Letter to Clients
June 2013

Price Points

"This is where it pays off, the training and the discipline."

George C. Scott, Patton

As investors, we deal with probabilities rather than certainties. While it behooves us to know as much about the companies in which we invest as possible, no amount of information, however carefully compiled and analyzed, allows us to pinpoint precisely how those companies will perform tomorrow, much less five or ten years from tomorrow. Since we don't have a crystal ball, what, then, can we do to tilt the tealeaves in our favor? Something we've found useful in navigating this inherent uncertainty is identifying "signifiers" that provide insight into what makes a company tick. One such signifier is how a company addresses the pricing of its products. A company's pricing style provides valuable information not just about the sustainability of its business model but also about its culture, tough-mindedness, and overall integrity. A thoughtful and consistent approach, one that incorporates both the strategic and the tactical, is a critical underpinning to success – and to the pay-off that we as investors ultimately demand.

Every company has two critical decisions to make about pricing: (1) how and where to make its product (i.e., how to address input costs or what we call the "recipe") and (2) how to price its product relative to those of its competitors (i.e., how to address market dynamics). The answer to these questions will depend in part on the industry to which a company belongs and in part on the attitude, culture, and strategy of the individual company. With respect to the first decision, each company has a recipe for what it produces, and though it can in theory alter that recipe to reduce input costs, its ability to do so is limited by the expectation its customers have of what the product should be. And with regard to the second decision, how to price relative to its competitors is informed by a company's understanding of demand for the product as well as the cost structure and market discipline of one's competitors, as demonstrated through how they are likely both to price their products and to change their recipe over a cycle.

How a company approaches each of these decisions tells an information-rich tale. To capture that, part of Marshfield's research is devoted to probing and analyzing the pricing philosophy and practices of each company we examine by answering a series of questions designed to sequence the company's pricing "DNA". Among the questions we ask are: does the company's recipe constrain its ability to lower input costs when

necessary or does it allow for flexibility; to what degree does customer stickiness or loyalty allow for price increases; to what extent does the company follow price cuts by others (and is it forced to do so); to what extent does the company "chase" share when pricing in the market for their product is weak or soft; and to what degree can – and does – it turn away unprofitable business. We are particularly interested in how a company prices under stress, and the recent financial crisis has provided us with ample material through which to sift. We try to identify and weed out companies that, during the downturn or since, cheapened their product or reduced price to maintain volume. It is our view that such a company will have a harder time raising price when the market for their product recovers, as the market will start to perceive that product as something that should cost less. Coupons or special discounts – especially on goods or services that are frequently consumed and therefore subject to a strong reinforcing effect through repetition – train consumers to expect lower prices and to put a lower value on the product or experience.

There is a continuum between goods and services that are pure commodities and those that are not commodities at all, with most products falling somewhere in between. In general, companies in commodity industries (think coal or steel) face more competition, more entry into their industry, and, as a consequence, have less pricing power. They also tend to have relatively little freedom to make changes to their recipe in order to reduce their input costs, as consumers have a specific expectation of what they are getting and it does not vary from producer to producer. In such cases, the only game for producers is to meet the standard at the lowest possible cost. Firms that can adjust their model to make the product cheaper will gain share rapidly. And because the recipe doesn't change from producer to producer, unless a company in a commodity business wants to shutter its mines or factories when the prices are unattractively low, they are essentially forced to participate according to the pricing whims of the market. The weapons in their pricing arsenal are therefore quite limited. This problem is exacerbated where reducing price has little stimulative impact on demand. The end result in such an industry is a stark choice between accepting an unattractively low market price with little or no increase in demand or shutting down.

