# Graham & Doddsville

FALL 2023

An investment newsletter from the students of Columbia Business School

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# Welcome to Graham & Doddsville

**Meredith Trivedi**, Managing Director of the Heilbrunn Center. Meredith leads the Center, cultivating strong relationships with some of the world´s most experienced value investors and creating numerous learning opportunities for students interested in value investing.

**Professor Tano Santos**, the Faculty Director of the Heilbrunn Center. The Center sponsors the Value Investing Program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry´s best practitioners. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.

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CSIMA Columbia Student Investment Management Association

We are pleased to bring you the 48th edition of Graham & Doddsville. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA). In this issue, we were lucky to be joined by eight investors who have plied their craft across geographies, asset classes, and market cycles.

We first interviewed **Michael Marone** and **John Rolfe,** from Crescent Rock Capital. We discussed their path to investing and "go anywhere" investing philosophy and framework. We also dig into their long positions in KBR Inc, Gerresheimer AG, Melrose Industries, and Sanken Electric.

Next, we interviewed **Ric Dillon**, **Jenny Hubbard**, and **Brian Hilderbrand**, from VELA Investment Management. We discussed how they are building out VELA, their valuation centric philosophy, and their long ideas on BWXT Technologies, Casey's General Stores, and Kirby Corp.

Then, we interviewed **Yaron Naymark**, founder of 1 Main Capital. We discussed his journey founding 1 Main Capital, the specifics of his investment process, and his long positions in dentalcorp, IWG, and Limbach.

Finally, we interviewed **Kevin Fogarty** and **Kevin Nichols**, of Value Creators Capital. We discuss their investment philosophy rooted in Graham and Dodd value investing principles, and their long positions in AMETEK and Copart.

We continue to bring you stock pitches from current CBS students.

In this issue, we feature the winners of the 2023 Pershing Square Challenge, Sam Hook ('24), Thomas Schlabach ('24), Nick Stern ('24), for their long thesis on Lithia Motors (NYSE: LAD).

We also feature the winners of the 2023 Darden Investing Challenge, Mario Stefanidis ('25), Jennifer Ma ('25), and Takuro Fijuu ('25) for their long thesis on Paypal Holdings, Inc (NYSE: PYPYL).

Finally, we feature the winners of the 2023 CSIMA Stock Pitch Challenge, Bhakti Thacker ('25), April Jiachen Li ('25), and Julie Zhou ('25), for their long thesis on Vertiv Holdings Co (NYSE:VRT).

You can find more in-depth interviews on the *Value Investing with Legends* podcast, hosted by Tano Santos and Michael Mauboussin, Head of Consilient Research on Counterpoint Global at Morgan Stanley Investment Management and adjunct faculty member at Columbia Business School. Recent interviewees include Tom Gaynor, Ray Dalio, Sheldon Stone, John Rodgers, and Nicolai Tengen.

We thank our interviewees for contributing their time and insights not only to us, but to the whole investing community.

***G&D Editors***

## 33rd Annual Graham and Dodd Breakfast

(*above*) John Armitage and Tano Santos; (*below*) John Armitage

Meredith Trivedi and Tano Santos

## 14th Annual "From Graham to Buffett and Beyond" Omaha Dinner

Mario Gabelli '67

The Heilbrunn Center
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# SAVE THE DATE

## *The 27th Annual CSIMA Conference*

## Friday, February 9th, 2024

9:00 am to 5:30 pm EST
2920 Broadway (115th Street)
Alfred Lerner Hall, Columbia University
New York, NY 10027

**Featuring:**

**John Griffin**, Blue Ridge Capital and **Ian McKinnon**, Sandia Holdings,
moderated by **Michael Mauboussin**, Counterpoint Global

**Jan Hummel**, Paradigm Capital,
moderated by **Tano Santos**, Columbia Business School

**Sallie Krawcheck '92**, Ellevest,
moderated by **Kim Lew**, Columbia Investment Management Company

**Best Ideas Panel**

Confirmed speakers include **Heloisa Sicupira '16**, LTS Investments; **Eric Wolff**, Gumshoe Capital; **Anna Nikolayevsky ’98**, Axel Capital;
moderated by **Samantha Greenberg**, ID.me

**Special Situations Panel**

**Cristiano Amoruso '12**, Lion Point Capital;
**Dov Gertzulin**, DG Capital Management;
**Keith Luh '03**, Franklin Mutual Series; **Amy Rice**, Oaktree Capital;
moderated by **David Glazek**, Sunago Capital Partners

**Ticket price:**

Conference Fee - $550
*Discounted tickets are available for Columbia Business School alumni and current students

**Register here!**

For inquiries, please contact: valueinvesting@gsb.columbia.edu

# Crescent Rock Capital

**Michael Marone**

**John Rolfe**

**Michael Marone is the Co-Founder and Co-Chief Investment Officer at Crescent Rock. Before co-founding Crescent Rock, Michael was a Partner at Pennant Capital Management (2008-2018). Prior to that, he served as Co-PM/Co-Managing Member at Argand Capital Advisors (2001-2008), Analyst at Buchanan, Parker Asset Management (1998-2001), Analyst/Trader at Paribas Corporation's Risk Arbitrage Desk (1997-1998), and Associate at Donaldson, Lufkin & Jenrette in Investment Banking and Merchant Banking (1995-1997). Michael holds a J.D./M.B.A. from Columbia University and a B.S. from Georgetown University, where he graduated summa cum laude.**

**John Rolfe is a Partner and Senior Analyst at Crescent Rock. Prior to joining Crescent Rock, he was the Managing Member at Argand Capital Advisors LLC from 2001 to 2018. Before that, John served as Principal at Fir Tree Partners (1997-1999) and Associate at Donaldson, Lufkin & Jenrette (1994-1997). He holds an M.B.A. from The Wharton School, where he was a Palmer Scholar, an M.S. from the University of Florida with distinction, and a B.S. from Virginia Tech, where he graduated summa cum laude.**

***Editor's Note: This interview took place on November 10th, 2023.***

**Graham & Doddsville (G&D):**

Thank you for being with us today. We think our readers will really enjoy this conversation. Michael, can you walk us through your background and how you first became interested in investing?

**Michael Marone (MM):** Sure. I never intended to go into the public markets. I thought my career would be more geared towards private equity and private credit. I have my JD/MBA from Columbia. From Columbia, I went straight into investment banking at DLJ, but spent most of my time there on the private side - primarily in the merchant bank - on a small team underwriting bridge loans for LBOs. It was effectively short-term private credit. I spent the balance of my time in restructurings and high yield, which all provided very solid training for analyzing cash flow and balance sheets.

But after a couple of years in the private credit side, I found that the mix between structuring and investment analysis was more heavily skewed towards the structuring side of the equation, which was frankly not really where I wanted to spend the rest of my career.

So I pivoted from there to a prop desk at a large European bank, which had a dedicated team doing event-driven, special situation investing, primarily distressed investing and merger arb.

After doing that for a year, I had the opportunity to work for Meryl Witmer – someone with whom your readers are probably quite familiar. Meryl was co-managing Emerald Partners at the time. Having previously worked for Michael Price, Meryl is a traditional value investor. Working for her was where I trained in fundamental analysis and value investing.

After a few years with Meryl, I co-managed a portfolio with John Rolfe, our current senior analyst, at a small firm. I eventually joined a larger organization, Pennant Capital, which was run by Alan Fournier. I was a partner and an analyst at Pennant for about a decade. Ultimately, I left with my current partner, Boris Vuchic, and we launched Crescent Rock.

**G&D:**

Who are some investors and mentors whose approaches particularly shaped your investment process and philosophy?

**MM:**

Meryl and Alan were the most instrumental in

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## Crescent Rock Capital

forming my investing approach. They were both great mentors but quite different from one another.

When I joined Meryl, Iwas just a handful of years into my career. I was very much raw material, especially when it came to fundamental analysis. My time with Meryl was very formative training, fully grounded in traditional value investing and primary research.

Meryl is very good at taking complex situations and breaking them down into their most basic elements. She taught me to follow the cash flow cycle of the business and the industry to determine where the investment risks and opportunities were.

The other thing I learned from her was that – at any given time – there are only a few things that really matter in an investment. so that's really where you should focus your research. You can't manage a portfolio boiling the ocean on every name, so you really have to focus your analysis on the most salient issues.

When I joined Alan, I was at a different place in my career. I had already been a portfolio manager and an analyst for over a decade. So certainly my time with him was different, but still a very good learning experience.

Like Meryl, Alan is a fundamental investor. Valuation matters. However, Alan's strength is discerning where the market's most attractive opportunity set lies and steering the research and investments into those rich veins in the market.

Alan taught me to recognize that the market provides different opportunity sets at different times. I learned you can take fundamental analysis and apply it to traditional value, to growth, to compounders, to special situations, what have you. And then – over the market cycle – you probably do better than if you had focused on one specific sector or style.

The second element that was quite different about most of my discussions with Alan was that when we discussed positions or research that I had done, the discussion was not just about the specific idea but rather about how it fit into the portfolio, how it fit into his bigger picture view. So there was more of a portfolio management training component to my interactions with Alan.

To summarize my experience, I had the good fortune to work with talented people that had complimentary approaches based on traditional fundamental research but applied it in different ways.

***"… recognize that the market provides different opportunity sets at different times."***

**G&D:**

Great, let's talk more about your firm as it exists today. Crescent Rock was founded in 2018 as a global long/short generalist fund that utilizes fundamental analysis. Could you provide an overview of your "go anywhere" investing philosophy and framework?

**MM:**

I think that our generalist, flexible approach builds on what I took away from Alan. When we launched Crescent Rock in late 2018, a generalist fund was very off-market. Allocators at the time were very much focused on sector-focused specialists.

I think a specialist strategy has its place, but I think the last couple of years has demonstrated that such a narrow focus can have more of a "boom / bust" outcome.

At Crescent Rock, we're investing for long-term, consistent, measured success over the cycle. As generalists, we pivot between different styles and sectors based on what the best opportunities that the market is offering at any given time, which can change quite rapidly. A generalist approach lends itself to that flexibility and hopefully, more consistent long-term success.

I should add that I'm at the point in my career where I've been doing this for 25 years. My

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partner Boris and our senior analyst John have similar experience. So when you've invested as a generalist for that long, you've touched a lot, so it's not as overwhelming as it might sound at first.

**G&D:**

So as a small generalist team, can you tell us about your idea generation process and how you maximize the time that you spend on actionable ideas?

**MM:**

Everyone would like to think that there's some sort of magic box that spits out ideas for you and that there's something very specific or proprietary to it. But I think in our experience that's more talk than reality. Idea generation often comes down to reading a lot, having experience, and making connections between the things that you know and the things that are opportunities in front of you.

We try to assess where we are in the economic and market cycles Once we define that, we ask, "what names and sectors do we know well that lend themselves to the particular environment?"

With three of our four investment team members having done this for a couple of decades each, we frankly have touched a lot and we keep good records of what we have researched, so we have a deep pipeline of names we've looked at. Our idea generation starts there.

**G&D:**

So how do you use fundamental analysis with your small team to efficiently get a variant view versus the sector specific or the strategy specific investors?

**MM:**

I would go back to one of the things I mentioned that I learned from Meryl – and I think this makes a big difference when you're talking about generalists versus specialists – which is that certainly there's a tremendous amount that you can learn and spend time on and research and diligence on any given name. And theoretically, a specialist approach lends itself to have a comparative advantage in that area.

But the reality is that at any given time, for any one investment, what really matters is quite narrow versus the full spectrum of information. So a specialist might know a name or a sector and track it for a dozen years, but all that knowledge doesn't necessarily come to bear at any one time.

A generalist familiar with the sector or name can do just as detailed work as a specialist can on the areas that matter at a point in time. Now the trick is staying current because let's say you're in an investment over three years, what matters today for that investment is probably different than what mattered in that investment three years ago.

In terms of the tools we use, it's not anything you wouldn't expect. Most of our analysis requires discussions with management, doing checks, consultant calls, things of that sort. We build our own models, although we are not hyper model driven here; the modeling we do is usually based on trying to look out just one or two years.

> ***"But the reality is that at any given time, for any one investment, what really matters is quite narrow versus the full spectrum of information."***

The variant view often comes down to judgment on how we're assessing risk/reward based on our pattern recognition. Over time, you start to see certain patterns take place in terms of what does and doesn't work. And the trick is figuring out, "Is this pattern the same? Is it 80% the same, and does the 20% that's not the same matter?"

John, anything you want to add to that?

**John Rolfe (JR):**

I think the important thing – like Michael said – is identifying the two

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or three elements that are going to really drive your investment thesis. It's very easy – certainly when you're starting out – to get caught up in the weeds and think you have to know everything about every aspect of the business. But the reality is that typically there are only a couple of things that are really going to drive the share price. You need to figure out what those are and where your view is different from the market's.

**G&D:**

That's fantastic. Could you share with our readers a little bit about how you structure your portfolio and how you think about sizing the positions in your long and short portfolio?

**MM:**

Sure. Our goal for our investors is to generate good risk adjusted returns while minimizing the risk of permanent capital impairment. Trying to minimize the risk of permanent capital impairment governs things you do and don't do in constructing your portfolio as a long/short fund.

One element is hyper leverage, on a gross basis. The typical posture of our fund is 100 long and 70 to 75 short, rather than, say, a 300% gross fund. You can run a very high gross and a very low net and say, "well, my net is very low and so there's not a lot of danger here because I have a low net."

In reality, that's not quite how it works. If your long book and short book are not speaking to each other, you're not as hedged as you think and if you're running 150 by 150, certain moves in the market on one side of your book could result in you having to cover significant losses to minimize further damage. And that's really where you start creating permanent capital impairment.

*"If your long book and short book are not speaking to each other, you're not as hedged as you think."*

So we keep our gross relatively in check. Typically, 150 to 175 posture, long plus short. We're almost never over 100% gross long.

The second element is position sizing. Today, you can certainly find a number of funds for whom 15 to 20% positions are not unusual. That level of concentration can certainly put up some very nice return numbers if it works well. But if you think about what the typical batting average is for even a very good investor, you realize that an investor likely has a couple of mistakes in the portfolio at any given time. If the 15 or 20% position is that mistake, you can really be blowing permanent holes in your capital base or get behind the curve such that it's difficult to make it up in any reasonable timeframe.

So, we limit our individual position sizing on the long side to 8% at cost and 12% at market. It's really unusual for us to go above 10% at market.

The short side of the book is a different animal from a risk management perspective as permanent capital impairment occurs more often from that side of the book. Since you can have unlimited losses, sometimes you're forced to cover losing positions. The concept of averaging down is not the same on the short side; when your shorts are not working, they're getting larger. So we keep position sizes much smaller. It is unusual for us to have an individual position on the short side larger than 150 basis points.

In this model, the top five long names typically aggregate 30 to 40% of capital. Our top 10 long names typically aggregate 50 to 60% of capital. And then – like I said – we have a very healthy diversification on the short side, which has worked well for us. We have been able to keep volatility quite low in the fund and generate a solid, balanced alpha annually on each side of the book.

**G&D:**

Crescent Rock has held short positions in regional banks. What would you need to see for you to get excited

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about long opportunities in the financial sector and in regional banks?

**MM:**

We were short regional banks coming into 2023, more so than we are now. Our view coming into the year was that, with the Fed tightening financial conditions and the likelihood of a mistake happening, banks were at risk. We believed that banks were over-earning on the credit side, and that with money markets where they were and heading up further that the Street was underestimating deposit beta as well.

So we felt the opportunity set for being short regional banks was quite good. We did not anticipate the calamity that happened in March with Silicon Valley and Signature, and frankly those events accelerated the realization of our expected returns from these short positions. Today, we still have a modestly short position in the regionals.

More specifically to your question, what does it take to get constructive on banks? Frankly, I would probably have to see a hard landing first. Banks and financials generally are good investments to consider after turmoil. March was not enough turmoil, not with financial conditions still needing to tighten.

Now if you asked me 12 months ago, I would have told you that the setup for the banks after a recession would be excellent, probably the best since the Global Financial Crisis. I have a view that we're going to have more persistent inflation, even after the next recession. While a recession will pull down inflation in the near term, I still think inflation will ultimately normalize higher than pre-COVID. With that in mind, you would have a better shaped curve for balance sheet financials; it would be steeper and likely be at a higher level. Both of those elements are critical to net interest margins, which is one of the most important elements of banks' financials. And banks are certainly in far better shape than before the Global Financial Crisis.

However, after what we saw in March, the regulatory response will probably be broad and persistent and structural ROEs are going down further. So I'm not so sure that the opportunity set, given what we had in March and potential regulation, will be as good in the next early cycle as it would have been. We'll just have to see how cheap the banks get.

**G&D:**

Moving on, what are ways that you try to avoid value traps when you're investing in Japanese stocks, and do you take additional steps with your fundamental research process for those stocks?

**MM:**

Avoiding value traps is important everywhere, but it's even more critical in Japan where it is much easier to get caught. Ideally, some sort of self-help or outside catalyst helps move that market value towards your view of intrinsic value. Maybe there is a new management team, a significant new product launch, or a corporate restructuring. Ideally, you also have the involvement of an activist investor who's had success in that space.

