A BRIEF ANALYSIS OF THE NOMAD INVESTMENT PARTNERSHIP'S INVESTMENT IN STAGECOACH PLC.

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THE INTRODUCTION

Nomad was an investment partnership run by Nick Sleep and Qais Zakaria (known as Nick and Zak) between the end of 2001 and early 2014. Their bi-annual letters are a treasure trove of investment knowledge and general wisdom. Unlike Warren Buffett, Nick Sleep is virtually invisible, making it harder to access the lessons buried within the specific investments that Nomad made. I believe this is an unfortunate situation and hopefully by digging into some of the specific investments – and what Nick and Zak said about them – we can gain some insights.

My first foray will be into an investment Nomad made in a company called Stagecoach.

THE RETURNS

Nomad purchased Stagecoach on the LSE in November 2002 for a price of 14 pence/share. At the time it was Nomad's largest investment - 8.6% of total assets under management. Nomad sold the position in 2003 at a price of around 90 pence turning a hypothetical $10,000 into $64,000 in about two years.

At its peak, Nick says that the position was about 15% of the partnership but would have been closer to 25% if you back out inflows of capital – something Sleep discusses with incredible insight and original thinking, and a topic worth discussion all its own.

Post-sale, Stagecoach would eventually rise to 390p, fall dramatically to below 140p during the financial crisis, claw its way back up to 420p, slowly drop back to below 40p, before settling at around 105 where it sits today. As of this writing (April 2022), there is a planned acquisition by National Express Group.

If held through till today, according to Refinativ data, Stagecoach returned 935% vs 607% for the S&P:

THE SETUP

Stagecoach is to Nomad as See's Candies is to Berkshire. One can find some written analysis and videos covering the details of the Stagecoach investment and the Chapter in William Green's incredible book "Richer, Wiser, Happier" (pick up a copy!) is a fantastic Summary of the partnership's idiosyncratic advantages.

The investment in Stagecoach helped develop the concept and importance of "destination analysis." Nick builds on this idea several times in his letters. Destination analysis is deceptively simple: investors should focus primarily on the eventual destination of an investment. This is qualitatively different than doing a terminal cash flow analysis, trying to guess the TAM or evaluating the durability of a moat. It is rather about understanding how this business fits into the world of the future. Will it be a lot bigger, smaller or stay the same? What critical assumptions must we make to have confidence in our predictions? What is the motivation and morality of management? Most importantly, has the destination changed?

This is accomplished by trying to understand inputs and outputs. We can ask "given what we want the outcome to be, what sorts of inputs should we look for." For example, if we have a management that is compensated based on stock price at a certain point in the future (input), what sort of behavior would we expect those humans to engage in, and what sorts of outcomes would such behavior drive over the long term (output)? If we have leaders who have little of their personal wealth in the company (input),

what sorts of decisions will they make (and not make) and how will that impact the long-term outcome of the business (output)?

Nick and Zek put a large premium on ethical behavior. For example, if management is cautious about admitting mistakes; our ability to do any kind of destination analysis is immediately muted. If management engages in “creative” accounting in order to meet short term EPS targets, how can we have confidence that they will act in the best interests of the long term destination of the business?

It is worth reading Robert Presig’s book “Zen and the Art of Motorcycle Maintenance” as I believe much of this focus on inputs and outputs, morality and self-reflective improvement springs from the core theme of that book: defining and continuously seeking out “quality.”

In addition to destination analysis, Nomad remained disciplined about getting a low price. Given we are, at best, moderately good at determining inputs and predicting outputs; price is the primary mechanism for reducing negative impacts errors are sure to have on overall results.

In the 2002 letter Sleep writes:

“When we evaluate potential investments, we are looking for businesses trading at around half of their real business value, companies run by owner-oriented management and employing capital allocation strategies consistent with long term shareholder wealth creation.”