In many ways, insurance looks like a commodity business. As long as the company is rated highly enough to reassure the customer that it will be in business at the time a claim might occur, there is little other than price (and terms and conditions) that, from the customer's perspective, differentiates one insurance policy from another on the same risk. And while you can vary the recipe to take out costs when pricing is unsatisfactory, such as by increasing the deductible, or adding various restrictions, comparative analysis is simple and customers, knowing how much and the kind of insurance they want, can easily do the math. In theory, this is a business where the lower the cost of the premium, the more likely a customer will sign up for the policy. This can work nicely for a supplier whose gross margins are high enough to tolerate a decrease in price, as the increase in volume can more than make up for the lower price point. But the great catch in insurance is that it is a business where a company never knows the cost of goods sold until after the premiums for the policy are collected (and sometimes long after), so playing the game of growing premiums at the expense of rate

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is an especially dangerous one. Add to that the risk that price sensitive customers, enabled by less than stringent underwriting standards, tend to increase the risk of adverse selection (i.e., the risk that you are attracting worse than average risks) and you have a potentially combustible mix. As we've discussed in the past, property casualty insurance is a deeply cyclical industry whose cycles are characterized by long periods of soft pricing followed (often subsequent to a disaster or series of disasters) by hardened pricing. The length and depth of the cycle fluctuates, further complicating the matter. As the cycle lengthens, everyone – customers and insurers alike – can fall prey to the delusion that the world has become less risky, thus reinforcing the downward trend in pricing through both lower demand and more relaxed underwriting. This behavior prevails notwithstanding the fact that unlike a commodity such as steel, where industry capital is tied up in factories, insurers' capital is cash and securities – which can far more easily be returned to shareholders via special dividend or buy-back during fallow periods.

While most companies pay lip service to such discipline, it is axiomatic (as well as our experience) that not all walk the talk. It is, however, clear to us that **Arch Capital** does. It has demonstrated over time that it is willing to relinquish business that it believes won't permit it an adequate return over the effective life of the policy. In the hard market between 2003 and 2007, Arch increased its earned premiums 33%; between 2007 and 2010, it reduced them 13%. Notably, as prices are now beginning to show signs of firming, Arch is finally beginning to grow its premiums once again. Since 2010, its earned premiums increased 15% through yearend 2012. As Dinos Iordanou, Arch's CEO, told us back in 2010:

> People get optimistic. In the aviation business, for the last 2-3 years the market didn't make money. Rates skyrocketed after 9/11. Exposure units, takeoffs and landings etc., were reduced. They came back to pre-2001 levels in 2008. 2009, they have come down further. Premiums came down significantly to the point where we have pretty much exited that business in commercial aviation. You have to monitor that, because at some point in time, you can get fooled by a lack of incidents. Incidents will happen. 10 year credibility is better than a 1 year window. We try to write with that in mind. That business saw some rate increases last October, maybe 15-20%. We think we need rate increases of 50% for the risk. We have the basic rate at which we don't like it, and a rate which we aren't involved at all.

Such steadfastness betokens a culture that is very comfortable with saying no, even to long-standing customers, and that is willing to pay good underwriters to sit idle. And as Dinos told us, those customers return; when the market hardens and prices go up, "if you are the open bar on the street, all of the drunkards are coming in, regardless of price. The reason it's a hard market is that they can't get competitive bidding."

At the opposite end of the spectrum from commodities are companies in industries that have monopolistic or oligopolistic attributes or that produce products that are unique or highly differentiated. Such companies have a fair degree of control over pricing as a

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result of either limited competition or barriers to entry and high (and stable) enough demand to support price increases. The classic example of such an industry is the railroad industry where, though railroads are no longer unregulated monopolies, they continue to exhibit a fairly high degree of pricing power due to the inability to substitute other forms of transportation, at least for certain commodities and on certain lanes. While railroads (like **Union Pacific**) today have reasonably significant pricing power, it is by no means unlimited, as about 20% of their business faces direct price regulation by the Surface Transportation Board, with the STB also having relatively broad regulatory authority with respect to other aspects of their business, such as labor, safety, and service that can limit their ability to moderate their input costs. Nevertheless, with the advent of better technology, network management, and on-time performance, Union Pacific has been able to improve its value proposition to its customers, wooing them away from alternative modes of transport such as barge, truck, and pipeline, depending on the good and the route. Rail has become so attractive that oil companies have begun to eschew pipelines in certain parts of the country because a train is the more flexible alternative, able to deliver oil to where its price is most attractive at any given time.