We have been opportunistically investing in Japan. The region is not an ever-present part of our portfolio. To date when we have had any sizable exposure to a given name in Japan, it has been in situations where there are talented, demonstrably successful activist investors already involved. We think that's quite critical.

***"To date when we have had any sizable exposure to a given name in Japan, it has been in situations where there are talented, demonstrably successful activist investors already involved. We think that's quite critical."***

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**G&D:**

Moving on to individual positions, we'd love to hear about your investment in KBR Inc. (KBR).

**MM:**

Sure, we have a few positions that we would be happy to talk about today and KBR is one of them. I'll give a bit of an introduction and let John delve into the details. KBR is representative of what the ideal long would look like for us. It was historically an engineering and construction ("E&C") company, typically not a good business.

E&Cs are traditionally opaque businesses with project level accounting, betting the balance sheet on massive multi-billion-dollar projects with long lead times. Often there is some opaque accounting and every few years you have a blowup and the balance sheet gets stretched because these companies perennially underestimate the cost of delivering a project three to five years down the line. We're talking about big heavy scale liquefaction infrastructure type projects and other similarly complex projects.

KBR has pivoted over the last handful of years into more of a government services company, similar to Booz Allen. In our longs we look for increasing earnings and cash flow growth, ideally paired with an improvement in the quality of that cashflow. KBR now fits in that mold.

When you have an increase in cashflow paired with an improvement in the quality of cashflow, you can benefit not only from the growth itself, but also multiple expansion to reflect that improvement in quality. Experience tells us these situations have turbocharged return potential.

We found a number of these names across different sectors and KBR falls squarely into that group. I'm going to let John go through more of the details.

*"In our longs we look for increasing earnings and cash flow growth, ideally paired with an improvement in the quality of that cashflow."*

**JR:**

So as Michael said, we've been involved for a little over three years, but the transition for KBR really started closer to seven or eight years ago when the current CEO, Stuart Bradie, came on board. When he joined in mid-2014, as Michael had said, the vast majority of revenue was energy and E&C related.

Probably about 90% of the revenue at that point was energy related and only about 10% of it was in government services. Over the last eight years that has been reversed. And today, government services is probably 80% of revenues, about 70% of EBITDA, and energy related revenue is only 20% today.

In addition, the company's exposure to fixed price contracts has declined from probably 50% of total contract value back in 2015 to less than half of that today. The government services business growth has been driven both organically and through M&A, and the M&A has helped them move from what was historically largely a lower value added pure logistics focus to a much higher value added engineering, design, and consulting focus.

The energy services business, which today is called Sustainable Technology Solutions, has also been completely transformed. As Marone said, it was historically overwhelmingly E&C. About 70% of that business was pure E&C, which is notoriously boom bust, and the providers are usually on the hook for contract overages, which makes it pretty dangerous. The E&C business has been exited completely at this point and what remains today on the energy side of the business is largely a licensing and advisory business that's focused on energy transition and zero carbon technologies.

You can really see that transition through the operating margins or the

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EBITDA margins. When KBR was primarily E&C, they were typically running a mid-single digit type EBITDA margin. Today the Sustainable Technology Solutions business has EBITDA margins that are north of 20%. They're very well positioned today as the focus is on green energy and energy transition. So they have probably a 50% global market share in the technology that's provided to ammonia plants. In addition to ammonia refining, they're big in other petrochemical refining, green hydrogen, blue hydrogen, and plastic recycling.

There are some solid consistent long-term tailwinds for the U.S. government services business. The U.S. government continues to move increasing amounts of its "non-core" functionality to contractors. That's driven in large part by lower total cost for outsourcing since the government can avoid the high pension and benefit expenses that are typically incurred by public union employees.

And as they've moved more of this non-core functionality out to outsourcers, it's really benefited the large global diversified contractors like KBR, who are really the only guys that are in a position to win these increasingly complex global contracts. They have about a 90 to 95% re-compete win rate in government services. So the business is highly predictable.

***"There are some solid consistent long-term tailwinds for the U.S. government services business. "***

They've got a strong backlog of about $17 billion, which is roughly two years of revenue. That's firm backlog. There's another 5 billion of unexercised options which would take the total to between two and a half and three years of revenues. And that backlog actually doesn't reflect the largest piece of business the government services segment has ever written.

They won a contract in 2021 called Home Safe, which is for the redesign and subsequent management of the DOD's family relocation program. That's a $20 billion contract over about a 10-year period. It should contribute when it's up to its full run rate somewhere between $100 and $125 million in EBITDA and about 50 to 70 cents a share in earnings annually. As is typical with these large contracts, there were initially some legal challenges from the losing bidders. Those have all now been resolved. The transition work has begun.

On the third quarter call a couple of weeks ago, management announced that the ramp-up of that contract was proceeding somewhat more slowly than they'd originally expected. The DOD has had some issues on their side with their technology provider. That technology provider has now been replaced and they're moving forward, but it has pushed the implementation timeline back on the contract.

They were originally supposed to be at a full run rate by 2025. That's probably now been pushed somewhere between six and 12 months for full run rate. When they announced this on the third quarter call, the shares responded very negatively. We think they meaningfully overcorrected. The contract is still very much on track. It's just been pushed back a bit, and ultimately it will be very accretive to the earnings and EBITDA for the company.

The company has a very solid balanced capital return policy. They do a combination of share repurchases and dividends. They have a very well thought out M&A strategy, which they've used to push up market in the value chain, particularly in the government services business. Despite this transformation of the business over the past five plus years, KBR continues to trade at a pretty meaningful discount to best of breed government services comps.

Today, you can buy the business for probably 10 times forward EBITDA, which compares to on

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average about 13 times for a pretty broad group of government services comps and 15 times for best of breed like a Booz Allen.

The STS business we think should easily be worth 15 times EBITDA. There's no real clean comps for it. It's pretty unique, but if you look at other IP-based businesses or other companies with unique niches, they typically trade at or above those levels and given the very much clean energy focus, we think that should be accretive for the multiple as well.

So yeah, that's sort of the overview on KBR. We do think if you get on a blended basis a 13 to 14 times multiple on that, there's modest leverage on the business, you've probably got upside of 75 to 80% in the stock from where it's today.

**MM:**

Over a couple of years.

**JR:**

Yeah.

**G&D:**

That sounds very attractive. Thank you for that explanation and maybe we can move on to Gerresheimer AG (Germany: GXI).

**MM:**

Gerresheimer is something completely different. Gerresheimer is a pharma packaging company. It had been a chronic under-performer. However, we believe they finally repositioned the business meaningfully and that transition is not well understood.

Additionally, the market's always looking for the next investment theme. Middle of this year, that was AI. This is not AI, but one of the other themes that has emerged even more recently is GLP-1s. And that does fall squarely into a beneficial growth opportunity for Gerresheimer. Again, I'll let John go into the details here.

**JR:**

Yeah, so as Michael said – putting aside the GLP-1 kicker on this – this is a pharmaceutical packaging manufacturer. And over the past three to four years under a completely new senior management team, they've seen a real step function improvement in their growth prospects. Despite that, they still trade at a very meaningful discount to their three public competitors. There are four total global competitors in the pharmaceutical packaging industry.

The management team came on board in 2018 / 2019 and took what was historically a sleepy 1 to 2% grower, and immediately began reorienting the business towards higher growth verticals. They did this in a number of ways. They increased the focus on inhalers and pens. They started moving from generic syringes to specialty syringes, auto-injectors and pumps.

They moved to expand their services into the design stage and the clinical trial stage for pharmaceutical customers. Previously, they'd only been involved with post-approval pharma products, so that opened up a large new growth area for them. They expanded their washing and sterilization services, which had previously just been for syringes, to also include vials and cartridges, and that allowed them to move from historically what had been a focus on bulk vials to ready-to-fill vials, which are a much higher growth, higher value add, higher margin subsegment.

They've established solid market shares across virtually every pharmaceutical delivery modality out there. They are number one in inhalers and pens, number two in syringes, number one in ampules, vials and cartridges. They're number one in plastic packaging.

They've also gotten tailwinds from secular industry trends. If you look today, biologics are accounting for a disproportionate share of overall pharmaceutical industry growth. This biologic strength benefits syringes since injection is the preferred delivery modality for most biologics. Biologics also have a very heavy reliance on glass vials where they have a very strong position. A lot of the biologics are caustic

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to plastic containers. They're also sensitive to light and to metals, which makes plastic containers unsuitable.

So if you add all this together, they've gone from a business that was growing 1% to 2% annually five years ago, that ticked up to 3% to 4% in 2020, ticked up to between 6% and 7% in 2021, and this year, they'll grow the top line between 10% and 11%. Looking forward, as Michael mentioned, the GLP-1s are a real upside kicker for these guys.

There are only a small number of global providers who can fulfill the contracts for syringes and auto-injectors for the GLP-1s. This year, Gerresheimer will probably only generate about €25 million of revenue from that business. That should grow to over €200 million over the next couple of years, and ultimately it could be a half billion Euro business for them.

The GLP-1 business is margin accretive to their consolidated margin. They have 20% pre-tax ROICs on the capex they're putting into the ground to address the needs of the GLP-1 customers. GLP-1s in general, it's probably a $20 billion market this year. It's expected to roughly quadruple by 2030.

And injection – which plays to Gerresheimer's strong position in syringes – is currently the preferred delivery modality for GLP-1s. It's the only available modality for newer GLP-1s, although some older formulations are available in oral. In addition to the revenue growth, the company's been improving other financial metrics as well.

The margins have inflected favorably even in the face of pretty meaningful expense inflation. Both the plastic and glass segment margins have inflected positively over the last few quarters. The higher growth verticals like biologics and GLP-1s are margin accretive and should continue to drive margin expansion going forward.

***So if you add all this together, they've gone from a business that was growing 1% to 2% annually five years ago, that ticked up to 3% to 4% in 2020, ticked up to between 6% and 7% in 2021, and this year, they'll grow the top line between 10% and 11%. Looking forward, as Michael mentioned, the GLP-1s are a real upside kicker for these guys.***

Management has laid out a target of 300 to 500 basis points of expansion over the next four years, about 100 basis points per annum. In addition, the new management team or newer management team has a much more disciplined focus on return metrics than prior management. Capex is subjected to more rigorous payback and return on capital thresholds. These guys now target a 15% blended pre-tax ROIC with a four-to-five-year payback on new capex projects. Those are both meaningful improvements over what they used to get.

And management claims that the GLP-1 contracts, which they've been signing recently, will deliver 30% plus margins. And as I said, these have 20% pre-tax ROICs. There are only a few other competitors out there who can fulfill these global contracts, which are increasingly demanded by the large global pharmaceutical manufacturers.

I'd say historically, an Achilles heel for valuation has been a lack of free cash flow for the company and we think that'll improve meaningfully as we get into the back half of next year. Historically, prior to the new management team coming on board, there was just a real lack of capex discipline. There was a focus on volume growth over cash generation. There was very poor working capital management. So that somewhat accounted for the poor cashflow. Subsequent to 2019 when the new management team came on board, this pivot that they executed required them to put a lot of capex into the ground.

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They've doubled their global syringe capacity among other expansions and that associated capex has burdened free cash flow over the past few years subsequent to 2019.

And then this year, they've started putting a lot of money to work for these major GLP-1 expansions. So you've had sort of these three eras, for each of which there's been different reasons for the lack of free cash flow, but it's certainly been suppressive to the multiple that these guys have been able to get in the market. So they've laid out their plans pretty succinctly. The capex cycle should start to wind down in the back half of 2024. The free cash should start to improve meaningfully, and we think that'll be a key catalyst to revaluing this company.

Today, Gerresheimer trades at eight to nine times EBITDA. That compares to about 15 times for SCHOTT Pharma, which is a newly public German listed competitor. Stevanato, the second competitor, trades for about 20 times EBITDA and West Pharma, which is a US-based competitor, trades for about 25 times.

The other explanation for the discrepancy besides the lack of historical free cash flow for Gerresheimer, is that the market tends to focus on what they view as high value solutions for each of these four competitors. Today, Gerresheimer classifies about a quarter of its revenue as high value solutions. That compares to 30% for SCHOTT, a little over 30% for Stevanato and 55% for West.

*"I'd say historically, an Achilles heel for valuation has been a lack of free cash flow for the company and we think that'll improve meaningfully as we get into the back half of next year. "*

So there's a very high correlation between the amount of high value solutions they're delivering and the associated trading multiple. If you look at the role of the GLP-1s as well as some of these other faster growth subsegments that Gerresheimer has targeted like the biologics, we think that 24 to 25% high value solutions allocation today should get to about 35% over the next probably three to four years. And we think that'll be another key catalyst in addition to the free cash flow improvement to drive some multiple expansion.

**G&D:**

You mentioned that GLP-1 drugs used to be an oral form and they switched more to injections. Do you see that reverting back to where consumers prefer having an oral form of GLP-1?

**JR:**

Yeah, I think there's a couple ways to think about it. I think at some point if you roll the clock forward, there will definitely be a mix in the market. The consensus seems to be that the diabetics will probably largely stick with the injectables. The injectables have some incremental benefits over the orals. There's some renal protective and cardioprotective benefits that you don't get with the orals.

At the most basic level, you would think an oral would be the preferred modality, but with the orals, typically you need to take them on an empty stomach. You also need to take them typically 30 minutes before ingesting any food. So you got to take them first thing in the morning.

A fair number of people also tend to develop digestive issues with them. We've seen this with some other drugs, so it tends to be somewhat more difficult to get people who are on the orals to stick with the regimen, which lowers the effectiveness of the drug for a lot of the people who take it orally.

So we think the market probably will bifurcate to some extent. We think the diabetics will probably largely stick with the injectables and

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we think some subset of folks who are taking it for weight loss purposes will probably end up sticking with injectables as well. So our expectation is that if you roll the clock forward five years, you'll probably still have a market that's using both of those modalities.

**G&D:**

Given the capital intensity of the business, why is the business valued through an EBITDA multiple? And you alluded to percentage of GLP-1s being used for weight loss purposes; do you have a view on what percent of GLP-1s would be consumed for weight loss purposes versus for diabetic reasons?

**JR:**

Taking your second question first, I think it'll be to some extent a function of pricing. And the nice thing about the GLP-1s, currently they're not covered for a lot of folks, particularly folks who want to take them for weight loss. And that's a function of price. So to the extent you are getting additional competition and prices come down, you'll drive meaningfully higher volumes.

We're just using industry estimates at this point in terms of the expectation that this could be a $75 to $80 billion class of drugs five years out. At least to date, those estimates have been doing nothing but increasing. So for what it's worth, Gerresheimer is also the largest producer in North America of pill bottles, which admittedly don't have as high of an ASP as a syringe, but they don't lose out completely on the orals.

In terms of capital intensity, I think the market has tended to value most of these businesses on an EBITDA basis. But if you do want to look at it on an earnings or free cashflow basis, if we roll the clock forward, we think within the next few years these guys will probably be doing between seven and eight Euros a share.

And so on that basis today, and that's obviously fully burdened for the capex, you are buying this thing at 11 or 12 times earnings on a business which we think is going to be sustaining double digit revenue growth rates for the foreseeable future. So we've tended to look at it on an EBITDA basis because we think that's how the market tends to look at it, but we think it's equally attractive if you look at it on an earnings basis or a free cash flow basis once these guys get through the current capex cycle.

**G&D:**

Got it, thank you. All right, moving on. We're very excited to hear about Melrose Industries (UK: MRO) and your outlook on it.

**MM:**

Melrose is transitioning from being a conglomerate to being a pure play aerospace company.

Melrose is also transitioning to a truly operational aerospace focused management team from what I would describe as having been a more "financial engineering" focused leadership team. And it's also a good time in the cycle to be a pure play aerospace company given demand growth and the ability to retain pricing, which is important in this type of environment. So again, I'll let John go into the details, but this sets up a bit differently than the other two, more of a discovery story.

***"It's a good time in the cycle to be a pure play aerospace company given demand growth and the ability to retain pricing, which is important in this type of environment."***

**JR:**

Traditionally it was some guys who were effectively operating a publicly traded private equity firm and they had this model of buying, building, improving, and then divesting distinct industrial platform companies. And they had a very strong track record of doing that over the course of sort of a decade plus with some very successful exits and subsequent returns of

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capital to shareholders.

At the beginning of this year, they really had just two remaining platforms. In April they divested one of those, the Dowlais Group, which was an automotive business, which left the remaining business as a pure play aerospace business.

In addition, about a month after they spun off Dowlais Group, the longtime PE oriented management team that had been responsible for this platform approach announced that they plan to depart early in 2024 and they will be leaving Melrose in the hands of the aerospace business operating management.

So that leaves a business that now has more directly comparable publicly traded competitors at a point of time in its lifecycle where the P&L for reasons that I'll go into is beginning to accelerate very meaningfully. The aerospace business is a high-quality business. About 70% of their business or their revenue is sole sourced with a higher percentage in the engine segment. The engine segment is the primary profit driver for the business today. Engines accounts for only about a third of the revenue, but probably 80 to 85% of the operating profit.

