whether a prospective corporate business partner is actually owned by a Russian oligarch with whom it's illegal to do business. The applications are generally mission-critical and well integrated into the workflow of the end-client's business.

The analytics business normally accounts for around 40% of total revenues and a low-20s percent of total operating profit, so it's more the tail than the dog of the overall company. But if it were its own publicly traded entity it would be highly valued, and rightly so. It is overwhelmingly a recurring-revenue business with high-90s retention rates, high-single-digit organic growth and strong competitive advantages.

As great as Moody's Analytics is, the company's credit-ratings business is even better. It's a quintessential toll bridge, earning fees from debt issuers of all kinds worldwide who require its ratings to more efficiently access debt-capital markets. The product the ratings business sells is credibility with the debt markets. That translates into lower borrowing costs for issuers, the savings from which dwarf the price issuers have to pay to Moody's for the rating. There have been many attempts to break down the effective duopoly of Moody's and S&P Global in this business, but new entrants don't have the credibility to warrant their selection by debt issuers even at a discounted price for the rating. This competitive dynamic in our view helps make Moody's credit-ratings business one of the great business franchises in the world, with proven pricing power, tremendous competitive barriers to entry, high margins – operating margins averaged 56% from 2017 to 2021 – and low capital requirements.

INVESTMENT SNAPSHOT

Moody's
(NYSE: MCO)

Business: Provides credit ratings on debt obligations globally and also offers a range of analytics products supporting risk-management efforts of institutional financial clients.

Share Information (@11/29/22):

Price	**289.53**
52-Week Range	230.16 – 403.73
Dividend Yield	1.0%
Market Cap	$53.03 billion

Financials (TTM):

Revenue	$5.72 billion
Operating Profit Margin	37.1%
Net Profit Margin	27.2%

Valuation Metrics
(@11/29/22):

	MCO	S&P 500
P/E (TTM)	30.7	19.1
Forward P/E (Est.)	29.9	17.8

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Berkshire Hathaway	13.5%
Vanguard Group	7.5%
BlackRock	6.8%
TCI Fund Mgmt	4.5%
State Street	3.7%

Short Interest (as of 11/15/22):

Shares Short/Float	2.0%

MCO PRICE HISTORY

THE BOTTOM LINE

John Neff believes the best investment entry points for the company – whose credit-ratings unit he calls "one of the great business franchises in the world" – are in environments like today's when rising interest rates hurt debt-issuance volumes. From today's price, his base case for the stock envisions an estimated 11-12% annual rate of return.

Sources: Company reports, other publicly available information

Like with American Tower, good entry points into the stock are rare, but the best times tend to be when debt issuance falls sharply and people then act as if it will never come back. That's exactly what's happened in 2022. Due to rising interest rates and widening spreads, rated debt-issuance volumes are expected to drop 35-40% from last year's record levels.

We take it you're looking through that to another side that is more positive for Moody's?

JN: Just looking at the amount of debt out there that's coming due in the next three to five years, the vast majority of that is going to be refinanced and will require new ratings. That creates a base level of debt issuance. Then you have to ask about the drivers of incremental debt issuance, such as M&A and capital spending, which are more cyclical and may not be in the near term what they were in the recent past. But there it's more a question of when, not if, those incremental sources of debt issuance return.

One risk to consider is the rise of private credit provided by companies like KKR and Brookfield Asset Management, for example, which could result in a reduction in debt-rating volumes for Moody's. Given the restrictive covenants for borrowers in many private-credit deals and the fact that Moody's can potentially insinuate itself in private deals as well – say on behalf of the private-credit firms' limited partners – we're not at the moment too worried about the overall competitive threat here.

What type of shareholder return are you expecting from today's stock price of just under $290?

JN: A few weeks ago our base case was for a 13-15% rate of return, but with the stock up more than 25% from its low last month, today that number is closer to 11-12%. This can certainly change, but in recent weeks it appears investors may have started to look over the valley of depressed debt issuance. As you know, we don't often trade around those types of things and are very happy to have a compounder like Moody's at almost an 11% position in the portfolio.

Why are you high on the prospects for Canada-based software company Constellation Software [Toronto: CSU]?

CC: Constellation is a provider of vertical-market software, which is typically developed with functionality and applications specialized to serve a specific industry. That could be almost anything – say, software to run mid-tier utility companies, homebuilders, transit systems or bowling alleys – but they tend to be smaller addressable markets with highly recurring revenues, high barriers to entry for the established players, and not a lot of interest from new competitors.

Here I would start the discussion with the capital allocator at the top of the company, Mark Leonard, who has built Constellation from the ground up since founding it in 1995. He was previously a venture capitalist and describes how he thought the returns in that business were subpar and erratic because the hit rate of high-IRR investments wasn't high enough.

INVESTMENT SNAPSHOT

Constellation Software
(Toronto: CSU)

Business: Acquires, builds and manages vertical software businesses that provide embedded workflow solutions to customers in North America, the U.K. and Europe.