With only Burlington Northern as its rail competition across most of the western half of the country, UNP has been able to convert its market strength into sustained – and seemingly sustainable – rate increases over time. Customer stickiness has allowed it to manage its input costs by doing such things as compelling customers to purchase their own container and tank cars, a move that only increases customer stickiness as a result of the capital investment by the customer. Even in the aftermath of the financial crisis, UNP's rates demonstrated reassuring resiliency. While it had excess capacity at the peak of the downturn, it was in no hurry to reduce rates; when we spoke with the company in 2011, this is what they had to say:

> It's about taking the right business at the right price. A great example: in the second quarter, we lost a fairly large international intermodal contract. Even in this market, there was capacity, but we didn't feel comfortable with what was proposed with the price, so the business walked. It's unfortunate, we don't like that, but it happens. We weren't even at a point of full capacity.

A company that is willing to see business walk, even in the face of excess capacity in a capital-intensive business, is a business with a disciplined culture – something we like very much indeed. What we have come to understand about Union Pacific, as we did with Burlington Northern before it (well before **Berkshire Hathaway** snatched it away from us), is that the discipline demonstrated by it in its pricing reflects the company's general approach to a series of critical attitudes that have a direct impact on operating performance: safety, labor relations, customer service, and the reinvestment of capital.

But very few industries have the kind of attractive structure that characterizes rail and enables it to change its recipe to reduce input costs (by, for example, requiring customers to load at night or to purchase their own rail cars – mostly in exchange for providing better service), to raise prices consistently and to turn away unprofitable (or

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marginally profitable) business without flinching. There are many, many companies that occupy the broad middle of the continuum between a commodity and a monopoly business, where some differentiation among products and services exists (though not necessarily a lot), some costs to enter into the industry exist (but not so much as to forestall it entirely), and some customer stickiness and brand loyalty exists (but not enough to prevent a customer from moving to a lower cost provider). How these companies approach pricing – especially during times of stress – is in some ways even more telling than the pricing behavior of monopoly and commodity businesses, as they have neither the latitude of the former nor the limitations of the latter.

In the aftermath of the financial crisis, the precipitous drop in house prices was accompanied by a sharp decline in new homes built. From a high of 1.8 million starts in 2006 to a trough of 550,000 in 2009, the market for new homes was all but obliterated. One of the ways that **Toll Brothers** made it through this crisis was by pulling in its horns and mothballing communities that were not earning their cost of capital. As Doug Yearley, Toll's CEO, told us recently, "we're willing to shrink as much as we have to in order to maintain profitability.'' While other homebuilders were forced to sell homes that they had built on spec at fire sale prices, Toll's business model is such that, almost always, it builds houses only after buyers commit to purchasing one. In addition, Toll has always declined to "chase deals that don't work today and only work if you make some bold assumptions", as Yearley put it to us. In contrast to the mostly private homebuilders with which it competes, it went into the crisis with manageable levels of well-laddered debt, which gave it further protection against being forced to generate cash flow in order to fund its debt burden. It was in the advantageous position of being able to ride out the storm without having to put product on the market at uneconomic prices. As a luxury homebuilder with one of the only real brands in the industry, Toll was somewhat limited in its ability to rewrite its recipe to accommodate leaner times, but it was nonetheless able to offer through incentives rather than reduced headline prices inducements to purchase homes. Because of Toll's long production cycle and the fact that for any one family the purchase of a home is a rare event, such inducements were not damaging to the brand. And while it did have to write down a fair amount of the land it held on its books and reduce its head count, it was able to make an operating profit in all but 2009 and 2010, when it suffered relatively modest losses.

While Toll was biding its time, Yearley consistently counseled patience to investors, predicting (accurately, as it now turns out) that at some point the household with two small children and a puppy would need separate rooms for its kids and a bigger yard for the now fully grown dog. In its most recent quarter, Toll's ability to tread water paid off handsomely: its profits were up 46% and it was able to increase prices on its homes by an average of about $26,000 per unit. Most critically, Toll understood the nature of demand and the psychology of its customers; once it saw that demand had been reignited, it began raising prices, exploiting the fact that, as Yearley recently explained, "in many markets, as prices increase, a sense of urgency takes hold and demand continues to rise". Toll's sensitivity to and intelligent strategy regarding price is illustrated by the following anecdote told by Yearley last month:

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> We're in Sunnyvale, Northern California, which is in the heart of Silicon Valley and I think we have 35 [houses] in backlog. I wish we could have every one back. We're raising the price $25,000 every three sales and then we raised [it by] $25,000 every sale and then we raised it $50,000 every sale and two weeks ago I told the guys raise it $100,000 because I want a week when we don't sell a home because I want to figure out at what price we have finally – and we raised it $100,000 and we didn't sell a house for the week and I was happy….