The engines business has ownership interests in 19 different civil engine platforms through what are called “risk and revenue sharing partnerships,” or “RRSPs.” These RRSPs are contract structures through which a consortium of companies contribute to the development, manufacturing, and maintenance of various civil and military engine platforms.

Melrose's specific contribution to the RRSPs are highly engineered components, rotating parts, fan blades and mounting structures primarily. These RRSPs are very long-lived programs. They typically have a 60 plus year life and that includes about 15 years of investment and development prior to commercialization, 15 years of production and then typically about 30 years of aftermarket support.

*“Management has targeted about 600 basis points of margin expansion in engines over the next three years, in large part due to the fact that they're now entering this very profitable section of the life cycle of these RRSPs. Currently they're running ahead of schedule in that 600 basis point margin expansion.”*

Based on that life cycle, RRSPs have very heavy upfront costs while the engine platform is being developed. That's followed by positive cash flow once the engine enters commercial service and then rapidly expanding margins and free cash generation as you get into the aftermarket service part of the life cycle. Each member of the RRSP has a fixed percentage ownership interest in the contract structure and is guaranteed their pro rata share of aftermarket profits regardless of the durability of the specific parts that they contribute to the engine.

So in Melrose's case, these parts that they're making, the fan blades, the mounting structures are typically installed for the life of the engine. So their share of aftermarket revenues is highly, highly profitable since there's virtually no cost of goods sold associated with it. They're on these 19 RRSPs including engine platforms that cover about 75% of all global narrowbody flight hours and about 70% of all global widebody flight hours. So they're very well represented.

Management has targeted about 600 basis points of margin expansion in engines over the next three years, in large part due to the fact that they're now entering this very profitable section of the life cycle of these RRSPs. Currently they're running ahead of schedule in that 600 basis point margin expansion.

More recently, the

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market has had some concerns about their exposure to one particular RRSP, which is Pratt & Whitney's geared turbofan engine, but we think that exposure is manageable. Melrose has about a 4% interest in that platform. The geared turbofan is an engine platform whose primary current application is on the Airbus A320. It has about a 35% market share on the A320. It has superior fuel burn efficiency, reduced noise versus some of the competitors. That's the primary selling point.

However, over the last couple months, some liabilities have come to light in relation to manufacturing defects with some of the non-Melrose parts in the engine. And the way these RRSPs work, although Melrose didn't design or produce any of the defective parts, they're still responsible for their pro rata share of the liabilities.

So if you look at the estimates that P&W has laid out, they think there's going to be £4.5 to £5.5 billion of liabilities associated with replacement of these parts and with making the airlines whole. Melrose has about a 4% interest. So it'll be about a £200 million cash cost for them, which will be incurred over multiple years. There'll be fairly limited annual profitability impact. While the P&W geared turbofan engine is important to them, it doesn't represent in any way, shape or form a dominant portion of Melrose's overall civil, narrowbody RRSP portfolio.

The other business, the structures business, is also attractive. Unlike other troubled structures aerospace businesses out there, like Spirit AeroSystems, Melrose owns all of its IP. This helps provide a more durable margin and return on capital profile.

Management is also targeting 600 basis points of margin expansion in this business over the next three years. That's through a combination of repricing a number of the defense contracts and some operational initiatives they've got underway. These guys have a long history of setting and achieving their margin improvement targets. So we have a high degree of confidence in their ability to do that.

We like where the commercial aviation business is in the cycle. Global air travel continues to recover from COVID disruption. Boeing and Airbus both have tremendous backlogs, five plus years each, and we think that'll continue to drive solid demand for both the engine segment and the structures segment over the next bunch of years.

Melrose today trades at about eight times EBITDA. The comps typically trade closer to 12. These are viewed typically as very high-quality businesses. The eight times, by the way, is out in 2025. It's important to look forward for this business a couple of years we think because of this ramp you're getting from the RRSPs as well as the margin improvement initiatives that management has underway. And we think that gap with the comps will narrow over the next couple of years as the margins improve and as free cash starts to really accelerate meaningfully.

**G&D:**

That's fantastic. And lastly, we'd love to hear about Japan-based Sanken Electric (Japan: 6707).

**MM:**

Sanken is a classic special situation opportunity. It is a Japanese company with a crown jewel asset, Allegro MicroSystems, which trades here in the U.S. Our view is that Allegro would be very attractive to certain strategic buyers.

There are two successful activists investors in Sanken: Effissimo, who recently was very successful with Toshiba, and Oasis, who themselves had prior success with Sanken.

Effissimo owns 19% of Sanken and Oasis is in the high single digits. So this is not an insignificant position, certainly for Effissimo. And now that Toshiba is behind them, I think there's a good likelihood that they turn their attention more specifically to Sanken.

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So again, I'll let John go into the details of what we like about Allegro MicroSystems and the non-Allegro business that Sanken has.

**JR:**

Yeah, so look, this is a pretty clean sum-of-the-parts story. The company has two primary assets. They have a 52% interest in this U.S. listed public subsidiary, Allegro MicroSystems. The second asset, which we think accounts for maybe 15 to 20% of the overall value, they have a wholly owned $700 to $800 million revenue producer of power semiconductors, they refer to that internally as Core Sanken.

Today, if you buy Sanken, you're basically purchasing their stake in Allegro MicroSystems at about a 50% discount to its tax-affected value. So you've got a double if they were just to realize their tax-affected value on the Allegro stake. And then you've got additional upside from the potential value of Core Sanken.

With respect to Allegro, they took it public I think about three years ago. It's a fabulous semiconductor design company. It's very, very well positioned. About 70% of their revenue comes from the auto end market. They're highly exposed to the EV and BEV transition. They have about two times the content per vehicle on an EV or a BEV versus what they get on an internal combustion engine automobile. They've tripled their market share in auto power ICs over the last five years.

About 20% of their revenue in total comes from industrial markets and here as well, from a secular exposure standpoint, they're in very good shape. They have high exposure to renewables, charging stations, solar farm components, and other secular growth areas. They have very good IP. They've been expanding their margins consistently since they came public, strong free cash flow generation and the top line has been growing at a 20% plus rate historically.

Since the IPO, they've added about 300 basis points to their gross margin targets, 700 basis points to their operating margin targets. They probably still have a little bit of room left to go there. Unlike a lot of other semiconductor companies that had a lot of demand pull forward as a result of COVID, these guys have typically been capacity constrained for the last few years. Demand to date has held up well, albeit with some recent puts and takes. There's been some digestion of inventory in the industrial channel that's been a little bit of a headwind recently.

Turning to Core Sanken, that's definitely a lower quality business than Allegro. It's an integrated producer of power conversion semiconductors. It's much more commodity grade than Allegro's products. The primary end customers historically have been in the Chinese white goods market and there have been obvious demand headwinds there recently.

Historically, given the mediocre performance and market exposure they have, the business has only been marginally profitable. That said, there are some reasons for optimism around the asset. They have U.S.-based semiconductor fab facilities, which have increasing strategic value given the recent trend towards onshoring here in the U.S. for semi fabs. In addition, they have restructuring actions underway that could meaningfully improve current profitability.

The fab subsidiary recently got a $150 million equity infusion from One Equity Partners, which was a pretty sizable vote of confidence. One Equity knows this asset very well. They were actually pre-IPO investors in Allegro. That investment's going to be used to expand 200 millimeter wafer capacity at the U.S. fab. The equity investment will also allow Sanken to deconsolidate the fab subsidiary, which should improve on an optics basis some of the operating losses they've had on and off with this Core Sanken business over the years.

So as Michael mentioned, the

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prevalence of these two activists, Effissimo and Oasis are critical to our thesis, given the fact that we're probably all familiar with plenty of Japanese companies that are cheap, but just sort of seem to stay cheap indefinitely. Both were meaningful investors in Toshiba. Effissimo was Toshiba's largest outside shareholder and was a driving force in the recent buyout proposal. So they will get liquid on that stake shortly, which will give them a large slug of cash.

Oasis on the other hand, has been an investor in Sanken for the past few years. They've already successfully pushed for a number of value enhancing changes at the company. They've pushed through improved governance, they pushed through a performance-linked director compensation package. They pushed the company to initiate the original restructuring actions at Core Sanken.

We think either or both of these guys could initiate tender activity in the stock, particularly as they come into this cash from the Toshiba liquidation. But generally speaking, we think there are probably multiple ways to get paid outside of tender offers. We think you could see a full divestiture of Allegro at some point. Improved profitability at Core Sanken could be a real catalyst for getting this thing revalued.

**MM:**

What is the valuation of Allegro through Sanken?

**JR:**

So today, I think we are buying Allegro, if you look at it through Sanken, it's six times EBITDA, probably seven to eight times earnings. So very, very cheap for a business which has been growing its top line at 20%, expanding margins, and spitting out a lot of free cash flow. Yeah, and that's buying it through Sanken.

**G&D:**

Thank you. Maybe we'll move to the closing remarks section. How do you allocate your time during a typical day, and how much time is spent on new ideas versus monitoring your current portfolio?

**MM:**

Every day is different, but if I aggregate time spent over a week or two, probably a third of my time is devoted towards thinking about where we are in the marketplace and the economy. A lot of reading, including what other companies are reporting or saying, companies that we don't have exposure to and how that might impact where we want to have the firm spend time doing research.

Probably a third of my time is related to sourcing ideas that ultimately the analysts will do the deeper research on.

And then last third is spent having discussions with the analysts, reviewing their research. So for example, now in earning season, there's significantly more time devoted to keeping current on the existing portfolio than there would be off cycle.

**G&D:**

Lastly, some advice for students. What makes a great analyst? What qualities and skills should analysts have? And what is the most difficult part about taking the leap from being an analyst to a portfolio manager?

> ***"From the seat of a PM, it's critical that your analyst is willing to tell you when they've got something wrong."***

**MM:**

I'm not sure there's one ideal type of analyst. Once you work with enough analysts you observe that they each have their own strengths and they could each bring something to the entire team.

There are some analysts that are very detailed oriented and can pull apart a complex situation quite easily. You have others that are more adept about making connections between their work and other opportunities, so they may be particularly good at sourcing ideas. And then you have some

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who are great working the phone, building models, and doing the primary research. The ideal analyst has all of those elements, but it is rare to find somebody that does all of those skills equally well.

I do prefer someone that's very detail oriented and curious. They ask a lot of questions, are interested in learning, and readily admit mistakes. From the seat of a PM, it's critical that your analyst is willing to tell you when they've got something wrong. The worst fear for a PM is that their analyst is keeping information to themselves for fear of looking like they made a mistake. That's not a good position for a PM to be in.

In my view, a recipe for success is a lot of reps and experience, and there's no real shortcut. You have to make a lot of mistakes, you have to get a lot of things right, you have to form some pattern recognition, and all that takes time. From there, I think you'll ultimately develop a framework that works for you.

In terms of moving to PM from being an analyst, in some ways it's similar. Instead of spending my time questioning companies or doing checks to develop a view on an investment, I'm really spending my time focusing all those questions towards the analyst. It's still the same exercise. However, as a PM, I'm certainly ultimately responsible for a lot more investments than I was as an analyst. That is an adjustment.

I also have to pull it all together, these discreet investment ideas that an analyst has and I have to make sure it all gels into a workable portfolio, making sure we're not aggregating risks or offsetting opportunities. Those are things that usually an analyst doesn't have to spend a lot of time thinking about.

I may know more than an analyst on any given name at the outset. I may know what the risks and opportunities are just based on my experience. But over time, the expectation is that the analyst will know the names in a lot more detail, which is why John is here going through the investment pitches. At any given time, John will and should know more about the investment than I do.

And that can be a difficult mental leap to make from being the analyst where you are in control of the information and knowledge of that investment within the organization to something else. Now I have to give up a little bit of that reign and know that the analyst knows that name better, which is why it's critical to hire the right analysts.

**G&D:**

Thank you so much for your time.

# VELA Investment Management

Ric Dillon

Jenny Hubbard

Brian Hilderbrand

**Ric Dillon, CFA is Co-Founder, CEO, CIO, and Portfolio Manager . He has more than 30 years of professional investing experience. Prior to VELA he founded Diamond Hill Investments in 2000, a public company based in Columbus Ohio. In the 1990s he founded Dillon Capital Management, where he served as President and CIO, until the company was acquired by Loomis, Sayles & Company, where he returned to work as a Portfolio Manager. Early in his career, Ric served as a Portfolio Manager at Loomis, Sayles & Company. Ric earned his MBA from the University of Dayton as well as a M.A. in Finance and a B.S. in Business Administration from The Ohio State University.**

**Jenny Hubbard, CFA is Co-Portfolio Manager of the Small Cap Strategy and a Research Analyst. Prior to joining VELA, Jenny served as a Research Analyst and Assistant Portfolio Manager of the Small-Mid Cap and Mid Cap Strategies at Diamond Hill Capital Management. Jenny has industry experience since 1996, including positions with ABN/AMRO LaSalle Bank and Avondale Partners. Jenny holds the Chartered Financial Analyst (CFA) designation, a M.A. in International Economic Development Policy from Stanford University, and a B.A. in English from the University of Colorado.**

**Brian Hilderbrand is Co-Portfolio Manager of the Small Cap Strategy and a Research Analyst. Prior to joining VELA, Brian was a Research Analyst at Diamond Hill Capital Management, covering restaurants, recreation, and managed care. Brian has industry experience since 2005, including Investment Analyst roles at Homrich Berg and LCG Associates. Brian holds the Chartered Financial Analyst (CFA) designation, an MBA from London Business School, and a B.B.A. in Finance from University of Georgia (magna cum laude).**

***Editor's Note: This interview took place on November 11th, 2023.***

**Graham & Doddsville (G&D):**

Thank you so much for being with us today. Could you please walk us through your background and how you first got interested in investing?

**Ric Dillon (RD):**

Well, I'll start with what was serendipitous for me. I was at Ohio State and went to visit my investment class professor, and while there, I saw a note on the door. This was back in 1977, so it was a different era in terms of communications, but the note on the door mentioned an investment position at an Ohio-based public pension fund. I applied and got it, so unlike probably most of you, I feel as if I lucked into it, and of course, I fell in love with it immediately. I'm very grateful for that serendipity.

The only other thing I would add is that for me, the CFA program was especially helpful in developing my passion for investing. Of course, I like to point out that back in those days, *Security Analysis* by Graham and Dodd was one of the textbooks for the program. A lot has changed, of course, but the idea of value investing was the predominant form back then. They didn't even call it "value investing" per se; it was just investing and valuing companies, which was somewhat standard. Clearly, over my career of 47 years, a lot has changed.

**Jenny Hubbard (JH):**

So, I had a liberal arts undergraduate background and majored in English, but I always loved to learn and was interested in many subjects. During my undergraduate studies, I took an honors econ course with eight other students; I really enjoyed the professor

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and the course really sparked an interest in economics. It just taught me a different way to think about the world. He encouraged me to do a master's program in econ, and so I did that at Stanford. The program was a bit esoteric, designed for those wanting to do a PhD or work in government policy. After graduating with my master's degree, I figured that a PhD was a pretty big undertaking. I needed to work a little bit to pay for my master's degree, and I was drawn to finance and investing, so I decided to look for a job in these fields and try working for a bit. Plus, the person who is now my husband was in school across the country and we were tired of a long-distance relationship, so that was a pull to get into the workforce as well. My parents and grandfather both worked in the field, so I grew up hearing about it. It seemed like a career where I could satisfy my love of learning and never get bored.

I started in acquisitions and corporate finance for a REIT and ultimately got a job on the sell side with a small niche firm. I had a great director of research. When I started, I didn't really know what I was doing, but fortunately, she was a Buffett-style investor and really influenced my research and writing. I'd been there for several years when Ric got ahold of some of my research. At that time, he was looking to build out his analyst team at Diamond Hill. We stayed in contact for a few years before I ultimately joined his team as an analyst covering the Consumer sector. Both Ric's investment approach and the culture he'd implemented at Diamond Hill really resonated with me. We've worked together now for about 15 years and have built upon what I feel are the best of both of those factors at VELA.

**Brian Hilderbrand (BH):**

I grew up in Augusta, Georgia, which was a great place to grow up, famous for golf, but not famous for investing. I don't remember it being a large part of my childhood, but I do remember in the mid to late nineties, I was in middle/high school when the internet bubble took off, and that really caught my eye. I went out and bought as many investment books as I could; I subscribed to the Wall Street Journal, and through my readings, I ran into Roger Lowenstein's book *Buffett: The Making of an American Capitalist*. That book started me on my value investing journey. I started there and then went on to the University of Georgia, where I continued trying to learn as much as I could about investing. I dabbled in some trading accounts and tried to learn what I could with the money I had.

