Letter to Clients
February 2015

There's No App for That

"Lo! Men have become the tools of their tools."

Henry David Thoreau

It's difficult to withstand the allure of the whiz-bang. Not only do new technologies—and cool new uses for them—capture our collective imagination, but they enable us to do things faster, better, from further away, and more seamlessly than ever before. But when it comes to investing, beware the better mousetrap. While patents, network effects and first mover advantages can help an innovator maintain its position for a while, many advances are either relatively easily replicated or fail to enjoy strong intellectual property protections. Many enjoy a short half-life simply because newer and better alternatives appear. As an investor, it's very difficult to understand what innovations will endure, much less which innovator in a particular space will prevail.

So what about investing in those who use these fancy new technologies better than their peers? That's not such a slam-dunk either. For customers in businesses of their own, the diffusion of technological advances throughout their industry can actually sharpen competition by levelling the playing field and making more accessible to all the tricks of a few. Thus has the inherently democratizing impact of much technological innovation fundamentally altered for the worse the competitive dynamics of many an industry. The arms race that is the adoption of ever better and more powerful technology comes as a given in today's world and virtually all companies by necessity must join that race. But not every industry rises and falls on the creation or deployment of state of the art technology. There remain those for which technological prowess is a necessary but not a sufficient component of sustainable competitive advantage. We at Marshfield gravitate toward such industries for the simple reason that we believe that what it takes to succeed in them is inherently less duplicable. We prefer, therefore, to focus on a very different kind of "software" as a differentiator, one that can't be bought off the shelf, reverse-engineered or built with R & D dollars: culture and old fashioned human attributes like drive, hard work and judgment.

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If the prototypical ideal business is ownership of the only fresh water supply on an inhabited desert island, then we're all out of luck given the regulation surrounding private monopolies in this country. The next best things—oligopolies—do exist, however. The ones worth investing in are often found in regulated industries where the barriers to entry are profound, the players few, and the regulations sufficient to keep newcomers out but not so onerous as to destroy returns for the incumbent players. Many of our companies, including **Union Pacific**, **Moody's**, **Visa,** and **MasterCard**, conform to that model. We'll save the ins and outs of those businesses for another day, but suffice it to say that they are among our highest margin businesses and—despite amplified regulatory noise—continue to earn excellent returns on capital.[1]

But most of our companies do not conform to this model. Indeed, on the surface, a number of our companies appear (at first blush, at any rate) to be in industries facing significant competition and even new entry. In the past we've written extensively about our financial services companies and what we believe to be their distinctively disciplined and resilient cultures. In this letter, we want to discuss another subset of companies. What tends to distinguish this particular subset, which includes **Fastenal**, **Expeditors International**, **John Deere**, **Yum! Brands**, and even our homebuilders is not the inbuilt advantages of an oligopoly nor the ability to leverage technological skills (though that is important and they each have that capability), nor even an unusual level of discipline for their industry, but rather other qualities that are both intangible and quite difficult for their competitors to replicate. What we believe our companies in this category share is a business that (1) cannot be supplanted by the clever application of technology (e.g., the transportation of physical goods, the preparation and serving of meals, the production of equipment needed to build on and work the land) and (2) requires the consistent application of human judgment and effort day in and day out and a culture that both cultivates and maintains the capability to do so. In a world that increasingly celebrates the paring down of the human element in business, we look for the opposite: businesses that thrive on personal interactions, a sense of ownership and a commitment to excellent service within the context of a (deceptively) simple-seeming business model. These things are hard to get right and impossible to fake. The software simply does not exist to replicate and inculcate culture, attitude and drive.

Fastenal, which sells fasteners and other industrial items to manufacturers and the construction industry, certainly knows its way around IT. But that's not the core differentiator for its immensely successful business model. The beating heart of Fastenal is its deep culture of service and the ability to integrate itself into the supply chain of its customers. While you'll find Fastenal stores near or even within big cities, the typical location for one of its 2,600+ stores is a smaller less urban community. The stores tend to be where the customers need them. Its trademarked motto is "Growth Through Customer Service", in pursuit of which it maintains a decentralized structure and a broad and deep stock of items its customers need on a regular—and typically urgent—basis. The small scale of the stores allows for liberally empowered staff to

[1] Others, such as **Martin Marietta Materials** and **Waters**, share some of these characteristics, if not quite the margins and regulatory structure. Though in the case of Waters, the regulatory burden imposed on its pharmaceutical customers greatly enhances the benefits of incumbency.

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know their customers well and to serve them proactively and with consistency. While its national competitors such as Grainger and MSC Industrial Supply have a less dispersed, “leaner” organization, Fastenal’s gross margins are much higher and its level of active engagement with the customer far superior. Its innovative use of industrial vending is an example. With almost 50,000 vending sites, dispensing things like work gloves, safety glasses, batteries and other consumables, Fastenal is literally in its customer’s workplace, with all the stickiness that implies. Unlike MSC, which also provides a vending solution, however, Fastenal uses its own employees to restock its machines. As Dan Florness, Fastenal’s CFO explained to us recently,

> If we are the ones stocking the floor or the vending machines, it’s very efficient to call us and say, “next time you come, bring us these three things.” Or our person who is filling the machine can stop by and try to sell some more products. By dropping things off, we can see the current environment and see what they are doing. We get an edge up because we hear something happening in the facility before it happens. It might be that we get our foot in the door before any of our competitors even know there’s a door. It’s a much different type of transaction than I have access to in an office. That is one of the reasons historically we’ve been able to distance ourselves from our peers in our ability to grow organically. We have more touch points with a customer earlier in the cycle.