I wish to pay close attention to the “fifty cent dollar” approach as Nomad’s two most famous investments, Amazon and Costco – today not seen as this kind of opportunity. The success of these investments has produced dangerous narratives promoting the idea that price isn’t very important if one buys great businesses “because look at how well Costco and Amazon did.” While this is occasionally correct, it is more often painfully incorrect (we love to whistle past the graveyard!). The cost of being incorrect increases exponentially as one puts less importance on price. It requires a special kind of confidence, dare we say overconfidence, as one “pays up” for great businesses. Nick and Zak remain disciplined at buying quality at a reasonable price. This doesn’t change. What does change is their time horizon and mechanism for evaluating how big that future dollar could become – and this is where Stagecoach comes in.

THE INVESTMENT

Nomad makes its investment in Stagecoach in November of 2002 for 14 pence/share following a dramatic collapse in the company's stock price.

What is meant here by "dramatic collapse" is best shown in a picture.

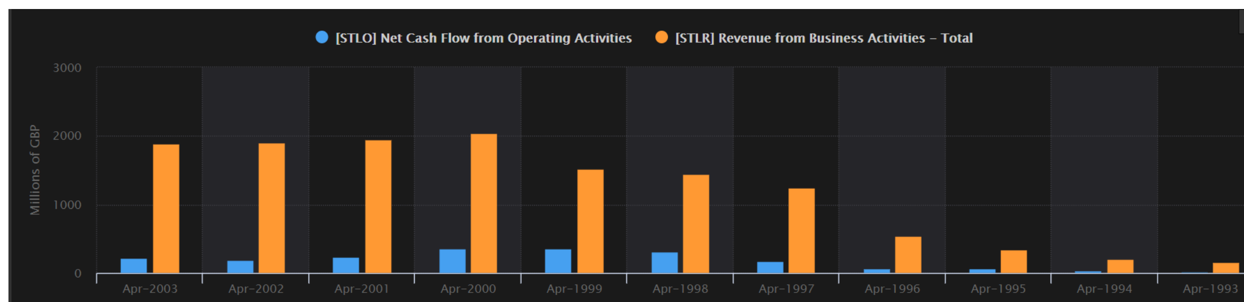
Between 1993 and 1999 Stagecoach's stock price rallies from around 25p to over 375p and then tumbles to below 20p. For those of us who believe a 30% or 50% drop in price is as bad as things can get, just wait a while.

Nomad's timing on its purchase is nearly perfect (don't feel bad, they don't do this every time).

But what is Stagecoach? Why do Nick and Zak like it? Why do they buy it after such a fall?

Stagecoach was originally a RV and minibus hire business; but pivoted to bus operations – and later rail operations - when the UK deregulated its transportation lines in the 1980s. One of the founders, Brian Souter proved to be exceptional at both optimizing the operations of busses in the UK; and as a chartered account was also good at making shrewd acquisitions. Like many founder/owner/operators Brian Souter had personal experience driving buses and operating all aspects of a bus.

The company IPO'd on the London Stock Exchange in 1993 valued at £134 million. Through acquisitions and organic growth (and maintaining efficient operations – called "plate spinning"), revenues and cash flows grew dramatically between 1993 and 2000:



Astute readers will notice that revenue and cash flow maintain their strength even though the massive drop in stock price (1999-2002).

What gives?

The stock price collapse (and by extension buying opportunity) is a result of several events coinciding to provide Nomad with a rare opportunity. While the major .com crash didn't happen until March of 2000, companies in 1999 were already being impacted by having their multiples come under pressure (at the time of this writing, April 2022, I believe we have seen a similar trend in the last 6-9 months though none can know what the future holds). In 1999 Stagecoach had a "lofty" Price to Sales ratio of 1.2 and Price to Cash Flow per Share was 6.2. A year later these ratios had dropped to 0.3 and 1.7 respectively. Secondly, revenue growth slowed, and profit margins were coming under pressure – two of the deadly antagonists in a "high growth" fairytale narrative. Perhaps most importantly, Souter had stepped down as CEO and the company's recent acquisition of "Coach USA," a US based bus operator and itself a

leveraged roll up, was not going to plan. From the 2001 Annual Report:

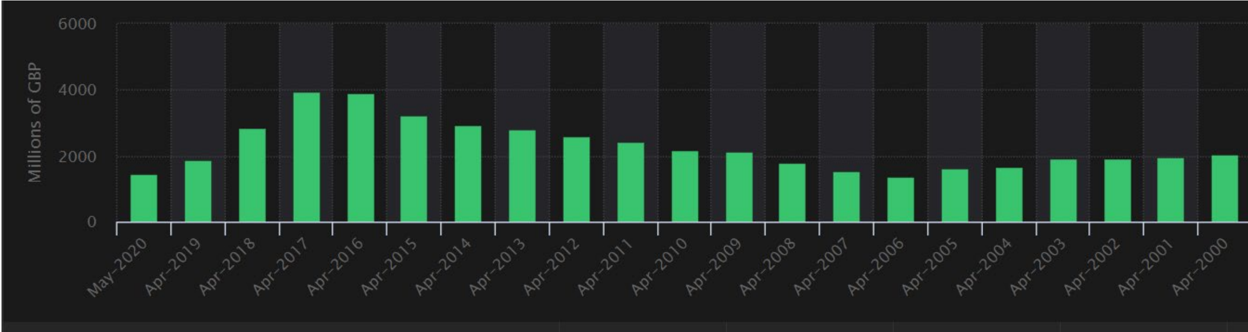
> This year has been a period of consolidation for the Stagecoach Group. Turnover from continuing operations for the year was £2,067.3 million (2000 – £1,760.7 million) and operating profit before exceptional items and goodwill amortisation from continuing operations was £197.8 million (2000 – £209.0 million). These results include a first full year contribution from Coach USA.
>
> While we continue to make good progress with the integration of Coach USA the business has not met the profit expectations that we envisaged at the time of our acquisition. As a result, we have revised our expectations regarding future profitability and have recorded a write down of Coach USA goodwill of £376.0 million. This has resulted in an overall reported pre-tax loss for the year of £316.5 million. This write down of goodwill does not affect the Group's continued strong cash flows or financing arrangements.

When one sees the words "year of consolidation" and "recorded a write down;" the "group's continued strong cash flows" does little to calm investor nerves.

As if things couldn't get worse, the events of 9/11 smash the transport industry and by 2002, Souter comes back with a strong determination and incentive (he still owns a large chunk of the business) to turn things around. The founder's commitment to focusing the business on operational excellence (vs growth), combined with a somewhat unjustifiably crushed stock price provide Nick and Zak with a low risk bet on a reasonably good business.

Let us consider the sequence of investment returns which follow. From the purchase in Nov of 2002 for 14p/share, the return is already a double by the end of the year (33p in early January, just 3 months later). This result has nothing to do with business transformations or improvement and is instead primarily a function of market sentiment. In 2003 (Stagecoach reports in April) reported revenues declined moderately (1.9b to 1.88B) but gross profit increased substantially (86.8m in 2002 and 133.8m in 2003). Having increased their original investment by 7 times in a few years, Nick and Zak take their profits and are on to other things… but they don't stop looking.

This is where things get interesting from a learning perspective, and it represents a change in Nomad catalyzed in future investments, notably Costco and Amazon. While revenue moderates through 2006, Stagecoach subsequently enters a second period of sustained growth:



This is also reflected in the stock price which spikes to 400p, collapses with everything else in the financial crisis (2008-2009) and then returns to that level over the next 5 years.

In the 2007 letter, Nick writes:

> *"Stagecoach was a success in the sense that shares purchased at 14p were sold at a high of around 90p. That is until one looks in the Financial Times to be reminded that the shares currently trade above £2.50. The mistake was to leave £1.60 on the table and was also caused by anchoring on the original purchase decision analysis (which required a value above 14p), rather than thinking about the destination for the business in years to come. The opportunity cost of the Stagecoach mistake is broadly U$12m today (and counting)."*

…and he goes on to say…

> *"…what we learnt at Stagecoach has helped us continue to own Amazon."*

THE LESSONS

Casually buried in the quote above is the concept of destination analysis later captured by the quote appearing in the 2007 letter:

> *"What is not recorded is the cost of the suboptimal outcomes that result from over-diversification which range from lack of investment work, high fees and, most dangerous of all, complacency which allows one to ignore the only real, long-term risk, which is the risk of misanalysing a company's destination."*

I may cover the Amazon and Costco investments elsewhere, but it is worth looking deeper into what Nick and Zak learned from Stagecoach and how they learned it.