From there, I wanted to move to Atlanta. Jobs were hard to come by in the analyst role, but I did move into investment consulting, private wealth management, and research roles. There, I learned a lot about the industry, met a lot of knowledgeable investors, and gained valuable experience. It kept my interest until I moved on to London Business School, where I learned under Columbia Business School alum and former Columbia professor, Eddie Ramsden. There, I tried to make the transition, like some of you are, into the role. It was post-business school that I met my now-colleagues at Diamond Hill. When the opportunity came to work with both Jenny and Ric again at VELA, it was a no-brainer, so I've been here since 2021.

**G&D:**

You've spoken about the impact that Warren Buffett has made on you all. Could you elaborate about Warren Buffett's approach and how it influences how you make investments?

**RD:**

As you all know based on where you are studying, Buffett learned primarily from Benjamin Graham. The core idea was owning a piece of a company as opposed to trading pieces of paper. The only thing you can control when buying a stock, setting aside the activist approach, is the price you pay for that stock. So, valuation is essential. VELA is Latin for "the sail of a ship,"

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but the VELA acronym also represents the guiding principles of our firm. The "V" in VELA is our valuation centric philosophy, which is at the core of what we do. Buffett mentioned in his 1993 investor letter that growth and value are part of the same equation. If you try to separate one from the other, the equation is essentially nonsense. Therefore, we believe estimating the intrinsic value of a company is essential. From Benjamin Graham, investing (instead of speculating) and getting that margin of safety right is so important. So, it's in our name, and it's in our DNA.

**G&D:**

VELA was founded in 2019, and the firm launched multiple equity strategies in 2020. Could you just maybe provide an overview of your firm and your strategies?

**RD:**

Beyond the valuation-centric investment philosophy, we feel that having experienced investors ("E") is really important for getting good results. We are committed to being long-term ("L") in everything we do. We often say that five years is the beginning of statistical significance and probably the end of people's patience. The "A" in our name stands for "alignment of interest." Upon joining VELA, each employee commits to investing only in our own strategies for each asset class in which we participate. VELA, collectively, is the largest investor in our mutual funds. We started with three funds at the end of the third quarter of 2020. We're both a wealth manager here in central Ohio, and an asset manager with our now four mutual funds and three separate account strategies.

***"The 'V' in VELA is our valuation centric philosophy, which is at the core of what we do."***

**G&D:**

Is there anything you want to touch on in terms of how you're thinking about building out the firm going forward?

**RD:**

When I started Diamond Hill in 2000, we started with a few portfolio managers that I had either known or worked with in the first few years. In 2002, we hired Jason Downey right out of Ohio Wesleyan. A year or two later, we hired one of our interns. I said to those two that we were going to build the research department with the two of them as the starting point. We added two or three people a year in that research role for the next 15 years while I was CEO. We plan to build out VELA similarly. We have a robust intern program, and we already have one person who works here, Max Grogg, who was an intern with us. We have another former intern who has accepted a position upon graduation.

We intend to build out the firm with research analysts and associates that we've developed ourselves, and we'll look to add some experienced people along the way too. This means two to three research people a year, and then probably two to three non-research people in either operations or other aspects of the business. For our wealth management business, we're starting again with Central Ohio, what I often refer to as "friends and family" business. The asset management business is more of a national business, primarily through intermediaries and consultants.

**G&D:**

When you are thinking about idea generation for the VELA Small Cap Strategy, could you talk about your process and then what you consider to be an attractive hunting ground for new small cap investment ideas?

**BH:**

Our idea generation comes from many different sources. One of the first places we start is with our analyst team, which Ric mentioned we're continuing to build out. Our ideas come from their research process, and these individual analysts are building out expertise

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within various industries. We're pulling on those resources to come up with ideas for small cap as well as our other strategies. One important note about both our research process and firm culture is that our portfolio managers are titled Portfolio Manager and Research Analyst. This means we conduct research alongside our analyst team. We think this is important because it opens up the lines of communication between us as portfolio managers and the analyst team. It's good that we're both in the weeds when we're looking at individual names. I've found that unique insights can be gained when combining my experience with the fresh perspective of an analyst.

The Small Cap Strategy also benefits from other VELA portfolio managers in their research process. If they identify a business that they like in their research and find it attractively valued, we'll be able to pull on that idea. That's one way. Then, we also do quantitative screens individually. For me, this usually means looking at businesses that have high returns on tangible capital that trade at an attractive valuation, similar to what I learned at London Business School. Within small cap, companies can be disadvantaged players relative to larger competitors, so we are always looking for dominant players in smaller markets.

**JH:**

Yeah, I'd also say in terms of quantitative screens, Bobby Murphy, who is our Director of Research, has created a couple that we've found to be valuable. They touch on the consistency of financial metrics over time. As an example, a business that might be trading at a P/E of 17 times or less but has consistently grown earnings in the high single-digit to low double-digit range over time, while also maintaining strong returns on invested capital and a 1.5x or lower leverage ratio over time. That would be another example of a quantitative screen. We also look at the 13F filings of other investors we admire. Max Grogg, who Ric mentioned, does a great job of going through 13Fs of investors that we admire. We take no shame in looking at those.

*"I've found that unique insights can be gained when combining my experience with the fresh perspective of an analyst."*

If they're talking about an idea that we're not familiar with, and it sounds interesting to us, we'll certainly look into it as well. Then, the last thing I'd say we do for idea generation is reading all the time about trends, events, and things going on in the world. Sometimes that can prompt an idea and you might think, hey, I think something's going to develop in one area or another. Which small cap companies cater to these areas? Where might we see increasing demand? Our constant reading can help us decide where to focus our bottom-up research.

**G&D:**

You write covered calls, which seems to be a unique attribute. So, how is this consistent with the firm's intrinsic value investment philosophy?

**JH:**

We really view the call option writing and our valuation of securities as inextricably linked, especially since small cap securities tend to be inherently less efficient than large cap securities. We have found this to be true in the options market as well. In our approach, we can often find opportunities to write a covered call at a strike price that is at or above our estimate of intrinsic value. This can give us a little bit of additional yield; or, put another way, lower our basis in a position. It also provides some downside protection and reinforces our sell discipline, because we're writing the option at a strike price at or above what we think the underlying security is worth. If we get to a point where we could get called out, it really just is another way for us to

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check our valuation assumptions, reassess, and see if indeed this is a security we want to trim or exit.

**G&D:**

You've talked a little bit about portfolio turnover and how you think about selling. How do you think about position sizing in your portfolio?

**JH:**

Again, probably no surprise to you, it's tied to our valuation discipline, the extent to which our investments are tracking our thesis, and when the valuation of names on our watch list start to look attractive. The last three years have been extremely volatile, with very large moves in the prices of the securities we own or are watching. Our turnover is generally a residual of our efforts to act on our assessment of dislocations between price and value. We strive for tax efficiency as well, so we will also harvest losses when it makes sense to do so. This and our covered call writing also factor into our turnover, although to a far lesser extent than just our underlying valuation discipline.

I want to add that while we do assess securities with a longer-term view, we don't equate long term with being complacent. If we see evidence that fundamentals aren't aligning with our thesis, we'll reassess. We may get out. Sometimes this can happen quickly with an unforeseen event, something we see that is particularly disquieting about our thesis. And sometimes it happens slowly. For instance, maybe we're not seeing the margin progression over time or the repositioning of a brand, or other indicators that we're looking for.

In terms of position sizing, it reflects a variety of factors, including our assessment of value, the quality of the business, how well we know a security, and our estimate of the range of outcomes. Our largest position, KEX, is close to 6%, and our top 10 holdings tend to represent around 35% of the strategy. These are businesses that we've either followed for many years and/or have become extremely comfortable with the underlying business trends, the range of outcomes is likely more narrow, balance sheets are good, and while they may not necessarily be our widest discount to intrinsic value, we feel more comfortable about the competitive positioning and trajectory of the fundamentals.

We could also have smaller positions, maybe as small as 50 basis points, and those could be instances of businesses where, comparatively, we might just be starting to learn about them. They're interesting to us. We think that the valuation is appealing, we are constructive on the underlying business fundamentals, but we're just learning about them. In those cases, we're building the position slowly more often than not. In

> ***"If we see evidence that fundamentals aren't aligning with our thesis, we'll reassess. We may get out... sometimes it happens slowly."***

addition, we could also have instances of smaller positions where, unlike the larger positions we have, we estimate that the range of outcomes could be wider. We want to manage the risk of downside a little more by having a smaller position.

**G&D:**

Could you discuss the biggest investment lesson that you've learned, or are there investment lessons and topics where you've changed your mind that you think our readers might want to hear about?

**RD:**

Well, I'll go first and I think each of us will have something to say about that. I'll use something that I'm not sure it was the biggest, but certainly one of the more recent lessons. It was in the spring of this year. It came with what happened to Silicon Valley Bank, First Republic, and Signature. For the first time since the Financial Crisis, you had an immense amount

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of stress occur very quickly. In fact, in this case, quicker than even in '08 with regard to the run on those three banks. First Republic is a bank that I held in very high regard. We did not hold it in the Small Cap portfolio, but we did in other portfolios here at VELA. In my view, they had done a great job of managing their business since they came into existence back in the mid-1980s. I've known them all that time. So, it was shocking to me what occurred, but it was understandable given what had occurred only days before at Silicon Valley Bank.

The fact that this could happen was unimaginable to me prior to March (2023). However, in hindsight, perhaps it shouldn't have been. What changed my mind about banks from that experience was that in this new world, in which we now know runs can occur effectively overnight, the important thing that banks have to do now, basically, is pay more for their deposits. It's the practical matter of it.

As a result, their net interest margins will be pressured by higher cost of deposits. So, we fortunately had relatively light positions in banks when this all occurred. That, on a relative basis, was to our benefit. That being said, I think we all have come away, especially me, with a new appreciation for the speed of what can happen with regard to banking.

I think the final thing I'll say about it is that throughout my career, I've seen periods of bank consolidation. When I started my career, there were around 30,000 banks and savings and loans. Today, there's less than half that number, probably less than 10,000, and I expect a lot more consolidation. The difference will be that in the old days, consolidation often happened at pretty healthy premiums. It was a good investment strategy to find some banks that were especially attractively valued and then see them get taken over. However, in the world that we're in today, where you'll see consolidations, there may be no premium at all. This is somewhat out of necessity, because the banks that don't have the other forms of income, other than just simply spread lending, are at a big disadvantage to those banks that offer many other fee-based services like trusts, investments, and so on. So, that's a very recent example and has definitely changed my view of banking and bank investing as a result.

**BH:**

I think the environment that we're going through right now with higher interest rates and the impact of inflation on our investments are lessons that haven't been taught in a while. But I think it reinforces why we do what we do. We are focused on downside protection within our portfolio. We want to invest in companies that have good balance sheets and can weather difficult environments. Right now, I think we're especially glad that we have that process in place, because we don't know what Mr. Market's going to do with our investments on a day-to-day basis, but we are working to protect client capital from permanent impairment. When Jenny, Ric and I start a conversation about a company, no matter what we think the discount to intrinsic value might be, the first questions are always going to be, "how's the balance sheet? What does the balance sheet look like? What's the business going to do to protect us if things don't go according to plan?" We often invest in companies with lower debt levels, but if the companies we choose to invest in maintain higher levels of debt, we look for a path to quick paydown or a business with cash flow stability. Of course, we look for a margin of safety and aim to buy businesses at

*"We are focused on downside protection within our portfolio. We want to invest in companies that have good balance sheets and can weather difficult environments."*

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discounts to intrinsic value, but I think investing in good businesses that can weather difficult times is a good starting point.

**JH:**

I'll just add this as an example of a decision we made related to our sensitivity to leverage and balance sheets. It was an investment that we had in Hanesbrands. It's a company we've known for some period of time, and they saw strong consumer

***"The only kind of bank you would want to have, beyond the one that has an attractive valuation and a sound balance sheet, is the kind that has a sufficiently diverse deposit base."***

demand coming out of COVID. They had pretty good control of their inventory throughout the process and we liked it for its more staples-like appeal to consumers, as well as the fact that all of its production, or the majority of it, was in the Caribbean basin. So, you didn't have some of the risks associated with producing the majority of your goods in China. It had a consistent margin profile over time, as well. We started to see indications that one of their core brands, Champion, was not doing well. At the same time, their leverage, which was around two times the level when we started to invest, was rising, and their fundamental results were deteriorating. In light of that, and our outlook on inflation and the probability of rising rates, we decided to exit Hanes. Today, leverage continues to be up substantially, margins on a twelve months trailing basis are much lower than what they were, and I think it's trading now around $4.  So, that's just an example of how destructive leverage can be to value.

**G&D:**

You've touched a little bit about how you think about downside risks and trying to have that margin of safety. You have exited multiple financial sector stocks because you've said the range of possible outcomes was too wide and unpredictable. What would you need to see in order to invest in new financial sector stocks and banks or however you want to think about that question?

**RD:**

There are companies in the financials sector that we have liked throughout this process, especially insurance companies. As an example, because they don't lend to consumers in the way that a bank does, Assured Guaranty, which we've owned for several years, is not affected in the same way by sensitivity to deposits. It has completely different business issues, good and bad. But with regard to banks, I think the only kind of bank you would want to have, beyond the one that has an attractive valuation and a sound balance sheet, is the kind that has a sufficiently diverse deposit base. Obviously, Silicon Valley Bank was an extreme example, but First Republic was not too far behind it, in terms of the deposit base being so concentrated that you could have the kind of problem that ultimately developed. In addition to that deposit base being much broader, I think having other businesses that they're in and providing other forms of income other than just spread based lending income is very important. But again, without valuation, we wouldn't be interested. So, it's necessary, but it's not sufficient for any investment. In the case of banks, we've got that heightened sensitivity. But for other companies in the sector, we have a niche investment banking firm, Houlihan Lokey, and their business dynamics are very different from the kind of banking we're talking about. Even though they're an investment banking firm, it's clearly very different and different still from insurance companies. So, I wouldn't say we're shy of the sector for the reasons that we've already talked about, but we are wary of most traditional banks at this point for these reasons.

**G&D:**

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Thank you. So, moving on to the individual position discussion, we'd love to hear about BWXT Technologies (BWXT).

**JH:**

That is a business for which I am the primary analyst. It might be interesting to just talk about the genesis of the idea and how we came across it, because I think it's a really good example of how we work together across the team to source ideas. In early 2021, defense stocks were hit pretty indiscriminately on concerns about budget cuts following the Biden election. And while we didn't know that the Russia/Ukraine war would occur at the time, we knew that Putin's posturing was more aggressive than it had been in many years. Also, there were indications that relations with China would continue to fray. At the same time, defense spending had been depressed. We thought for all the reasons I mentioned that this was probably not a long-term probable outcome. So that prompted some of us to look into and research defense businesses within each of our investable universes to see if there were any companies that warranted a closer look. Many of them are more consulting type businesses where turnover can be pretty high and barriers to entry pretty low.

I came across BWXT, which looked really interesting. It had been, I think, unduly stigmatized, not only due to concerns about defense spending, but also because they had gone through a pretty significant capex ramp over the prior couple of years to increase capacity and enhance some of their niche competencies. We thought there was a likely chance that capex would return to more maintenance type levels, so you'd see an improvement in free cash flow over the five-year time horizon. Then, I started researching their core business, which has very high barriers to entry and consistently high margins and returns on invested capital. We're talking a high teens margin business that is underpinned by the US Navy. Specifically, BWXT provides critical aspects of naval nuclear propulsion for Navy subs and aircraft carriers.

Given the imperative of national defense and the strategic importance of naval defense, in particular, to the geographies where we're seeing significant conflict and threats right now, we were fairly confident that the government would be committed to increasing defense spending. The visibility for BWXT's core business is very high. You can look at the Department of Defense budgets and planned build outs of naval ships and see what is projected out for 10 years and what's expected to come online. In addition, another small cap holding we have is a Navy ship builder, Huntington Ingalls. Because we own Huntington Ingalls, we follow their ship building plans and they happen to build many of the ships for which BWXT is building content. So, that core business, which represents about 80% of BWXT's total revenue and profit, is very attractive and tends to be countercyclical.

On top of that, BWXT has many other capabilities in terms of its nuclear competencies that will work to help solve many other global issues. These include nuclear fuel and uranium processing. They've also started building micro reactors, and in fact have beaten out

***"These microreactors, which the US is working to install in military bases around the world, are intended to be more immune to cyber-attacks. That is likely to be a promising driver of future growth for BWXT."***

competitors for recent contracts, which are very important for powering the defense grid. As you might've heard, one of the biggest threats from China is cybersecurity. These microreactors, which the US is working to install in military bases around the world, are intended

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to be more immune to cyber-attacks. That is likely to be a promising driver of future growth for BWXT.

They also, in their Commercial segment, are very proficient with nuclear energy. Canada probably has the cleanest grid in the world, and 60% of their power comes from nuclear energy. BWXT has been working with many of Canada's power sources to provide equipment, manufacturing, technical services, safety checks, and other services for nuclear energy facilities for some time.

Given the concern about fossil fuels going forward, the US has started to get interested once again in nuclear energy. BWXT is working on some promising projects in terms of building smaller nuclear reactors for the US. That's another potential growth area.