Share Information
(@11/29/22, Exchange Rate: $1 = C$1.36):

Price	**C$2,109.03**
52-Week Range	C$1,783.98 – C$2,385.80
Dividend Yield	0.3%
Market Cap	C$44.69 billion

Financials (TTM):

Revenue	C$6.16 billion
Operating Profit Margin	14.5%
Net Profit Margin	7.9%

Valuation Metrics
(@11/29/22):

	CSU	S&P 500
P/E (TTM)	67.1	19.1
Forward P/E (Est.)	26.5	17.8

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	4.5%
Vanguard Group	3.2%
Akre Capital	3.0%
BlackRock	2.1%
Manulife Asset Mgmt	2.0%

Short Interest (as of 11/15/22):

Shares Short/Float	n/a

CSU PRICE HISTORY

THE BOTTOM LINE

The market doesn't appear to appreciate as well as it should either the company's unique acquisition-driven strategy or the related execution of it, says Chris Cerrone. He believes the company's free cash flow per share can increase over time at a high-teens annual rate and, given the current share valuation, expects a comparable return as a shareholder.

Sources: Company reports, other publicly available information

He realized that high-growth businesses often develop into poor economic businesses. Instead he wanted to invest in just high-quality companies, even if the growth rates were slower. That led him into vertical-market software.

Constellation no longer discloses the number of acquisitions it makes in any given period, but we assume the number is dozens per year and in the multiple hundreds in aggregate. Constellation since its founding has generated an overall IRR, after-tax and burdened by excess cash, of over 20%. They typically buy companies that are founder-led, with fewer than 100 employees and that hold the #1 or #2 position in their vertical market. This type of software tends to be a very small absolute cost of running the end-customer's business, but is absolutely essential to the daily business operation, keeping customer churn rates very low.

One interesting aspect of the strategy is that the company often does little in the way of integrating or altering the businesses they buy. What they do provide would best be described as coaching. Mark and his small headquarters staff are primarily focused on collecting and analyzing data from all the businesses to arrive at best practices that are then shared with all of the individual business leaders. It's not at all command-and-control, but has proven very effective in getting best practices implemented across the portfolio of businesses.

Is the runway for reinvestment here still sufficient?

CC: They talk about having 40,000 potential vertical-market-software acquisition targets, so the issue is more trying to convince target-company entrepreneurs to sell to them instead of the other guys. Management also tracks what they call their coverage ratio, which is the percentage of available deals that they even hear about. They estimate that number today to be in the 20-30% range – given the company's size, they will likely have to improve on that in order to maintain historical levels of growth.

One criticism of the company is that the organic growth of the existing portfolio of businesses is in the low single digits. That's partly a function of the fact that they're willing in some cases to purchase businesses with declining revenues. If the purchase price is low enough, even a declining business can generate a satisfactory IRR so long as you're right about the rate of decline or, obviously, if you through improving the business can reverse it.

ON SUCCEEDING A STAR:

We have the benefits of his wisdom at our disposal – very helpful in an environment we haven't seen in decades.

With the shares trading at around C$2,110, how does your math around growth potential versus valuation work out today?

CC: Given that the vast majority of their capital is reinvested to make acquisitions that earn at least high-teens IRRs, we think free cash flow here can grow at a high-teens annual rate over time as well. With the shares trading at a low-20s multiple of free cash flow, we think it's reasonable to expect our return as shareholders to match the rate at which the company grows its cash flow.

Mark Leonard is known as being very private and the company doesn't put a lot of emphasis on Investor Relations. Do you think that hinders at all market sentiment on the stock?

CC: We think the company and management represent the gold standard in terms of shareholder alignment. Compensation plans are clear and well described. Mark and his family own roughly 7% of the shares, with insiders overall owning 11%. Employees are generally paid a salary plus a bonus based on revenue growth and returns on invested capital, and they're required to invest 75% of their after-tax bonus in Constellation shares, which are held in escrow for a minimum of four years. There are no stock options and the share count hasn't changed for a decade.

Top management answers questions at the annual shareholder meeting, but they don't do quarterly earnings calls. We actually like that and have recommended the same policy to a number of our other portfolio companies. I think it's difficult for a CEO to manage a business with a five- to ten-year time horizon when he or she is providing quarterly guidance and updates and having to constantly take questions from analysts who are trying to make 90-day predictions.

There are similarities between Constellation and another of your top holdings, Roper Technologies [ROP]. Describe the potential you see in it.

CC: When we spoke about this five years ago Roper was still mostly an industrial conglomerate, but it was in the process of transforming itself to focus primarily on software and network-related businesses. Over this past summer the company announced the sale of its last remaining cyclical industrial and energy businesses. Following the transaction, software and network businesses will make up roughly 75% of annual sales and we expect that percentage to continue to grow over time.

Like Constellation they've been very active in M&A and target leaders in niche vertical-software markets where competition is around customer intimacy more than price. To give a few examples, Roper owns a company called Deltek, which provides software and market intelligence primarily for government contractors to help them comply with the wide variety of purchasing, accounting and tax requirements involved in that world. Its Vertafore division provides software to help manage the day-to-day workflow of independent and captive insurance agencies. Aderant, another portfolio company, does much the same thing for law and other professional-services firms.