The most important lesson for myself is that we should form a kind of "anti-portfolio." This is a mutation of Umberto Eco's "Anti-library:" a room containing the books one has yet to read. The "anti-portfolio" contains the companies one didn't buy or sell – or in aggregate, the portfolio one doesn't own. I track several such anti-portfolios, and I am embarrassed to say they tend to perform as well or better than my actual returns.

The anti-portfolio forces us to reflect on our decisions in a painful and objective way. Nick and Zak are pre-wired to continue to look for mistakes in their decision process and the behaviors driving them (inputs) and the long-term consequences to investor returns (outputs). In the case of Stagecoach, they conclude that they did not put enough emphasis on the destination of the company and instead focused too much on the percent gained and the relative size of the holding in the portfolio (15% at the time of sale, 25% if we ignore fund flows). Nick writes:

> *"The analytical mistake in both cases was to have a static view of a firm formed at the time of purchase, which failed to evolve as the facts changed. This error was reinforced by misjudgments such as denial (the facts had changed) and ego (we can't be wrong). There was also an over-reliance on price to value ratio type analysis, which can encourage a tighter range of outcomes than occurs in reality."*

He continues:

> *"Destination analysis is consciously central to how we analyse businesses these days. It helps us ask better questions and get to a firm's DNA. What we learnt at Conseco may well have kept us out of the US banks last year, and what we learnt at Stagecoach has helped us continue to own Amazon."*

[Sadly, Nick's analysis of the Conseco investment appears in Marathon's Global Investment Review (Vol 16, No.6); a copy of which I have not been able to find. If anyone knows where it may be found, I would love to read it!].

Stagecoach represents an evolution in thinking at Nomad; but one that comes from an orientation of constantly identifying and learning from mistakes. Investors are keen to learn from the particular instances of mistakes of others, but often miss the broader lesson of having a generalized orientation that leads to such learning. This lesson is encapsulated by the Edo era Japanese Poet Matsuo Bashō:

> *"Do not seek to follow in the footsteps of the wise. Seek what they sought."*

Disciples of Nick and Zac, Warren and Charlie, or anyone else for that matter, are encouraged to avoid blindly copying the specific actions of their idols; and instead focus on what it is they were looking for in the first place. We will likely find that each of us likely has a separate journey to arrive at the same destination. Focusing our heads down on the footsteps we risk losing ourselves along the way.

It is easy to take the lesson from Nomad that "thou shalt not sell a good company too soon;" but the more important lesson is "thou shalt be on the constant lookout for mistakes and be dedicated to learning from them and incorporating them into your own journey."

THE EPILOGUE

To exemplify this lesson of destination analysis and how it might be applied, let us return to Stagecoach.

Nomad shut its doors in 2014, prior to the second collapse of the stock; and Nick and Zak do not speak in public. As a result, we can only speculate as to what they may have done had they held Stagecoach for the duration.