Also, while small, BWXT Medical could be a nice growth business in time. BWXT has very strong capabilities with respect to medical radioisotopes, which is an area where they're making great progress in terms of not only diagnosing, but also treating cancer. They have some very niche abilities there. They've recently won some contracts to provide some of these materials to larger pharma companies. If they get FDA approval for their Tc -99m material, which is said by the company to be one of the most promising materials for nuclear medicine, BWXT Medical could grow to a meaningfully sized business over time.

If you take a step back, this is a company buttressed by a very strong core business that's critical to national defense, many promising growth areas across their other nuclear capabilities, and you have a chance for increased cash flow conversion. We think even at current prices, it's not fully discounting the potential upside we could see in revenue growth. Then, there is also the accompanying multiple expansion that may occur as the market begins to appreciate BWXT's unique ability to respond to a number of very important secular trends.

**G&D:**

Thank you for that, we'd love to hear about Casey's General Stores (CASY).

**BH:**

Sure. When we look for opportunities, we look up and down our market capitalization range. We find a lot of compelling ideas that are oftentimes underfollowed on the smaller side, and we also find ideas where mid-cap names will converge with the top end of our market capitalization range. Casey's is a good example of that, a name that we've followed for a long time. We've watched it grow to 2,500 locations over the years. It's now the third-largest convenience store chain (as well as the fifth-largest pizza chain) in the US. It is a well-known company, especially in the Midwest and the 16 states that they operate in, with strong customer satisfaction ratings despite being a large chain.

Although non-fuel revenue represents only one third of their sales, it generates two thirds of the company's gross profit. On top of that, Casey's is less reliant on certain convenience store items, such as tobacco sales, to do well. Post pandemic supply chain disruptions and gas shortages positively impacted their fuel margins, and the volatility brought on by the invasion of Ukraine caused another spike in those fuel margins last year. And then, as time went on, we think the market began to worry about the sustainability of those margins.

As for the industry, it's fragmented and a lot of the small operators lack scale within prepared food or gasoline procurement. So that tends to be a good environment for Casey to compete in. In the industry, break-even prices for gas have increased considerably over the past few years, so we believe it's less likely that fuel margins will revert to where they were pre-pandemic without additional financial turmoil. Then, from a valuation perspective, we thought it was interesting that Casey's, at the time of purchase, was trading at similar valuations to some of its less

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advantaged public peers, as well as a discount to our estimate of intrinsic value.

One thing we are monitoring is EV penetration, but we note that EV penetration within the Midwest is below the country's average, and we believe that Casey's is well positioned for the EV transition given their strong balance sheet. They own a lot of their real estate, which gives them flexibility to adapt to a changing environment, and we think that they could be a beneficiary from EV charging since charging customers will stay in the store longer, making them more likely, in our view, to seek out retailers with quality prepared food offerings while they wait.

**G&D:**

Lastly, we'd love to hear about Kirby Corp (KEX), an inland tank barge operator.

**RD:**

The primary analyst on Kirby is Jason Downey, who with Bobby Murphy, runs our All Cap Concentrated separate account strategy, as well as our Income Opportunities strategy. Kirby is a business that I think Jason has followed for probably 15 years. They're the leader in the inland barge business in the United States, having a dominant market share. What we believe they have done very well over periods when the market is soft, is that they have been a consolidator acquiring barges and companies to increase their market share. They've done it at very opportune times and prices, which they can do being the leader in that business in terms of market share.

So, we like the fact that they're not only a leader in market share, but they have a management team that is very good at allocating capital astutely and at the right time. As you probably know, companies generally have a poor record of making acquisitions. So, when you find one that's the exception to that norm, it can be very valuable. Clearly, there's some cyclicality to the business, and so at times, valuations can be depressed, margins can be depressed, and they are currently, but we expect those to expand over time as well, benefiting from their scale. We take a lot of confidence in the depth of Jason's knowledge of the company.

**G&D:**

And on the acquisitions, how do you all think about inorganic growth versus organic growth in the business going forward? So, when the margins are depressed and they can attractively buy, are you accounting for that in your valuation?

**RD:**

Absolutely. It is definitely a part of the thesis. Some businesses lend themselves much better to organic growth, and that's of course what you like to find because it's in certain ways the easiest, the safest from a financial risk perspective. But mature industries don't avail themselves often to that. So, when you're in more of a commodity type business, a more cyclical industrial type business, then it's imperative to get growth oftentimes through acquisition. But the problem, as I already mentioned, and I doubt that it's different outside the US, but certainly in the US historically, companies have done on average a poor job at making those acquisitions. There's lots of explanations as to why that would be, but allocating capital, as Buffett knows better than anybody, is a skill that can be particularly valuable. We're glad to say that Kirby has done it well, in our estimation, and will most likely continue to do it well. We, as enthusiasts of Buffett and Graham, hope that we also are good allocators of capital in our efforts.

*"Allocating capital, as Buffett knows better than anybody, is a skill that can be particularly valuable. We're glad to say that Kirby has done it well, in our estimation, and will most likely continue to do it well."*

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**G&D:**

Thank you for that. We'd also love to hear more about your typical day. How do you allocate your time each day? What do you do more or less of compared to when you started working in the industry?

**RD:**

Of course, my role is a little different in that as CEO of the company, I've got some management responsibilities as well as investment responsibilities. That makes my day different. I'm involved with other parts of the business more so than others, like growing VELA through business development efforts. That does take more of my time than anybody else on this call, but it's hard to say that there's a norm. It's more episodic on a daily basis, which is one of the fun things about our business. But one thing that is a constant for all of us, and I know they'll say this, is reading. You have to read a lot to understand a lot. That's always been the case, and it always will be the case, I imagine. I don't think podcasts or artificial intelligence will change the need to be eager to learn as much as you can about a lot of different businesses and companies.

So that's the one constant. When I graduated from high school in '74, we used slide rules, if you know what those are. That was before calculators were invented. The first spreadsheet I had the pleasure of using was in 1981, something called VisiCalc. So, on the technology side, obviously much has changed over nearly five decades and made certain aspects of our business easier. Gathering information is certainly much easier, but again, the central tenets are the same and reading, thinking, and having conversations with colleagues about these things that we're talking about are all very, very important.

**BH:**

Just adding to what Ric was saying, I think one reason why we like the job and what we do is probably that there is no typical day. We're doing different things, learning about new businesses. As far as allocating time, we mentioned earlier that we are portfolio managers and research analysts, so we are allocating a fair amount of time to research and coming up with new ideas.

> ***"You have to read a lot to understand a lot. That's always been the case, and it always will be the case, I imagine. I don't think podcasts or artificial intelligence will change the need to be eager to learn as much as you can about a lot of different businesses and companies."***

A lot of that is spent in conjunction, as I mentioned, with our analysts. In a practical sense, we're talking to them on a daily basis via Teams, but we also plan research-focused meetings with each individual analyst, about weekly to monthly, depending on the analyst, their experience level, and coverage.

Then, maybe what we do a little bit differently today than what I had done earlier in my career...great advice to me has always been to cut the screen off and worry a little bit less about stock prices on a given day, and more about bigger picture and long-term business fundamentals. That's a lesson that that you learn early on, but something that becomes easier over time, and that's probably one of the biggest differences between the beginning of my career to now.

**JH:**

I agree with everything Brian said about turning off the screen, and I do that more now, just having more experience in the industry and being a portfolio manager. But during earnings season, your day can definitely look different than non-earnings season. While we are long-term, the fact of the matter is that earnings do provide

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clues to how underlying securities and their business fundamentals are tracking with our thesis. Sometimes earnings updates can

> *"If you're not a humble person, you're unrealistic and therefore prone to errors from that."*

prompt big price movements. During earnings season, for at least the first half of our day, we are paying close attention, using any new information to reassess our holdings and make sure that things are tracking in line with our thesis. If we're seeing evidence that they're not, we aim to act on that and also to take advantage of opportunities that are presented by short-term price dislocations. Then, in non-earnings season, you have much more latitude and time during your day to evaluate and explore new research opportunities and get in even more of that reading in that Ric referenced.

**G&D:**

Thank you. Moving to advice for students. When hiring analysts, what qualities and skills is VELA looking for? Certainly it's an eagerness to read and love of reading, but what other qualities and skills are you all looking for?

**RD:**

Well, I'll start once again with three traits that Buffett refers to: integrity, intelligence, and energy. He goes on to say that if they don't have the first, the next two will kill you. So as best you can, ascertain the integrity question, and we would add, and this maybe helps to ascertain integrity, humility. It's a very humbling business, because you're making estimates, many of which won't be correct. As a result, if you're not a humble person, you're unrealistic and therefore prone to errors from that. The real love of this field and the love of this type of investing will come through in our interviews, and I think that's what we're looking for; a passion for it. Someone who clearly will, as a result of that passion, be a self-starter.

So those are the things, but I would also say it's someone who is a team player. I think that sometimes in our industry, people can be very individualistic, and I think that can be problematic. At VELA, we want to have communication and collaboration. We don't have votes on very many things, but we do encourage a lot of communication and collaboration, and so team players are very, very important.

**G&D:**

We'd love to hear what you like to do for fun outside of investing and any fun unique hobbies that you all have.

**JH:**

Well first, outside of investing, I have three kids, so nurturing them and enjoying watching them grow takes up a lot of my free time. But in addition to that, anything outside. I love to ski, play golf, and I have a number of animals that are fun to take care of. Then, in terms of mental and physical fitness, I like to box. I don't spar or anything, but I just do the mitts. The gym gives you exposure to different walks of life. I'm always meeting interesting people in there, and it frees up my mind to something else. You have to pay close attention, or you might get a mitt in the face, so it does give my mind a little break from investing and gets out some excess energy at the same time.

**G&D:**

That's tough to beat. We don't know if Brian or Ric could beat that.

**BH:**

A lot of my free time is spent with my children. I have four children, and they're very active in sports, so you can find me every weekend at the park watching them play or coaching their teams. I've followed baseball my entire life and I grew up in a time where the Atlanta Braves were in the playoffs every year, and it was great to relive that in 2021 with my oldest son when the Braves won the World Series. He's 10, and he

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shares my love of baseball, and he just won his fall baseball championship, so it was really fun to experience that with him.

**RD:**

I don't have anything interesting to compete with that. I have one child, and I play golf.

*VELA Disclosure:*

*The views expressed are those of the speakers as of November 2023 and subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.*

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Sam worked at PJT Partners Restructuring and Special Situations Group during the summer and will be returning to join the group upon graduation. Prior to joining the MBA program at CBS, Sam spent the previous 5 years in private credit as co-founder of ARC Rock Capital. In his role he led the origination, due diligence, and execution of oil and gas transactions in Canada and the United States totaling over $70mm. Prior to ARC, Sam worked as a natural gas trader and analyst for Rice Energy Inc. Sam earned a Bachelor of Science in Finance from Wake Forest University, graduating in May of 2014.

**Thomas Schlabach ´24**
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Tommy has 12 years of service as a US Navy veteran. In the Navy, he was a SEAL team leader and served in a small clandestine unit which primarily conducts maritime operations across the globe in support of national security. Throughout the past year, Tommy has worked as a Large Cap Strategy analyst-intern for Diamond Hill Capital Management, and as an intern for Invesco. Tommy is a 2nd year MBA student and is the head of Professional Events for CSIMA.

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Nick is a second-year MBA student at Columbia Business School. He started his career at Agramericas, analyzing commodities and public equities. He joined Deloitte's audit practice in 2019. In 2022, he joined C.W. Di Stefano Enterprises as an analyst. During his time at Columbia, Nick interned at Diamond Hill and American Century Investments. He studied Accounting at the University of Miami in Coral Gables, Florida. He is a Certified Public Accountant and a CFA Charterholder.

# Lithia Motors, Inc. (NYSE: LAD) - Long
## 2023 Pershing Square Challenge (1st Place)

| Capitalization | |
|---|---|
| Share Price ( Sep 2023) | $304.00 |
| FDSO | 27.5 |
| FCF/ Share (2022) | $ 65.14 |
| **Market Cap** | **8,370** |
| Net Debt | 5,441 |
| **EV** | **13,811** |
| **Target Price ($/Share)** | **$640** |
| Multiples (Consensus) | (x) |
| EV/'23E EBITDA | 8.2 |
| P/E'23E | 7.90 |
| TTM ROIC'22A | 9.6% |
| **4-year IRR Target** | **25%** |

| Financials (US$'M ex | FY18 | FY19 | FY20 | FY21 | FY22 | FY23E | FY24E | FY25E | FY26E |
|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | 11,821 | 12,673 | 13,127 | 22,832 | 28,188 | 31,131 | 34,104 | 39,751 | 49,003 |
| Growth Rate % | | 7% | 4% | 74% | 23% | 10% | 10% | 17% | 23% |
| **Gross Profit** | 1,777 | 1,954 | 2,224 | 4,259 | 5,152 | 5,510 | 5,968 | 6,877 | 8,380 |
| Gross Margin % | 15.0% | 15.4% | 16.9% | 18.7% | 18.3% | 17.7% | 17.5% | 17.3% | 17.1% |
| **EBITDA** | 522 | 577 | 785 | 1,790 | 2,114 | 1,961 | 2,083 | 2,364 | 2,812 |
| EBITDA Margin % | 4.4% | 4.6% | 6.0% | 7.8% | 7.5% | 6.3% | 6.1% | 5.9% | 5.7% |
| **EBIT** | 447 | 495 | 693 | 1,663 | 1,941 | 1,961 | 2,083 | 2,364 | 2,812 |
| EBIT Margin | 3.8% | 3.9% | 5.3% | 7.3% | 6.9% | 6.3% | 6.1% | 5.9% | 5.7% |
| **Net Income** | 265 | 271 | 470 | 1,062 | 1,261 | 1,291 | 1,363 | 1,559 | 1,883 |
| FDSO | 24.5 | 23.4 | 24.1 | 29.0 | 28.3 | 27.6 | 27.3 | 27.0 | 27.0 |
| **EPS** | $10.82 | $11.60 | $19.51 | $36.63 | $44.57 | $46.78 | $49.92 | $57.75 | $69.73 |
| Growth Rate % | | 7% | 68% | 88% | 22% | 5% | 7% | 16% | 21% |

**<u>Recommendation</u>:** Long LAD with a 4-year target price of **$640**, representing an upside of 105% and an IRR of 25%. Established in 1946 as a single family-owned dealership in Medford, OR, Lithia Motors is now the largest automotive dealership group in the US with recent operations beginning in Canada and the UK. LAD's current valuation does not recognize: 1) the company's underlying earnings power from their aggressive, but disciplined acquisition strategy; 2) the strategic layout of the company's network in support of their eCommerce platform, Driveway.com, and 3) the lucrative potential of Driveway Finance Corporation.

**<u>Business Description</u>:** Lithia Motors is a retailer of new and used vehicles and related services. It operates in three segments: Domestic, Import, and Luxury within the new and used car space. The company has 338 stores in 26 US states, Canada, and the UK. The company has expanded largely through the acquisition of dealerships in smaller regional markets but now seeks to grow in any part of the U.S. and English-speaking international countries. Annual TTM revenue from 23Q2 was $29.3 billion and the company aims to achieve over $50 billion in revenue by year-end 2025.

**<u>Investment Thesis:</u>**

**<u>I. Aggressive but disciplined acquisition strategy.</u>**

- For more than 20 years Lithia has maintained a disciplined acquisition strategy at between 3-7X normalized earnings levels and intangibles acquired at approximately 25% of sales.
- Decentralized strategy: Lithia Partners group (LPG) was established in 2015 by CEO Bryan DeBoer as a decentralized approach to grow store count while also giving the top performing managers more skin in the game. Today, nearly 1/3 of managers participate in LPG.
- In 2020, Lithia set out to achieve an added $25B in revenue from acquisitions. Now, just beyond the halfway point, LAD is 64% of the way to achieving this goal. While many of the other public dealership groups pour money into buying back stock, Lithia has been creating value through disciplined acquisitions.
- Fragmented market with barriers: The auto dealership space in the US is comprised of >16,500 dealerships, and the top 10 groups account for just 10%. Most of these dealerships are in groups of 1-5, so think small family businesses. There are several reasons why dealerships are ready to sell and specifically sell to Lithia: 1) reputation for giving managers autonomy to run their business, 2) premier online strategy, 3) Lithia Partners group, 4) Keep 95% of employees in place. The franchise laws in the US and extensive OEM relationships prevent most PE and others from entering the auto dealership industry.
- Management raised equity in 2021 to provide fire power for the 2025 plan, but the company will fund all future acquisitions from robust free cash flow generation.
- M&A Runway: Using a conservative dealership cap of 5% of total OEM dealerships across the 16,773 dealerships in the US gives a rough estimate of 949 potential dealerships. Today, Lithia owns 338 which leaves a potential of 667 dealerships available for M&A. Using the average dealership revenue, this equates to $42B in revenue from acquisitions. Finally, using the average revenue acquired by Lithia over the last 5 years ($2.4B), <u>Lithia has approximately 18 years of M&A runway</u>.