Interestingly, Roper tends to purchase businesses from private-equity owners,

which means it's often paying a fair price for a high-quality asset where necessary industry consolidation and cost-cutting has already been mostly done. The businesses operate on a stand-alone basis, but again like at Constellation, headquarters staff is actively propagating best practices to help drive incremental revenue growth and process efficiency. During Brian Jellison's tenure as CEO from 2001 until 2018 – when he became sick and sadly passed away – the company as it transformed compounded free cash flow at 14% per year and the share price compounded at 17% annually.

We assume you're comfortable with Mr. Jellison's replacement?

CC: So far, so good. Neil Hunn was promoted to president and CEO from chief operating officer and we believe the acquisition and governance policies remain unchanged and continue to be executed at a high level. One small but positive change we think is indicative of the integrity of corporate governance here is that the board directors recently voluntarily decided to reduce their annual compensation, which is not something you see very often. The practice instituted in the early 2000s was to award board members a fixed number of shares every year as compensation. As the share price compounded, the value of that stock award increased dramatically over the years. That they addressed that voluntarily we think speaks to the alignment of the board with shareholders. We actually made a point of commending them for this and they told us that we were one of the very few shareholders who noticed. This supports our view that proxy statements are very much an underappreciated source of information about how public companies behave and their alignment (or lack thereof) with shareholders.

The share price at a recent $425 is roughly halfway between its 52-week high and low. How attractive do you consider the shares at today's price?

CC: We think the company should generate a low- to mid-teens IRR on its M&A, translating into low-teens annual growth in free cash flow per share. The mid-$300s was obviously a better entry point than where we are today, but we consider the stock's current mid-20s multiple of free cash flow to be consistent with what we could expect in five years. That means we expect shareholder returns from today's prices to match that low-teens annual growth in free cash flow.

Chuck Akre retired from co-managing the Akre Focus Fund with the two of you at the beginning of 2021. Any surprises through that transition?

JN: As was the plan, nothing happened on a cliff basis. Our day-to-day didn't materially change on January 1, 2021. We had a collaborative decision-making process before Chuck stepped away and it remains one. Chuck has been very hands off since officially stepping down, which I'm sure hasn't always been easy for him, but it's something we very much appreciate. He routinely reminds us that we're managing the vast majority of his family's net worth and, thankfully, is extremely comfortable with that fact.

INVESTMENT SNAPSHOT

Roper Technologies
(NYSE: ROP)

Business: Diversified provider of application software, network software and technology-enabled solutions serving a variety of what it considers to be defensible niche markets.

Share Information (@11/29/22):

Price	**425.25**
52-Week Range	356.21 – 494.31
Dividend Yield	0.6%
Market Cap	$45.10 billion

Financials (TTM):

Revenue	$6.14 billion
Operating Profit Margin	27.9%
Net Profit Margin	47.3%

Valuation Metrics
(@11/29/22):

	ROP	S&P 500
P/E (TTM)	40.5	19.1
Forward P/E (Est.)	26.4	17.8

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
T. Rowe Price	11.7%
Vanguard Group	8.9%
BlackRock	7.2%
State Street	4.0%
Franklin Resources	3.0%

Short Interest (as of 11/15/22):

Shares Short/Float	1.1%

ROP PRICE HISTORY

THE BOTTOM LINE

The company's long and well-executed corporate transformation is mostly complete, says Chris Cerrone, who expects it to continue to prosper as it builds out its core software and network businesses. From today's stock price, he believes shareholder returns should match his low-teens annual growth estimate in the company's free cash flow per share.

Sources: Company reports, other publicly available information

CC: We have all the benefits of his wisdom at our disposal, which from someone who has been involved in the business professionally since the late-1960s is always helpful, but it's particularly so now in a macroeconomic environment we haven't seen for multiple decades.

JN: This pre-dates Chuck stepping down, but one thing I worried the most about with a multiple-PM structure is that we'd get name creep in the portfolio and become less concentrated on our absolute best ideas. I'd have my names, Chuck would have his, Chris would have his. The reality has actually been the opposite. We had 30 or so individual positions when I became co-PM in 2014 and that number today is 18.

That speaks somewhat to how we operate. We have a systematic way of assigning what each PM can do on his own and with how much, and we don't require shared conviction or consensus. We've never believed in managing money that way – there's too much potential to create tension and resentment and we think it results in sub-optimal outcomes.

What I would say, however, is that while we don't operate on a consensus basis, we do operate on a shared-understanding basis. We try to communicate well about what we're working on, why we like something, what we're learning about it as we go, and where we stand in developing conviction. Ideally we go from shared understanding to shared conviction on any business. I want to be able to articulate why I believe we need to own something well enough for Chris to understand that and agree with me.

Given all that, when those rare opportunities come along when great companies become great investment opportunities, allocating cash to them is relatively straightforward. What we're looking for in companies is crystal clear and doesn't change with the market environment. VII