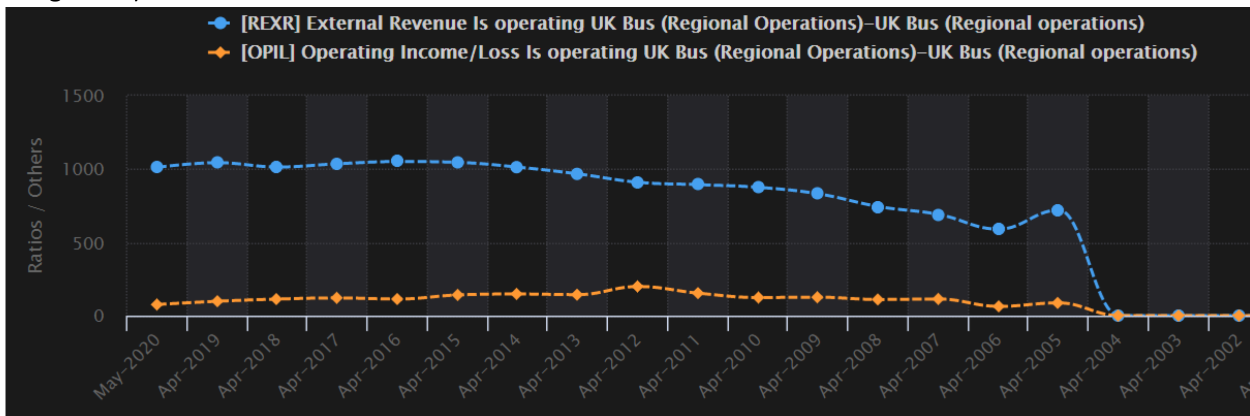
I am FAR from an expert on the economics or operations of bus and train operations in the UK, or anywhere else. Nevertheless, I have looked through the annual reports of Stagecoach with "destination analysis" in mind. I likely would not have felt comfortable investing in Stagecoach as it entered the rail market. I find it substantially more difficult to understand than busses. It is subject to cooperation between private companies and large government entities via an operational contract won through a periodic bidding process – all words that would keep me up at night. The ebb and flow of government positions (i.e a Labour government may have very different policies than a Conservative government) are not friends of destination analysis. At a high level, I can imagine it would be exceedingly difficult for a private company to make "excessive profits" without drawing the ire of legislators who will then subsequently alter regulations to reduce profitability. Whether this is beneficial or not to the public, I can not say… but it is not beneficial for confidently predicting the destination of the business.

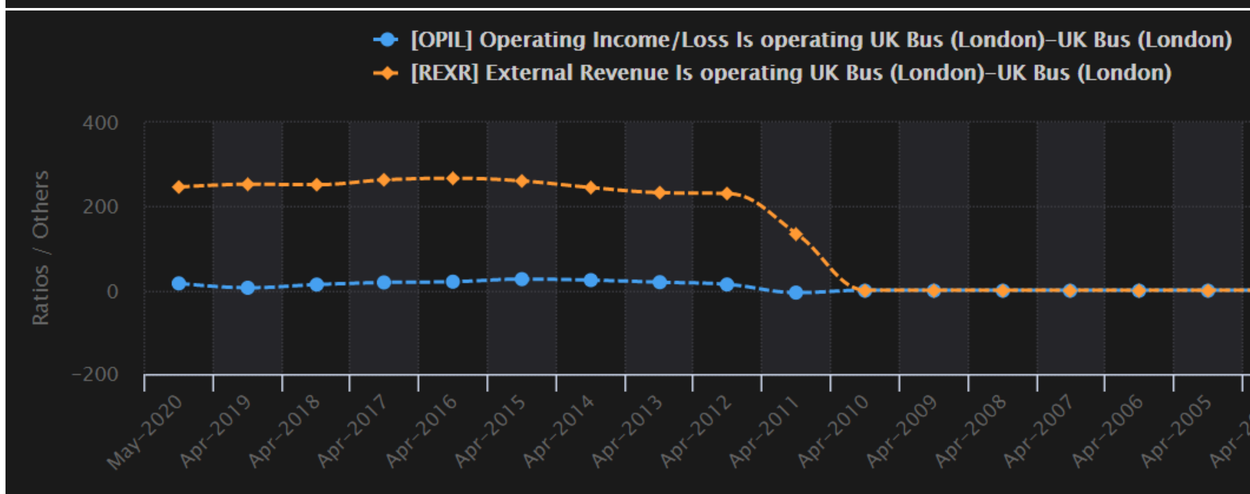
Let us look at the long-term revenue and operating income of the “bus” part of Stagecoach vs the “rail” part:

RAIL

We see a picture of rising revenues (good for growth and TAM!) with consistently unpredictable operating incomes (not so good for managing cash).