**<u>II. Lithia's eCommerce platform Driveway.com is positioned for success in the rapidly changing auto industry.</u>**

- LAD's aggressive acquisition strategy has been strategically focused to be within 100 miles of 95% of the population to foster an effective eCommerce platform, Driveway.com.
- The company's footprint is better positioned than all other dealership groups and Carvana with more

## Lithia Motors, Inc. (NYSE: LAD) - Long

than 300 dealerships which can serve as reconditioning centers. The infrastructure of dealerships for reconditioning is operating at 25% and storage is at 50% leaving no additional cost required for the Driveway business model (analysis below).

- The driveway business model will cater to an increasing demand for online transactions in the automotive space and will assist Lithia in creating an ecosystem of vehicle servicing, trade-ins, and insurance.

**III. The market is missing the lucrative potential of Lithia's captive F&I business, Driveway Finance Corporation.**

- High Quality Portfolio - Lithia can be selective with insurance offers at the top of the funnel. This results in a high-quality portfolio with an average FICO score of 707 in 2022 and 732 in 4Q22, which is higher than Capital One, Ally and CarMax. Additionally, the 30-day delinquency is low at 3.7%.
- Benefits of Volume - In FY22, Lithia sold >311k used vehicles and wrote $2.1B of auto loans. In 2020, Lithia began selling insurance through its network of LPG managers, and this approach showed the strength of the Lithia network as the company nearly tripled quality receivables in less than a year. These volume benefits allow LAD to capitalize their debt in the ABS (currently rated BB+).
- CECL accounting requirements create near-term losses, but by 2025, DFC will provide ~$3 in added EPS with a conservative penetration rate to 20% of used vehicles and 4% of new vehicles.

**Valuation**

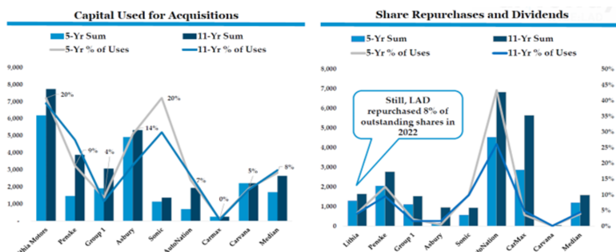
- LAD's share price has declined by 25% since April 2021 while the underlying earnings power of the company has grown. Using 2019 normalized margins, and a conservative P/E ratio (5-yr average- 10.3X, 10-yr avg- 11.9X, 25-yr avg 12.3X), I arrive at a 2026E EPS of $60.85 and a share price of $608.50 using a 10X P/E. This represents an IRR of 23% from a current share price of $306 (Sep 2023). The base case probability is 70%.
- In my downside case, multiple remains contracted to 6X (Currently 7X). In this scenario, inventories rise and demand stalls as the economy enters recession. Downside PT is $209, and the probability is 10%.
- In my upside case, Lithia meets management 2025 guidance of achieving total revenues of $50B, and I project the same growth rate to 2026. Margins are XY above 2019 levels as the Covid-19 benefits continue and sales stabilize based on renewed demand driven by an aging car-parc (average vehicle age in the US is 12.5 years). A normalized multiple is achieved based on the 25-year average (12x). Upside case EPS is $80.43 and P/E NTM is 12X to arrive at a PT of is $965. Probability is 20%.

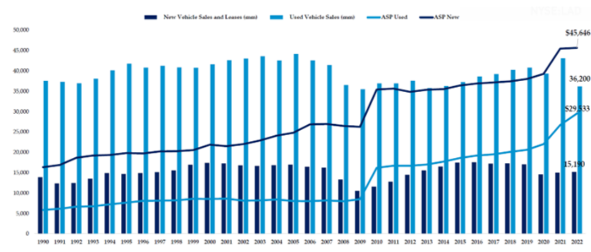
**Key Risks and Mitigants**

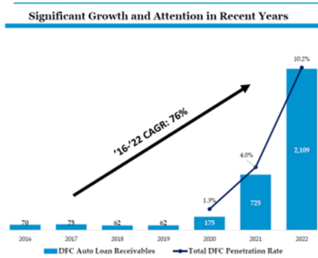
**I. Agency Model Disruption.** When Tesla and Rivian entered the market, they did so by circumventing the dealership system. This leads to an idea that OEMs can complete sales directly to consumers in the same way. This model has become popular overseas, where there are less-stringent franchise laws. *Assessment: LAD is in the strongest position to adapt with dealerships in +100 markets and investments in eCommerce and technology. Our assessment is that OEMs need high-performing groups like LAD.*

**II. Maintenance Decline from EVs**. As EVs become a larger part of the overall fleet of vehicles, dealerships will lose out on the revenue from maintenance because there will be fewer moving parts, and their service intervals will be far less frequent. *Assessment: There will be new streams of revenue from EV maintenance. Dealers can conduct maintenance on batteries with leases and replacement. Sensors and wipers, which have high safety implications, will make customers stickier to dealerships, and the high level of expertise will create an extra barrier to entry. This phenomenon has proven to be true in Scandinavia where EVs represent ¾ of vehicles on the road.*

**III. Over-the-air (OTA) Updates.** There is tension surrounding who owns the customer after the point of sale as OEMs are now able to provide OTA updates to the software and other service-related issues. This also relates to subscription services as OEMs begin to offer additional services such as heated seats on a subscription plan. *Assessment: Lithia Motors is investing heavily in technology and is well positioned to provide services to customers' homes and to share in this recurring revenue.*




**Potential for Lithia's Captive Finance Portfolio**

| | LITHIA | ally | Capital One Auto Finance | CARMAX |
|---|---|---|---|---|
| '22 Auto Loan Receivables (billions) | 2.1 | 81.0 | 78.4 | 16.3 |
| Growth Rate '21-'22 | 191% | 7% | 3% | 7% |
| Average FICO Score | 708 | 684 | 53% >660 | 703 |
| 30 Day Delinquency | 3.7% | 2.1% | 6.2% | 4.0% |
| '16-'22 Receivables CAGR | 76% | 4% | 9% | 7% |

| | LITHIA | AutoNation | PENSKE | ASBURY | GROUP 1 | Sonic |
|---|---|---|---|---|---|---|
| Northwest | 17% | 5% | 0% | 3% | 0% | 4% |
| Southwest | 29% | 25% | 9% | 31% | 10% | 20% |
| North Central | 14% | 12% | 11% | 24% | 2% | 12% |
| South Central | 11% | 17% | 10% | 3% | 54% | 30% |
| Northeast | 15% | 7% | 33% | 0% | 27% | 8% |
| Southeast | 9% | 33% | 38% | 36% | 8% | 27% |
| Canada | 4% | 0% | 0% | 0% | 0% | 0% |
| Total Dealerships | 338 | 260 | 151 | 156 | 197 | 111 |
| Assessment | ✓ Well balanced network, only presence in Canada, weak spot in southeast | ✗ Highly concentrated in the sunbelt | ✗ Highly concentrated on the east coast | ✗ Concentrated in southeast, lacks presence in the NE and NW | ✗ Concentrated in south central region with low presence in NW, NC and SE | ✗ Concentrated in south central region with low presence in NW, NC and SE |

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# PayPal Holdings, Inc. (NASDAQ: PYPL) - Long
## 12th Annual Darden @ Virginia Investing Challenge (1st Place)

**Recommendation:**

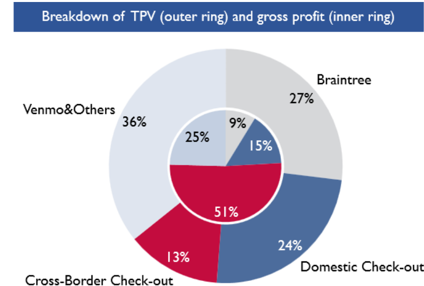
Long PYPL with a FY28 price target of $110, representing 112% upside and an IRR of ~15%.

**Company Overview:** PayPal is a multinational financial technology company that facilitates digital payments for customers ranging from individuals to large enterprises. Its core business is branded check-out, where e-commerce users use the PayPal button to complete their transaction. The company serves businesses through its payments gateway platform Braintree, which it acquired in 2013. The acquisition also included Venmo, the popular peer-to-peer payment platform which handled over $200bn in TPV in 2022. Due to perceived challenges from competitors like Apple Pay, Shop Pay, and Cash App, PYPL is down over 80% from its 2021 highs, despite continuing to grow payment volumes, revenue and operating earnings.

**Investment Thesis**:

1. **The core checkout business of PayPal displays a robust moat anchored in consumer trust:**
   - Despite the cross-border checkout segment accounting for only about 13% of the total transaction volume, it contributes to ~50% of the overall profit according to our estimation, thanks to a notably higher net take rate.
   - Over the past decade, PayPal has excelled in implementing consumer purchase protection, a factor that has significantly bolstered consumer trust. This aspect of purchase protection is particularly crucial in facilitating cross-border transactions. Our consumer survey supports this, revealing that over 70% of consumers believe payment protection is essential in online transactions. Cross-border merchants would loss consumers when they remove PayPal button.
   - The effectiveness of PayPal's purchase protection service is fundamentally anchored in the extensive consumer data it has amassed, coupled with its formidable two-sided network, which endows PayPal with substantial bargaining leverage over merchants.
   - While there is a general consensus that PayPal's core checkout business might lose a substantial market share to rivals like Apple Pay, we maintain a more optimistic outlook. We argue that the cross-border checkout business is poised to maintain its robust market stance, underpinned by a unique core value proposition to consumers unmatched by any competitor.

Breakdown of TPV (outer ring) and gross profit (inner ring)

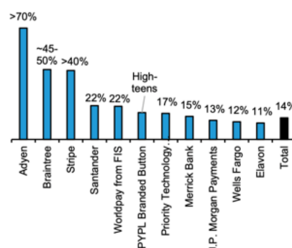



<u>Our customers feel safe with the dispute protection that PayPal provides them with.</u> When purchasing high-end items like a EUR 20,000 watch or handbag, a lot of people pay via PayPal, and they know that they're going to be protected. And we've done a testing in the past trying to <u>remove PayPal from a given market for a period of time and our NPS drops because of the PayPal removal</u>, because certain people didn't feel us safe.

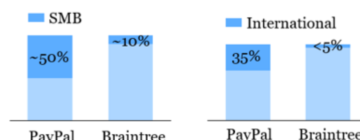
—A Cross-border E-commerce Merchant

2. **Braintree is more robust than perceived by the Street:**
   - Modern gateway players have plenty of runway to penetrate into legacy players. Braintree, Adyen, and Stripe, have exhibited twice the faster growth than legacy bank acquirers.
   - With its strategic shift towards SMBs and international expansion, Braintree's take rate is anticipated to increase to at least 25 bps in the future.

Growth Difference between Modern and Legacy Gateway Players




SMB and International Businesses Sales Breakdown of PayPal and Braintree

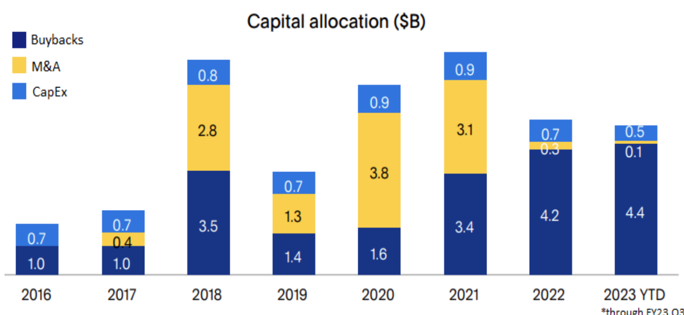


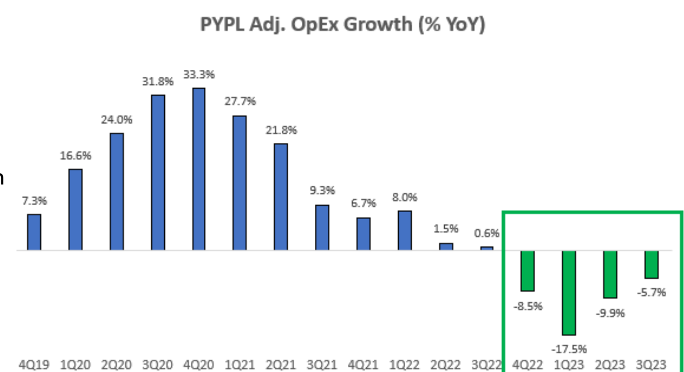
# PayPal Holdings, Inc. (NASDAQ: PYPL) - Long

- Thanks to its scalable business model, Braintree will be positioned to offer more competitive pricing, more data, and mitigate fraud more effectively, thereby strengthening its operating leverage in the future.

**III. Revised capital allocation and recent management change highly supportive of valuation:**

- Alex Chriss appointed as PayPal CEO in September 2023, replacing Dan Schulman who led since 2014.
- Previously CPO of Intuit Small Business Group, which grew to comprise more than half of Intuit's revenue.
- Margin expansion opportunity with SMB growth Stripe, which focuses on SMB, garners take rate ~20 bps higher.
- CFO Jamie Miller appointed in November, with decades of experience leading transformation strategies at EY, Cargill, and GE.
- Chriss focused on making PayPal leaner and more cost efficient. Buybacks on track for record >$5bn in FY23 combined with 10% Opex cut and historically low CapEx.
- Virtually no M&A in 2023 compared with >$7bn in acquisitions from 2020-2022.
- First tranche of ~$44bn sale of BNPL receivables to KKR closed in October, netting $1.4bn in proceeds, most of which will go towards share repurchases.
- Sold logistics business Happy Returns to UPS for $455mm in cash proceeds, as Chriss has promised a "leaner" PayPal.

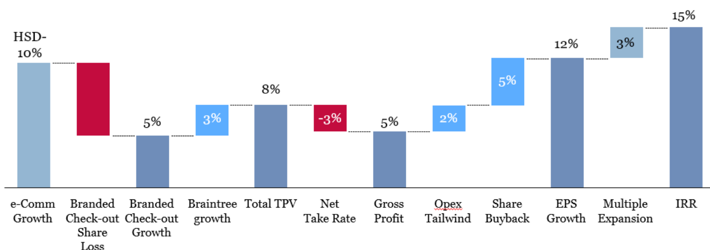



**Valuation:**

- Base case exit P/E multiple of 12x, up marginally from 11x today.
- 70/30 TPV mix of SMB + International vs Large Enterprises for Braintree. Braintree take rate expansion to 25 bps.
- Modest TPV and revenue CAGR of 8% from 2023-2028; 13% adj. EPS CAGR.
- IRR of 15% through forecast period inclusive of branded check-out share losses and take rate compression from core button and cross border.
- Share buybacks to drive 5% of IRR as new management allocates nearly all FCF to shareholders.

## Valuation - IRR driver breakdown




| | Bear | Base | Bull |
|---|---|---|---|
| **TPV growth:** | | | |
| Core button | 0% | 5% | 8% |
| Cross border | 0% | 5% | 5% |
| Braintree | 10% | 15% | 20% |
| Braintree net take rate | 15bps | 25bps | 27bps |
| % of FCF used for share repurchase | 60% | 70% | 70% |
| Venmo monetized | No | No | Yes |
| OPEX rate reduction | 1.3ppt | 2.8ppt | 4.1ppt |
| Exit PE multiple | 8x | 12x | 13x |
| 2023 Target Price | 47.80 | 61.37 | 69.69 |
| 2023 Upside/ Downside | -10% | 16% | 31% |
| 2028 Target Price | 51.85 | 110.18 | 143.35 |
| **IRR (5-year)** | -0.44% | 15.76% | 22.03% |

**Risks and mitigants:**

- Cyclicality of check-out business: PayPal's checkout business primarily hinges on e-commerce, especially in consumer discretionary categories, which typically display countercyclical trends.
- Competition in domestic check-out and gateway business: Apple Pay and Shop Pay are notable competitors to PayPal's core operations. However, their market presence for over a decade suggests that the impact is factored into PayPal's share price.
- Credit risk: PayPal's loans to merchants through its PayPal Working Capital product introduces credit risk. But this exposure is mitigated by its scale: in FY2022, the total loan pool was $2.1 billion, a figure modest compared to its $10.8 billion in cash.

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# Vertiv Holdings Co (NYSE: VRT) - LONG
# 2023 CSIMA Stock Pitch Challenge (1st Place)

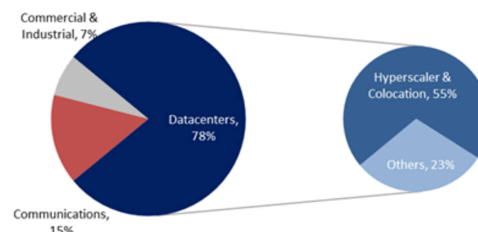
| | |
|---|---|
| CMP | 43 |
| Mcap $bn | $16 bn |
| Avg trading | $275m |
| 52-week range | 12-44 |
| Float | 90% |
| EV/ EBITDA (CY23) | 16x |
| PE (CY23) | 23x |
| ROIC (CY23) | 17% |

| Variant View | CY23e | CY24e | CY25e | CY26e |
|---|---|---|---|---|
| **Revenue growth** | ***20.9%*** | ***11.4%*** | ***11.7%*** | ***12.2%*** |
| *vs Consensus* | *20.3%* | *8.4%* | *6.4%* | *6.0%* |
| **EBITDA margins** | *16.5%* | *17.6%* | *18.0%* | *18.4%* |
| *vs Consensus* | *16.3%* | *17.3%* | *17.9%* | *18.2%* |

**Recommendation:**

Long VRT with a 3-year price target of $71, representing 65% upside and an IRR of 17%.