What Yearley was doing was engaging in price discovery through experimenting with different price points to determine the limits of what that local market would bear. In the same call, Toll's CFO noted that he'd been hearing from their folks in the field that they had encountered angry prospective customers who had come in the previous month when a house was selling for $550,000. Rather than putting down the $1000 refundable deposit, they had taken some time to consider the purchase. When they returned, the price had shot up to $625,000, and they wanted something for having been there before. As the CFO put it, they got something, alright: regret. Why is Toll telling these stories? Not just to brag a bit to their shareholders, but to put the word out broadly that now is the time to buy without regret. This is a team that understands that price is power, and that having and exercising control over it is crucial. Toll's attitude toward pricing its homes underscores its discipline, fidelity to its brand and aversion to excessive financial leverage. These are invaluable traits in a business steeped in promotion and animal spirits.

Perhaps no company better exemplifies the refusal to buy market share and to chase price than freight-forwarder **Expeditors International**. Expeditors has a long history both of ceding market share to competitors rather than competing on price and of taking share during times of strong pricing. What the folks at Expeditors understand in their bones is that you can't buy profitable market share in a business that is differentiated by a strong service component. Adjusting its recipe by cutting input costs would, by necessity, dilute their brand by eroding service. In a recent colloquy with investors, Expeditors waxed eloquent about price discipline:

> Historically, many managers in our business have tried to fool themselves, or others, into thinking they could aggressively purchase market share. They did this by employing two different methods:
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> 1. By offering lowball rates or succumbing to the strong arming "make them eat dirt" procurement tactics that some organizations use to extract truly lowball rates. These lowball rates appear to be tolerable in the short-term but prove to be devastatingly unsustainable in the long term; or
> 2. By making acquisitions, feted as "brilliant" and "accretive" in their announcement, to only later, with whispered funereal soberness and amid crushing lay-offs and large write-offs of "goodwill", be divested, de-emphasized or closed outright.

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As they go on to emphasize, once you separate market share into profitable versus unprofitable, it becomes clear that chasing the latter is a fool's game. Especially since, in this business, customers are willing to pay multiples of pre-existing rates when something disruptive such as a natural disaster or capacity shortage threatens the continuity of their supply chain. As in insurance, waiting for such an event to influence the forces of supply and demand so that price becomes acceptable is by far the superior strategy. Further driving this home, the company avers that

> how prices will move is of lesser concern to us than how we will be able to react to those changes. We remain resolute that if we offer the best customer service at a reasonable price, we will be able to selectively, in the long term, target and take profitable, sustainable, and value-enhancing market share.

From time to time, a customer leaves Expeditors for a competitor offering a lower price. And quite often, that same customer returns to Expeditors hat in hand. And Expeditors encourages a culture where the customer is welcomed back with open arms. See why we love these guys?

How to price one's product is immensely complex and must take into account input costs, the nature and structure of the market into which you are selling the product and customer demand and its stickiness. Much of this involves factors beyond the direct control of the producer, but there are numerous key choices that a producer makes along the way toward arriving at a definitive price. To understand both how much pricing freedom a company has and how it exercises that freedom is to peer into the heart of a company as, ultimately, pricing drives profits and profits drive returns. A considered approach to pricing encodes an array of core attitudes and behaviors. In particular, the willingness to stand apart from the crowd, to give up share when necessary and to be patient in anticipation of a change in the cycle or the economy bespeaks the kind of toughness, maturity of judgment and culture of integrity that we believe important to long-term success. So while we don't have a crystal ball and we're most certainly not psychic, we can at least try to read a company's fortune by paying close attention to its pricing behavior.

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