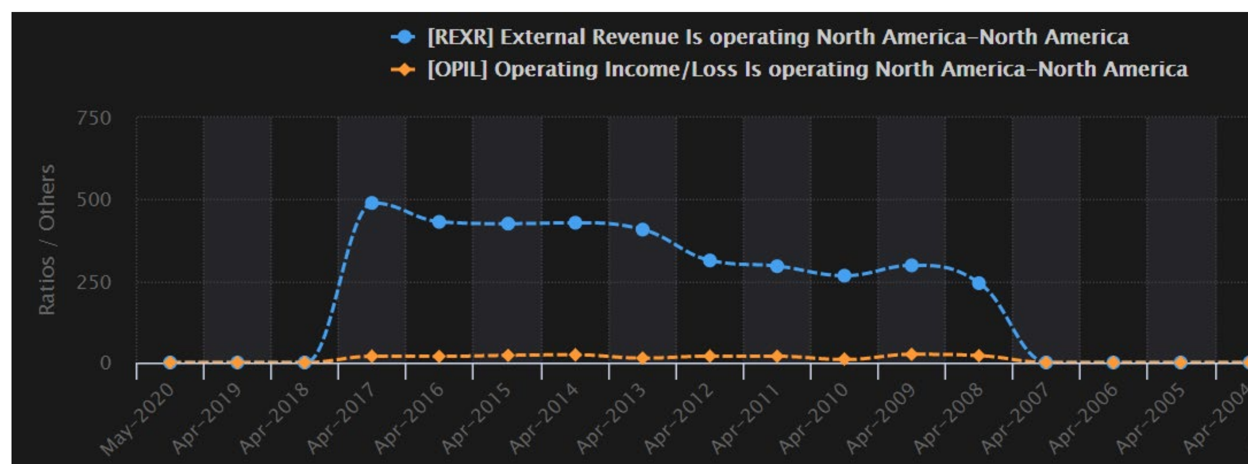
Compare this to the revenue and margin of the UK Bus business (separated into “London” and “Regional”)





A much more predictable and calmer, sleep-inducing graph.

Finally, here is the “North America” segment, largely represented by the Coach USA acquisition; later sold in 2018.



While not as bad as the UK rail business, it is qualitatively worse than the UK bus segment.

This difference is also reflected in annual reports by the company, for example this snippet from 2018:

As previously announced, we have reported further, significant exceptional costs in the year ended 28 April 2018 in respect of our Virgin Trains East Coast franchise. Further details of these are provided in section 1.5.4 of this Annual Report. We regret the losses the Group has experienced on the East Coast franchise, notwithstanding that these were significantly influenced by factors outside of our control. We nevertheless continue to see good

If we look at Revenue and Operating profit mix that year, we see the same picture. Most of the revenue (roughly 2B of the 3.2B) is driven by the UK Rail and US Bus segments, while 135m of the total 152m in operating profit come from the UK Bus operation!

REVENUE

	2018 £m	2017 £m	Functional currency	**2018** Functional currency (m)	2017	Growth %
Continuing Group operations						
UK Bus (regional operations)	**1,012.5**	1,015.7	£	**1,012.5**	1,015.7	(0.3)%
megabus Europe	**–**	20.2	£	**–**	20.2	(100.0)%
UK Bus (London)	**251.8**	263.4	£	**251.8**	263.4	(4.4)%
North America	**470.9**	488.8	US$	**630.0**	632.3	(0.4)%
UK Rail	**1,495.2**	2,160.7	£	**1,495.2**	2,160.7	(30.8)%
Intra-Group revenue	**(3.6)**	(7.6)	£	**(3.6)**	(7.6)	
Group revenue	**3,226.8**	3,941.2				

Operating profit by division is summarised below:

OPERATING PROFIT

	2018 £m	% margin	2017 (restated) £m	% margin	Functional currency	**2018** Functional currency (m)	2017 (restated)
Continuing Group operations							
UK Bus (regional operations)	**112.9**	11.2%	117.0	11.5%	£	**112.9**	117.0
megabus Europe	**–**	–	(4.3)	(21.3)%	£	**–**	(4.3)
UK Bus (London)	**13.3**	5.3%	18.4	7.0%	£	**13.3**	18.4
North America	**21.0**	4.5%	18.2	3.7%	US$	**28.1**	23.5
UK Rail	**24.9**	1.7%	28.5	1.3%	£	**24.9**	28.5
Group overheads	**(15.3)**		(14.1)				
Restructuring costs	**(4.0)**		(4.8)				
Operating profit before joint ventures, non-software intangible asset amortisation and exceptional items	**152.8**		158.9				
Joint ventures – share of profit after tax							
Virgin Rail Group	**25.9**		24.8				
Citylink	**1.2**		1.4				
Total operating profit before non-software intangible asset amortisation and exceptional items	**179.9**		185.1				
Non-software intangible asset amortisation	**–**		(9.1)				
Exceptional items	**(47.8)**		(128.7)				
Total operating profit: Group operating profit and share of joint ventures' profit after taxation	**132.1**		47.3				

More details on the financial results for the year are provided in sections 1.5 and 1.6 of this Annual Report.