**Business Overview:** VRT sells critical infrastructure solutions (Power, Cooling, IT infrastructure, and service/maintenance) for Data Centers, Communication, and Industrials. 60% of Vertiv's business is recurring (replacement of older infrastructure and maintenance). VRT has ~15% market share in global infrastructure solutions. 78% of Vertiv's revenue comes from Data Centers.




**Key Thesis:** Led by increasing use cases of data centers and the low vacancy rates, data center investments by Cloud and Colocation companies are expected to grow at 12% CAGR over the next 3 years. VRT will grow faster than the market by 1.5x due to strategic acquisitions and market leadership in the fast growing liquid cooling segment. Our variant view is primarily on revenue growth. We estimate a 12% CAGR over the next 3 years vs consensus is at 7% CAGR.

**Investment Thesis**:

**I. Continued robust spending on building data centers:**

- Our variant view is on continued robust capex spends on data centers over the next few years. We are focusing on the 55% of Vertiv's revenue that comes from selling infrastructure to Hyperscale and Colocation companies. The rest of the business is expected to grow in line with the GDP.
- For 55% of the business, We arrive at a 12% CAGR over CY23 to CY26 based on 1) management commentary of cloud and colocation companies on capex spends on data centers, 2) the low vacancy rates of existing data centers.
- The consensus is estimating a lower growth rate because of the high spending over the last 5 years in this space. However, our primary research suggests "the use cases for data centers are expected to go up as data grows at a fast pace (~25% CAGR) - first it was work from home, then streaming, gaming and now AI . Autonomous driving will also boost demand"- Meta data center engineer.

| | 2018 | 2019 | 2020 | 2021 | 2022 | 9mCY23 | 2023e | 2024e | 2025e | 2026e |
|---|---|---|---|---|---|---|---|---|---|---|
| Equinix | 55% | -1% | 10% | 19% | -14% | 30% | 18% | 9% | 9% | 9% |
| Digital Realty | 20% | 7% | 45% | 22% | 4% | 31% | 19% | 8% | 8% | 8% |
| Amazon | 47% | 37% | 30% | 37% | 29% | 13% | 13% | 10% | 10% | 10% |
| Microsoft | 19% | 23% | 24% | 25% | 21% | 17% | 17% | 17% | 17% | 17% |
| Google | NA | 53% | 46% | 47% | 37% | 26% | 26% | 19% | 18% | 17% |
| **Average** | **35%** | **24%** | **31%** | **30%** | **15%** | **24%** | **19%** | **13%** | **12%** | **12%** |

## Vertiv Holdings Co (NYSE: VRT) - LONG

**II.**

GOOGL: "...We expect elevated levels of investment in our technical infrastructure increasing through the back half of 2023 and continuing to grow in 2024...including investments in GPUs and proprietary TPUs as well as data center capacity..." (Jul 2023) "CapEx this year will include a meaningful increase in technical infrastructure versus a decline in office facilities..." (Apr 2023)

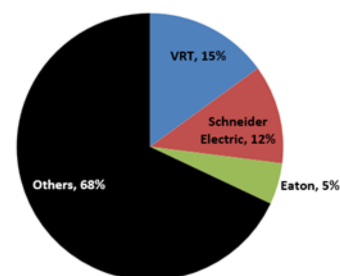
AMZN: "...expect fulfilment and transportation CapEx to be down, partially offset by increased infrastructure CapEx to support growth of our AWS business..." (Oct 2023)

MSFT: "...the acceleration is really quite broad. It's both on -- both the data centers and a physical basis plus CPUs and GPUs and networking equipment..." (Jul 2023)

DLR: "...we purchased additional land in Amsterdam which could support another 40 megawatts of potential IT load, providing ample runway for both enterprise and service provider growth..."

**VRT will grow at 1.5x of market led by sector consolidation and fast growing liquid cooling segment:**

- The critical infrastructure industry is highly fragmented, with the top three players controlling only 32% of the market (2018 data). The top 3 players are VRT (15% market share), Schneider Electric (12% market share) and Eaton (5% market share). With a global presence, presence across all segments (power, cooling, and racks), renowned brand and good service levels, all three players are best placed to capture market share. The remaining 68% of the market consists of regional players or players with presence in only limited segments. These 3 players have actively acquired assets over the last decade. Vertiv's management has also indicated that it is actively looking for strategic acquisitions.




- In comparison to Schneider and Eaton, VRT is known for its broad range of product SKUs (one expert calls VRT a "one stop shop"); important given the need for customized solutions.
- During our visit to data center of Columbia University, we found out that Columbia university uses VRT's coolers. Further, VRT was recommended by New York State Energy department to Columbia to reduce their energy consumption.
- Further, given the increasing density of servers, there will be shift to liquid cooling from air cooling. VRT is the market leader in this space due to its partnership with Green Revolution Company (GRC), a market leader in immersion cooling.

**III. Margin expansion of 240bps over next 3 years:**

- We estimate 18.5% EBITDA margins by CY26, expanding from 14.5% in 9mCY23 (17% already achieved in Q3CY23). Consensus is at 18% EBITDA margins for CY26.
- In CY21, VRT was impacted by inflation for raw materials and was slow to pass on prices to customers. Margins recovered to 17% in Q3CY23, mainly due to price hikes and fixed cost leverage. In CY23, new CEO, Giordano Albertazzi was brought in from EMEA business, where he led 5.5x EBIT margin expansion while growing topline at 10% CAGR.
- More steps are underway to support margin expansion- aligning incentives of salesforce to margin and revenue growth, manufacturing efficiencies and increasing the number of suppliers. Further, as per our primary research, transition to liquid cooling will aid margin improvement for VRT led by higher service rates.
- Aligned incentives - 79% of the new CEO's pay is based on Operating profit, Free cash Flow and Stock price.
- Looking at the commentary and margin guidance of Schneider Electric and Eaton, we can see that there is a clear focus on margins for competitors as well.

**Valuation:**

We assign an EV/EBITDA multiple of 16x on CY26 to arrive at Target price; 16x multiple is based on the current multiple of Vertiv and current peer average multiple.

| | Mcap | EV/ EBITDA | | | | PE | | | | ROCE | EBITDA growth | EPS growth |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | ($ bn) | 2023e | 2024e | 2025e | 2026e | 2023e | 2024e | 2025e | 2026e | 2023e | CY23-CY26e | CY23-CY26e |
| Vertiv | 16.4 | 16 | 14 | 12 | 11 | 25 | 19 | 16 | 13 | 17% | 16% | 22% |
| Eaton | 77.4 | 18 | 16 | 15 | 13 | 25 | 23 | 21 | 18 | 11% | 11% | 11% |
| Schneider Electric | 84.1 | 13 | 12 | 11 | 10 | 21 | 19 | 17 | 16 | 13% | 8% | 9% |
| | | **16** | **14** | **13** | **11** | **23** | **20** | **18** | **16** | | | |

**Risks and mitigants:** 1) China Risk: VRT currently derives 13% of its business from China. VRT has a local set up in China, which puts it in a better place.

2) **Price pressure from Hyperscalers/ Colocation:** In 2018, VRT reported that it has a diversified revenue base (top 50 clients contributed to 40% of sales). However, given the high-spending on-data centers by these two segments over the past 5 years, revenues from these players now account for a higher percentage of sales. There could be pressure to squeeze price, but VRT has some pricing power due to the risk averseness of clients, its focus on good quality /quick service (220 service centers and 3500 service engineers) and its ability to provide customized solutions.

# 1 Main Capital

**Yaron Naymark**

**Yaron Naymark is the founder and CIO of 1 Main Capital, a concentrated, long-biased, value-oriented fund that he founded in 2018. The firm invests in high-quality, reasonably-valued businesses with long reinvestment runways and special situations experiencing a temporary dislocation and undergoing an element of change that will lead to near-term revaluation.**

**Prior to founding 1 Main Capital, Yaron accumulated over a decade of experience, including investing roles at multi-billion-dollar value-oriented public and private equity firms.**

**Yaron is a South Florida native, a lover of the outdoors, and currently lives in Connecticut with his wife, two kids and their family dog.**

***Editor's Note: This interview took place on October 26th, 2023.***

**Graham & Doddsville (G&D):**

We're excited to have you join us, Yaron. To get started, walk us through your background and how you first became interested in investing?

**Yaron Naymark (YN):**

Definitely. Before we start, I just want to say that I've been a longtime reader of the publication, and I really admire what you guys have done with it. Thanks for taking the time to talk with me today.

I've been running 1 Main Capital for about six years now, but I've been studying investing and honing my investing skills for pretty much my entire life. I was raised by small business owner parents, and many of their friends also operated businesses. Although they lacked college educations, some were able to achieve financial success and independence at relatively young ages through business. I was fascinated by how they were able to do that. So, while all the other kids would go play after dinner, I would sit back and listen to them talk about growth investments, HR issues, working capital management and the like - I really enjoyed learning about business from them.

As I got older, I started reading the Buffett letters and studying investment greats like many people do early in their investing careers. I went on to study finance at the University of Florida before starting my career at Citi in the summer of 2008. There, I thought I would work on LBO financings. However, soon after I finished training, Lehman Brothers collapsed. Instead of working on LBO financings, I ended up working on bankruptcy financings. In hindsight, this was a blessing because I had a front row seat to see how balance sheets and business models impacted business decisions in periods of economic uncertainty and market volatility. It was then that I decided I always wanted to be strong money rather than weak money. Being able to invest aggressively during periods of uncertainty can create meaningful long-term value, while being forced to cut costs, divest trophy assets or raise expensive capital in those times can destroy it.

> ***"Being able to invest aggressively during periods of uncertainty can create meaningful long-term value, while being forced to cut costs, divest trophy assets or raise expensive capital in those times can destroy it."***

After Citi, I decided to move to the buy side. I realized private equity would be a great place to start an investing career for a couple of reasons. First, when buying a company outright, deep fundamental due diligence is incredibly important. Since you can't just change your mind the next week like you can in the stock

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market, you really need to know what you are buying. Second, being in a control position allows you to really understand the inner workings and decision making of corporate boards and management teams. In public markets, investors are informed of corporate actions, but don't have the opportunity to sit in the boardroom to see how those decisions were made. During my time in the LBO world, I gained a lot of that experience. While I enjoyed my time there, I eventually moved to public equities, allowing me to spend most of my time studying businesses, evaluating management teams, and making investment decisions - which is what I enjoy most…and less time on the dealmaking process, which includes things like raising financings, making investment committee presentations, writing offering memos, and negotiating legal docs.

There, I worked at two hedge funds where I applied the private equity approach to public markets and was able to see many investment theses play out. This is really the best way to get better at public equity investing, where decisions must be made in real time and with imperfect information. Like in sports, the more practice repetitions you get and the more live games you play, the better an investor you become. In those roles, I got lots of reps and game play, which improved my understanding of how stocks move. I also started thinking more deeply about portfolio construction and risk management, which are vital to any public equity investor's long-term success.

It was after those roles that I decided to start 1 Main. I always had the entrepreneurial bug and, while there is never a perfect time to launch a subscale fund and take a bet on yourself, if I was ever going to take the shot, the time to do it was before I had kids and a mortgage. I was confident I could find another job down the line if 1 Main didn't scale. More importantly, I believed I could do it better than other managers, many of whom solve for things like fee maximization over long-term risk-adjusted performance. In addition to my confidence that I was a good business analyst, thoughtful risk and portfolio manager, I believed that I had finally accumulated sufficient work experience. So, I started 1 Main in early 2018, and it has been a fun ride. Six years in, I am happy with the growth of the partnership and am more confident today than I was when I first started it that I have what it takes to be one of the greats.

**G&D:**

Who are some of the investors and mentors that have had the biggest impact on you and your investment philosophy?

*"Great investors have a unique combination of confidence and humility."*

**YN:**

I've learned a lot from all the prior firms I worked at, but one of the benefits of studying investing in today's world is that you can also get exposure to investors you don't have direct access to. It is just as easy to learn from podcasts, YouTube, and public letters. This allowed me to study some of the investing greats in a way that I wouldn't have been able to if I had started 40 or 50 years ago. In terms of fundamental analysis, Warren Buffett and Joel Greenblatt have each had a significant impact on my style. Both are incredible at explaining fundamental analysis, including how to understand a business' quality and how to think about valuation. When it comes to portfolio construction and risk management, I've always admired how Stan Druckenmiller and Dave Tepper aggressively sized highest-conviction positions and quickly changed their minds as new information emerged. Great investors have a unique combination of confidence and humility, and these two have embodied that perfectly throughout their careers. A common thread among all the greats is that they are incredibly

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malleable and lifelong learners – even as they age. There are others that I admire too, but those four have had a significant impact on my style and philosophy.

**G&D:**

Could you give us a brief overview of 1 Main Capital? Where did the name come from?

**YN:**

1 Main is a long-biased investment partnership that seeks to compound capital at hall of fame levels for the next 30 years. Having great returns for such a long period means it must be accomplished in a good risk-adjusted way. To me, that means owning a portfolio consisting mostly of high-quality, well-managed and well-capitalized businesses, at below market multiples - such that changes in multiples represent a source of upside rather than downside to the natural compounding of intrinsic value.

To elaborate, long-term business values typically compound with per share earnings or free cash flow. However, if an investment is made at a high entry valuation, you're constantly fighting multiple contraction, which is like gravity, over your hold period. I would rather have the potential for multiple expansion or, at a minimum, avoid compression. For this reason, I'm looking to buy companies at below-market multiples. Usually, that means they are misunderstood in a meaningful way. As they become better understood, the hope is that the market will reward the investment with a higher multiple. But at a minimum, I want to believe that the multiple has limited room to decline.

In terms of quality, I like to play in end markets that are outgrowing GDP, such that the products or services are becoming increasingly relevant to the economy over time. I also prefer markets that are consolidated and rational such that businesses within them can earn sustainably attractive, unlevered returns on capital.

Within those end markets, I try to find businesses that have leadership positions, and where they're taking share from competitors. It is also important to recognize and avoid major concentration that could negatively impact a business, such as customer, supplier, regulatory and geographic.

Next, good companies should be run by competent and honest management teams that are aligned with minority shareholders. Not every decision a management team makes will turn out to be successful, but each one should be of sound business judgement based on all available information at the time it was made. In terms of alignment, management should do well if outside investors do well, and they should do poorly if investors do poorly. This typically means management should own meaningful amounts of equity in their companies or have thoughtful performance-based compensation structures.

*“...long-term business values typically compound with per share earnings or free cash flow. However, if an investment is made at a high entry valuation, you're constantly fighting multiple contraction, which is like gravity, over your hold period.”*

Lastly, I prefer investing in businesses that are well-capitalized. As I learned at the start of my career, there's no faster way to destroy long-term shareholder value than being forced to sell your best assets or raise expensive capital when times are tough. On the other hand, there's no easier way to create long-term value than to play offense in those periods.

While those are the characteristics I look for, there is of course no such thing as a perfect investment. It's all about assessing and getting comfortable with trade-offs – and the only way to do that is by conducting deep

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fundamental diligence and combining it with good judgement.

Now, 30 years is a long time. When investing with that type of duration in mind, it's important to not go too far out on the risk curve, because no matter how good returns are over a short period, if you blow yourself up even once you can destroy an entire track record.

For this reason, I avoid portfolio leverage, meaning I usually run below 100% gross. I never want to worry about a prime broker knocking on my door telling me I have to de-lever in times of volatility. Avoiding levered businesses and avoiding portfolio leverage ensures that I am always strong money.

You also asked how the name came about for 1 Main Capital, right? The first apartment I lived in with my now wife was the clock tower building in Dumbo, Brooklyn. Its address was 1 Main Street, and we loved it there, so that's where the name came from.

**G&D:**

When you look back to when you launched 1 Main, what do you think you got right and what do you think you would've done differently?

**YN:**

I think what I got right was that I didn't try to build a business that was marketable to others. Instead, the goal was to build a business around an investment strategy that I could adhere to over time, from a first-principles basis, and that could generate strong long-term performance. This is especially important because I have nearly all my liquid net worth invested in the partnership and some of my closest family and friends have material investments in the fund too. I'm not trying to maximize long-term fees. I really want to do what is best for my existing partners, and I think I've set up the partnership to do that. In terms of what I would do differently, I would've launched with a higher asset base if I had the option to, but otherwise I set it up the way I wanted to run it over the long term.

*"Avoiding levered businesses and avoiding portfolio leverage ensures that I am always strong money."*

**G&D:**

Diving into your investment process, your portfolio is full of recurring revenue businesses that can thrive in various economic scenarios. Could you touch on how you go about generating ideas and if your idea funnel has changed over time?