Fastenal combines the advantages of a know-your-customer mom and pop with the sourcing and logistical advantages of a scale player. And notwithstanding technological advances that have made it easier to order just about anything from a distance and get relatively speedy delivery, the ability to get things today that you didn’t know you needed until…just now…and to be able to rely on your supplier to in effect hold your inventory in the meantime represents a powerful value proposition indeed.

A spiritual cousin of Fastenal, **Expeditors International** is in a business that has benefited enormously from the intelligent application of information technology. As a non-asset based logistics supplier, Expeditors deals mostly with transnational shippers, connecting them with air and ocean carriers, aggregating their freight, and finding solutions to complex problems associated with the movement of their goods. While a competitor can in theory muscle its way into this business by building powerful computing systems and algorithms (thanks to the democratic dispersion of technology), that competitor is unlikely to steal much if any share from Expeditors, regardless of the level of its spend. What really sets the Expeditors model apart—and creates customer stickiness—is its laser focus on ushering its customers through a complex shipping process that often includes arcane customs procedures and multiple carriers. The Expeditors culture is explicitly one of employee empowerment and accountability, with pay tightly linked to performance over long periods of time. Employees for whom the cultural fit is right tend to stay a long time and get rewarded commensurately. By its own description, its culture is critical to its success:

> At Expeditors, our culture is about exceeding our customers' expectations and providing a place for our employees to make a career. It is noticeable that our people just care more. They move faster, work harder and are better rewarded

> than our competition. Our offices are neat, organized and set up in accordance with our quality standards. It's a simple philosophy that works - we will do all we can to protect our culture.

As testament to the success of its model of melding technological prowess with a deeply human-centric culture is that, though Expeditors' pricing is rarely the lowest available, it has continued to gain share over time. Expeditors' long-time CEO and keeper of the cultural flame retired last year; while his successor has a long history as an operations guy steeped in the company's ethos, the change bears watching. No one again will respond to investor questions such as one asking why there has never arisen a transportation quote aggregator like Travelocity or Expedia in the freight space quite like Peter Rose did in 2013:

> The very first thing…is the difference between what is being moved around and stored….i.e. people, who can walk, talk, drive, adjust for themselves to accommodate problems, or opportunities, or log onto the web for themselves; versus freight, which has to have all of those functions done by someone else….Given [the] critical service elements…delivered by a well-motivated, well-trained human being who, in our case, is an Expeditors employee, we think the personal touch still wins out, particularly since most freight doesn't have arms, legs, mouths (thankfully) or ears.

We will miss Rose's engaging commentary but keep our own ears open for any missed beats as Expeditors continues on without him.

John Deere, the iconic producer of tractors, combines and other agricultural machines and construction and forestry equipment, is a company that, increasingly, traffics in technology. But Deere is most clearly distinguished not by its embrace of "smart" machinery that knows things like when and how far apart to plant crops through its integration of software and high-tech sensors into its equipment. Instead, it is most clearly separated from its (also rapidly "teching-up") peers by its deployment of human capital and its deep sense of partnership with the farmers it serves.

In 1837, the original John Deere, a fabricator of small hand-held tools like pitchforks and shovels, had the insight to fashion a sawblade into a plow, thereby creating the first steel plow (new technology!), with the advantage over cast iron plows that its blade didn't get clogged by the loamy soil of the Midwest. As the company expanded and in time produced gasoline powered tractors and other implements for the benefit of the agricultural industry, it became an embedded supplier to much of the nation's breadbasket. What is particularly important in its history—and what continues to resonate among farmers to this day—is the fact that during the Dust Bowl and the ensuing financial struggles of the farm belt, Deere never repossessed any farm equipment. That culture of partnership with the farmer continues to imbue the modern company.

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We believe that customer-centric culture to be of a piece with another key element of Deere's strategy. Unusually, Deere has maintained a defined benefit plan for its employees and has used it to attract and retain the kinds of workers who take pride in what they produce and plan to make a career of it. In direct competition for the best skilled labor with Caterpillar, which is just down the road from them, it tends to win out—and have far less labor trouble to boot. Since Deere's farm equipment is typically only constructed when ordered, the enhanced personal commitment of the fabricators makes a relatively personal transaction even more so. As anachronistic and expensive as it is, Deere's pension plan is a significant differentiator in an industry that competes on the quality of its equipment rather than solely on the price at which it sells.

Finally, Deere's business model itself is dependent upon a distribution network of dealers around the globe that, unlike those of its major competitors, sell only Deere equipment. They tend to be located close to where their customers are, facilitating accessibility and responsiveness. The dealers service and provide parts for the machines when they need it, keeping down-time to a minimum, something especially critical given the exigencies of the agricultural calendar. Closeness to the customer enhances brand loyalty and stickiness and serves as a point of marketing contact. While technological advances and adoption of state of the art systems help drive share gains, the service component often seals the deal.

You could call each of these three companies a bit old fashioned. Their almost quaint reliance on human beings might appear to some to be foolishly costly in an increasingly lean, tech-driven world. But Luddites they're not. Each deploys technology comprehensively and intelligently. Perhaps most crucially, however, they understand that there are aspects of running their business that no phalanx of physicists and math whizzes can simulate via algorithm. And for us, given the breakneck pace of technological innovation and the whimsicality of success in picking tech winners, this is the kind of social media investment that's right up our alley.

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