This was already the case in 2016 where management wrote:

Revenue for the year was up over 20% at £3,871.1m (2015: £3,204.4m). Total operating profit (before intangible asset expenses and exceptional items) was up 0.7% at £228.8m (2015: £227.1m). Earnings per share before intangible asset expenses and exceptional items were 3.7% higher at 27.7p (2015: 26.7p). The results include the contribution from Virgin Trains East Coast, which began operating the East Coast rail franchise in March 2015.

In that year Operating Profit from UK Bus was 133m on Revenue of 1.2b vs the Operating Profit of the US/UK Rail of 78m on revenue of about 2.5b. We get double the revenue, for half the profit! It takes only a few unexpected bumps in the road to turn those numbers negative and indeed in the following 2 years the UK Rail segment loses money.

Why does management persist in funneling substantial energy and resources from a good business into what they know is an inferior business?

I can see two reasons.

The first is that shareholders overvalue growth; and executives are under constant pressure to grow. If a business doesn't have more sales year over year, it risks having its stock price punished and, worse, questioning what the CEO is doing (presumably a CEO who avoids growth in favor of maintaining profitability is doing nothing). Through the lens of inputs/outputs and destination analysis, if management is focused on driving up the stock price through growth they will make decisions (inputs) that will dramatically change the picture of the company (outputs).

For the second reason we will turn to Oscar Wilde:

> *"Marriage is the triumph of imagination over intelligence. Second marriage is the triumph of hope over experience."*

Once management "marries" UK Rail and US Bus operations, hope springs eternal. Long term shareholders need be aware of such acquisitions and see them as analogs for fickle participants in relationships. We have our spouse we loved for years (UK Bus) but we are getting a bit tired and bored, so we look for more. UK Rail and US Bus look pretty good… sure they have problems; but with enough love and attention we can fix those up and afterwards we can add to our overall joy! Sadly, after the honeymoon we discover that our flawed new spouse brings us substantial excitement, but not the kind we expected. They also demand more of our time and attention, decreasing the quality of the previous relationship. We find that exiting the new relationship is quite a bit more challenging than entering it. We have made the error of trading a good relationship for a less good relationship because we confused (or were incentivized incorrectly) quantity with quality.

After millennia of experience, we still struggle to internalize Aesop's warning that a dog with a bone crossing a bridge is better served not looking greedily at his reflection. The unquestioned desire to "get more" or "become bigger" often leads to disaster. There is often more value in simply improving the quality of what we already have.

Nor should we blame management for making poor decisions. CEOs and executives often receive their incentive as salaries, bonuses and stock options. These are often tied directly or indirectly to the SIZE of the business primarily represented by the stock price (after all we can always defer profitability to a later date… once size is achieved!).

I suspect that Nick and Zak would have sold out of Stagecoach at some point in these years; because their destination analysis would have brought into question the quality of these less attractive businesses; and the wisdom of management persisting to make them work. In future we may look at Nomad's position in Monsanto to support this [I may take this on later]… but as with all events that didn't occur, we cannot know for sure.

THE CONCLUSION

For anyone idiosyncratic enough to get this far, I honestly hope that this meandering dive has been a helpful journey. For myself, writing is primarily a mechanism for clarifying my own thoughts and mind. Insofar as it benefit others, that's a wonderful bonus for me.

I believe the ultimate lessons we can learn from Nick and Zak are their adherence to honesty, self-reflection and a sense of moral purpose throughout their activities: before, during and after Nomad.

Investors and fund managers all seek to accumulate wealth, but to what end?

We would be well served to ensure we do regular destination analyses on ourselves to ensure we are headed to where we believe we should arrive.

Otherwise, what is the point?

My own conclusion is that "the one who dies with the most toys" has not won; but lost twice: once in the accumulation and then again in the final destination.