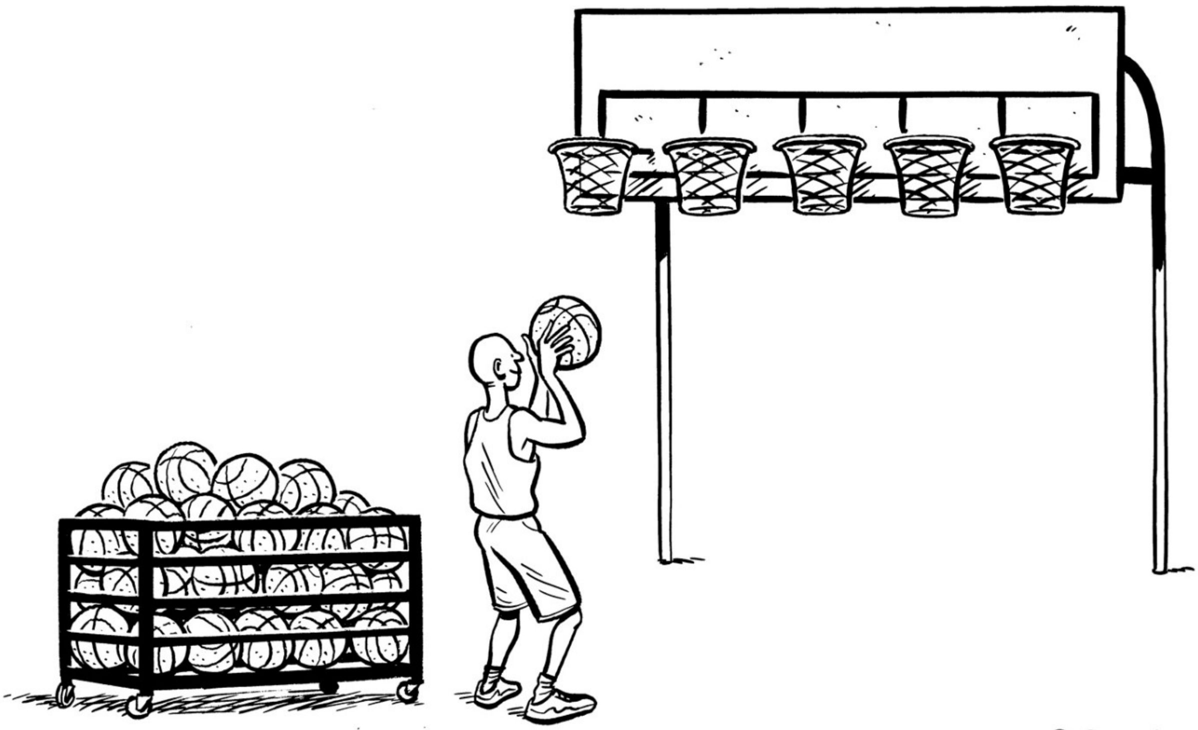

Introduction

This is the first in a series of short notes that explore Structurally Advantaged Business Models ('SABM'). My definition of a SABM is one where there is something that is intrinsic to the nature of the business model itself which gives it an advantage over other types of business. A SABM is durable by design. The ravages of competition still apply, but a SABM has both strong armour and powerful weaponry.

Option Builders

In business and in life we talk about 'keeping our options open'. The more the better. The cheaper to acquire the better. Long-dated options are an underappreciated source of advantage.

Owning a diversified basket of independent call options is durable by design. Put simply, it means there are lots of ways to win.

One of the best examples of this model is the business of running a private equity portfolio. Each portfolio company is independently leveraged, meaning that if one fails, it doesn't affect the outcome of the others. The winners take care of everything. It's not by accident that carry-eligible private equity professionals are consistently among the highest paid of any other profession. The private equity industry is one of the most prolific in minting billionaires. If you are lucky enough to be a carry-eligible partner in a large PE fund you are wielding the classic Archimedes long lever.

The venture capital industry is a variation on the same theme. The equity in each investment is a call option on the success of venture backed businesses.

A strong balance sheet is a common factor among option builders. The best opportunities frequently present themselves in times of crisis, when liquidity and confidence are in short supply. Option builders have the dry power to capitalise. They have the resilience to stay the course and extract the time value of options.

Flexible and resourceful teams are a critical, perhaps the critical, underappreciated source of option building capacity, and of course execution, as ultimately the value of option building derives from those that are exercised. Complex options require flexible execution skills. I have spoken before about the relative contribution between A players and B players. In a classic 80/20 situation, where 20% of your staff (the A team) is delivering 80% of your results, the A team is 16x more effective than the B team. If it's a 90/10 situation, which is frequently the case, the difference is a staggering 81x. As a value-oriented investor, I have frequently underestimated the ability of a great management team to deliver performance that was nowhere to be seen on a spreadsheet or financial forecast.

An 'option friendly' workforce is likely to be split into many autonomous units, which maximises optionality. A good example is the way Constellation Software has numerous independently run business units. While they share best practices, each unit head has full autonomy.

IAC is another good example of an option building business. Though it looks like a conglomerate, the DNA is entirely option oriented. It finds small opportunities which are independently run, then when they are big enough, they are spun out, with the focus returning to nurturing the next batch of options.

Finally, as individuals we can access the benefits of a basket of call options quite easily by buying a diversified equity index fund. And, of course, in our personal relationships we should be building bridges, not burning them.

TAM Busters

I was going to write about TAM busters as a separate category but have included it here instead given the close link to the practice of building/owning options.

What's a TAM buster?

A TAM buster is a business that repeatedly expands its total addressable market.

Amazon is probably the poster child, first with its move from books to other categories, then from selling its own goods to creating a third-party seller marketplace and most impressively, the creation of Amazon Web Services. While the first of those TAM busting moves might have been predictable, the last two were far less obvious.

Blackstone came from nowhere in managing real estate to becoming one of the world's largest property asset managers by breaking out from its core private equity business.

Alphabet, Facebook, and Alibaba have each busted out of their original target markets, multiple times.

The Collison brothers at Stripe are TAM busters extraordinaire, breaking out from payments to a whole host of online business management solutions.

Daniel Ek at Spotify is going beyond music streaming to break into audio and in so doing is taking on a huge opportunity to disrupt linear radio.

Aman Bhutani at GoDaddy is moving beyond basic DIY websites into marketing and commerce adjacencies which are multiple times larger than its initial addressable market.

In its 2020 investor day, Salesforce showcased its "Portfolio of Expanding TAMs".

I suspect the following are some of the common threads of TAM busting business models:

- A strong core cash-generative business that is a protected source of resilience. Bets on new markets are not made by risking the farm.
- Long term growth-oriented leadership that is willing to sacrifice short term earnings to make multiple, yet carefully evaluated, experimental bets.
- Flexible/capable independently managed sub-teams.

Great management is fundamental to the ability to execute a TAM busting strategy. Identifying TAM busters in advance is hard. Perhaps the best place to start is with management teams that have done it once or twice already, in which case the odds are favourable that they can do it again.

Conclusion

Owning a diversified basket of independent call options, including the option to attack adjacent and new markets (TAM busting) is a Structurally Advantaged Business Model.

For SABM # 2, I am going to explore businesses with "Friendly Embedded Leverage".

Laurence Endersen

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