**YN:**

I'm looking for names that can compound their free cash flow per share at attractive rates for extended periods, regardless of what GDP does. I'm looking for those names to also be well-capitalized, well-managed and trading below market multiples. That combination is not very common, which allows me to quickly screen for names that fit the strategy. I then spend time on those that meet the initial criteria, some of which make their way onto my watch list. From there, I monitor them, and force rank them versus existing positions.

In force-ranking positions, I'm always looking at the go-forward returns that I expect, relative to my confidence in achieving them. Confidence can stem from having followed a business for a long time, and it can also increase with higher business quality.

Obviously, it's easier to have confidence in businesses with recurring revenues or secular tailwinds than those that are highly cyclical. So, I look at expected IRRs together with my confidence in the underlying assumptions and try to put the fund's capital into names with the highest IRRs and least business risk where I have the greatest confidence.

I generate these ideas in many ways - I read, run screens, talk to other investors, management teams and stakeholders in businesses. I ask friends what services or

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products they're using. I'm interested in many businesses, public or private. I try to understand what their end markets looks like, margin profiles, and capital intensity. My curiosity makes the process very organic, which is important given the strategy's concentration. It is imperative to take the time to study and understand a business in depth, which is hard to do if it's viewed as work rather than a hobby.

So, the initial screen allows me to say no to names quickly, and then I spend most of my time on names that I find interesting, and that meet the criteria I'm looking for from a first-principles basis.

**G&D:**

We have heard that you have a differentiated view on how to spend the first few hours looking at a company. What is that process?

**YN:**

Earlier in my career, I would watch a six-hour investor day and then spend hours spreading financials in Excel before realizing there's something that disqualified an investment. Now, I look for the things that would disqualify that investment upfront, so that I don't waste time. That includes scanning a proxy, where you can get insight into how management is compensated, how much stock they own, and what their incentives look like.

Similarly, looking at balance sheets can help rule new ideas out. Of course, the more stable a business, the more debt it could support. However, if a balance sheet is too risky, there is no point spending time trying to understand the income statement. Even for businesses that can support debt, when are the maturities? What are the covenants? Things that might make a balance sheet too risky can be quickly understood.

Disqualifying ideas upfront prevents you from spending too much time on things that'll never make their way into the portfolio. It also lets you spend more time on new ideas that are actionable, as well as on monitoring existing positions and continuing to force rank names within the watch list.

**G&D:**

Can you talk about position sizing and how you view risk in the context of portfolio construction?

**YN:**

The max size for any given investment really depends on its downside, not upside. I spend a lot of time thinking about how much risk an investment has, which is really anything that could destroy or erode future earnings power. Positions with great downside risk are always going to be smaller no matter how attractive their expected IRR. On the other hand, ideas with less potential downside can be bigger. It's also important to think about how a new idea fits into the broader portfolio. A position that adds diversification can be larger than one that further concentrates the portfolio to a particular risk.

Understanding how big a position could be helps me determine how much upside I demand from it to make its way into the portfolio. I'm always looking to put most of our capital in the highest IRR names with the lowest potential downside. I tend to have 10 to 15 investments, sometimes up to 20 in the portfolio. The biggest ones are chunky because it's hard to find great ideas. So, the biggest names could be 15% of the fund, or more. For those, I'm looking for well above-average IRRs, but more importantly lower potential downside. The higher the business quality, the better I understand management, and the lower the valuation, the less risky an investment is in my view.

Of course, free cash flow generation and growth are imperative because together they de-risk your assumptions over time. When a business generates cash, it buys down the enterprise value. And when it grows, it buys down the multiple.

Lastly, having the ability and confidence to look further out is helpful

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because that's where you are likely to find the biggest variance relative to consensus. If you are right on a business, then the further out you look, the more of a bet you are making on earnings rather than its multiple.

**G&D:**

How does valuation factor into your process?

**YN:**

I try to buy things where I think the multiple will at a minimum be flat over time, and potentially expand over our ownership period. For me that means typically buying things below a market multiple. The lower the business quality, the larger the discount I demand. The higher the business quality, the lower the discount I demand. When making investments at a below-market multiple, it becomes possible to get multiple expansion if either fundamentals or business perception improve. With each of my investments, I like to believe there's the potential for at least one of those two things, if not both.

**G&D:**

Many investors say one of the hardest things to do is to sell. We read in one of your letters that despite all the reasons to sell, the fund has stayed the course and remained largely invested. What must happen for you to sell an investment? Would you sell based purely on valuation?

**YN:**

Yes, I do sell purely on valuation. I'm a very valuation-focused and IRR-focused investor. I typically sell an individual name if I lose confidence in the business or management or reduce it as its go-forward expected IRR becomes less attractive. In terms of portfolio exposures, I normally like to stay as close to fully invested as possible when there are good ideas. Of course, if I ever think we might be entering a scenario where the economy may be permanently impaired, I have no requirement to stay fully invested.

A slightly different way of saying it is that I'm not trying to avoid the volatility that comes with typical recessions. They're too hard to predict (at least for me), and it's hard to consistently jump in and out of the market without detracting from performance. I would rather own businesses that could play offense and create incremental value in those periods.

It's important to remember that, over the long-term, beta delivers high single digit, low double-digit annual returns. If you want to outperform the market, hedging out beta is very counterproductive. It makes much more sense to capture alpha with security selection, and layer it onto beta. Of course, the other option is to lever up alpha while hedging out beta, but that strategy is more susceptible to blowing up at some point. When choosing between these two approaches, I'd rather accept added volatility with lower blowup risk than seek lower volatility with higher blowup risk.

***"I'm not trying to avoid the volatility that comes with typical recessions. They're too hard to predict (at least for me), and it's hard to consistently jump in and out of the market without detracting from performance. I would rather own businesses that could play offense and create incremental value in those periods."***

**G&D:**

There is a big discussion on the concept of edge, and we really liked a quote from one of your letters: "Having confidence in the long-term earnings trajectory of a business is one of the strongest forms of edge an investor can have in the marketplace and one of the hardest types of alpha for others to arbitrage away." How do you go about creating confidence in that long-term earnings trajectory and what gives you confidence in this specific edge?

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**YN:**

I genuinely believe most investors are looking 3 - 18 months out, which makes it a very competitive period. With this time frame, investors rarely have a highly differentiated view on earnings. Instead, they are mostly making a bet on multiples. My preferred strategy is looking further out since there is less smart money thinking in 3–5-year increments. Importantly, small differences in assumptions compound, leading to meaningful differences in out-year estimates. As such, the further one looks, the more impactful it is to be approximately right on the earnings rather than on multiples. In my opinion, earnings are easier to predict than multiples – especially when approached with strong fundamental analysis, deep diligence, and good judgment.

Of course, the more diligence one does and the better business analyst they are, the more confidence they have in their projections, which gives them staying power. When a stock moves against you, it's imperative to know whether you want to add to a position, reduce it, or do nothing. It is not uncommon for stocks to have big moves based on short-term fundamentals, while the long-term picture remains intact. When that happens, it is imperative to have done the work so that you know how to act to protect and grow your capital.

***"Importantly, small differences in assumptions compound, leading to meaningful differences in out-year estimates."***

**G&D:**

Are there any noteworthy lessons you've learned over the past few years or areas, topics, themes, where you've changed your mind?

**YN:**

I've realized that I want to avoid businesses with identifiable business challenges, even if the issues are 10 years out. Those headwinds might not be impacting numbers today, so you might have confidence in projections five years out. However, as time passes, they will start impacting the multiple at an accelerating rate. I prefer owning businesses where I think the multiple should expand, and in these cases, you know almost with certainty that the opposite will occur.

Another lesson I've learned is that momentum is a very powerful force in investing. Companies that have a long history of success are much more likely to continue to outperform those who have a history of disappointment. Lastly, in life and investing – simple is better. The more complex an investment is, the more can go wrong and the higher the return you should be expecting from it.

**G&D:**

Walk us through a typical day in the life of Yaron Naymark. How do you allocate your time, and how has that time allocation changed since you launched your fund?

**YN:**

I typically start every day by checking the news on the portfolio and the watch list. I spend a lot of time staying up to date on existing investments. Those are the ones that could hurt us the most if I miss something. This includes checking SEC filings, and talking to competitors, customers, suppliers, other investors, or the company itself. I spend a few hours most days on names in the portfolio. I'm also looking for new names. I'm researching the watch list, which I really don't view as work. It's fun.

Of course, there are administrative parts of the business too. On the IR front, I'm always talking to like-minded, long-term partners who could potentially join for the ride. I recently partnered with Willow Oak to help on the operations and IR front, which has been great. They have taken a lot off my plate. At this point, probably 20% of my time is on administrative

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and IR, and 80% is on the existing portfolio and new potential ideas.

**G&D:**

On that note, one thing that we've heard quite often is the importance of having great partners. Could you talk about the IR side of the business and how you've been able to attract and maintain long-term capital?

***"Writing quarterly letters has really helped me think deeply about my philosophy. It has also made it easier for others to self-select in."***

**YN:**

When I first started 1 Main, I had been an analyst at two prior funds, but not a portfolio manager. I didn't feel like I had the right to market to people I didn't know until I had a track record to speak to. Initially, while I was proving out the strategy, new partners were mainly friends, family, and people who trusted me through word of mouth. Over the last two years, I've started meeting and talking with institutional investors who are like-minded. The conversations have been great, and I am optimistic that some of them will join for the ride.

Regardless of the investor type, it's a lot of fun talking to people about the strategy. Writing quarterly letters has really helped me think deeply about my philosophy. It has also made it easier for others to self-select in. When people read the letters, they understand my principles and strategy. Because of this, the conversations I have with people who read the letters tend to be worthwhile from the moment they begin.

**G&D:**

Now, let's get into a discussion of individual positions within the portfolio. To start off, could you talk about dentalcorp?

**YN:**

Sure. dentalcorp is the largest dental service organization (DSO) in Canada, with over 500 practices. DSOs roll-up dental practices, which are great businesses. They exhibit consistent growth, driven by a captive customer base that gets teeth cleaned, and cavities filled regardless of the economic environment. Basically, small local utilities.

Big picture, the dental industry has been consolidating and continues to do so. In the US, around one third of dental practices are owned by DSOs, while in Canada that figure is only a single digit percent of practices. It's not inconceivable to think of a world where half of all dental practices are owned by DSOs, as older dentists retire and new, young dentists lack the capital needed to buy practices. This industry consolidation has been taking place at attractive multiples – dentalcorp is currently buying practices at 7x EBITDA.

The combination of underlying business growth and ability to deploy capital at attractive multiples drives DSOs to deliver consistent and attractive free cash flow per share growth. For this reason, DSO platforms typically trade for 15x EBITDA. Accordingly, when dentalcorp came public in 2021, it did so at a full multiple.

However, shortly after its IPO, the stock sold off meaningfully for several reasons. First, the company deployed significant amounts of capital into acquisitions at what were historically high multiples. Following the pandemic, individual dentists bid up practice multiples due to their ability to borrow at near-zero interest rates. Despite the inflated valuations, dentalcorp deployed its IPO proceeds into M&A because it had raised capital to grow. However, due to the high multiples, the company acquired less EBITDA than it should have relative to the amount of capital deployed.

On top of that, the business suffered from inflation. Dental practices typically adjust pricing once per year, but their costs can change at any time. Following the pandemic,

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the hygienist market in the US and in Canada tightened meaningfully, as older ones retired, and new ones delayed enrollment into training programs. This caused wages to accelerate, which caught dental practices offsides, hitting their margins.

Lastly, dentalcorp's interest expense grew as rates rose. These three headwinds caused the company to miss consensus estimates in an environment that has not been very forgiving to illiquid stocks.

While early IPO investors were willing to accept low float at first, they assumed that the company's sponsor would further sell down its stake, increasing the liquidity. However, given the decline in share price, those sponsor-secondaries are now on an indefinite hold. This has driven some of the IPO investors to exit their positions. At the same time, many new potential owners have been unable to initiate positions due to liquidity constraints. All these issues should change with time.

Importantly, dentalcorp has traded down to what should be a trough multiple. It sells for a high single digit free cash flow multiple today, which is too cheap for a business of this quality. Margins will recover into 2024 and FCF is now being deployed at much lower multiples. The company has also fixed 75% of its interest expense, making it less susceptible to rates going forward. For these reasons, the company should grow free cash flow per share at attractive rates in 2024 and beyond.

As FCF per share grows, the stock should follow even if the multiple stays at currently depressed levels. Eventually, the shares will get to a level where the company's sponsor is comfortable further selling down its stake. As liquidity improves, larger funds will be able to look at the company once again. In my view, this will drive the multiple back to a more typical level for DSOs. However, even without multiple expansion, growth in free cash flow per share should be enough to deliver a satisfactory return from today's prices.

Today, dentalcorp trades at half that multiple that a scaled DSO platform typically demands in private transactions. It is bigger and more diversified than most. What's more, if run for cash flow, EBITDA would be much higher, as the significant expenses associated with the M&A team would no longer be necessary. There's a wide margin of safety in terms of valuation. The business quality is high. I think there's a lot of growth ahead, both organic and via M&A. I like buying high quality businesses below market multiples and this checks all the boxes.

**G&D:**

How do you get comfortable with the long-term earnings trajectory of dentalcorp?

**YN:**

Dentistry is something people need and don't stop spending on even when times are tough. There are some elective procedures that people defer, but for the most part, cleanings, and cavities must be addressed. Technological obsolescence risk is very low. AI is not going to kill the need to keep your teeth in good condition. It's highly diversified in terms of customers. It has millions of customers, and thousands of doctors and hygienists. When thinking about the quality of the business, it checks many of the boxes. It can grow pricing with inflation or slightly above. It's just a very high quality, diversified cash flow stream, and so that's how I think about the business.

**G&D:**

IWG is another name in your portfolio that interested us given the contentious nature of the industry it operates in.

**YN:**

International Workplace Group is a bigger version of WeWork that's been around for longer, but many people haven't heard of. They operate flexible hybrid office space around the world, with over 3k locations, and have been around for over thirty years. Their brands include

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Regus, Spaces, HQ and some others. They are in the process of transforming their business from a capital-intensive one with lots of operating leverage, to a capital-light business with less operating leverage. Historically, IWG has signed long-term leases with landlords, converted locations into flex space using its own capital, and filled that space with short-term tenants. The company's profit was highly dependent on the occupancy and pricing they were able to generate for the location. When occupancy declined a bit, profits would go down a lot. When occupancy increased a bit, profits would go up a lot. They were earning good returns on capital, but it was capital intensive which constrained growth.

Today, IWG is offering management contracts where the company operates locations using its model in exchange for a 15% management fee. The company still converts the locations into flex office space, but it does not sign a lease and landlords are the ones paying for the buildout. IWG simply fills the space, operates it, and takes its 15% fee. Landlords are increasingly turning to IWG with this arrangement since they have so much empty space to fill. While it took IWG over three decades to open 3,000 locations under their conventional model, they're on track to add 1,000 locations per year under this new management model starting in 2024.

Importantly, the management model shifts all the operating leverage to the landlord. There's no lease expense, or lease liability to IWG. It's a pure management fee business. By 2027, more than 50% of their EBITDA will come from fees. It will be a much higher quality business.

While other operators are also offering this management model to landlords, IWG is the only company that has been profitably operating coworking space for decades. As such, landlords view it as safest to go with IWG. There's tremendous growth ahead here.

IWG trades at a low double-digit free cash flow multiple today. If you exclude growth investments IWG is making in the biz dev team that pursues these management agreements, it's trading at a single digit free cash flow multiple. As the management fees ramp at high incremental margins, cash flow will likely grow to many multiples of current levels over the next four or five years. At the same time, the capital intensity of the business will decline dramatically. Historically, the company reinvests its free cash flow into new locations, but now, they will be able to buy back stock and pay dividends instead. I'm really excited about this one.

*"It's a pure management fee business. By 2027, more than 50% of their EBITDA will come from fees. It will be a much higher quality business."*

**G&D:**

Running at scale, how do you get comfortable with mitigating the risk of short-term leases and knowing that IWG's tenant could just walk out tomorrow?

**YN:**

The leases are shorter, but there is also much more diversification across tenants. Losing a tenant in the flex model is not the same as losing a tenant in the traditional model where it may represent an entire floor of occupancy. More importantly, as IWG transitions to management contracts, occupancy matters even less because there's no minimum rent it needs to pay the landlord. I strongly believe demand for this type of model will continue to grow. In a world where the only way to get office space is to sign a 10-year lease, businesses did that. But in a world with excess office capacity, why would a company sign a 10-year lease?

Long-term leases reduce business flexibility. Companies that sign long-term leases often

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## 1 Main Capital

end up taking more space than they need to account for future growth. In today's world, that makes very little sense to do.

Because of excess supply, users of office space are now in the driver's seat. Landlords must meet them where they are if they want to fill empty space. That means offering them short-term leases. At the same time, landlords are simply not set up to support small tenants with high turnover. They're used to signing 10-year leases and collecting rent checks. The flex model is much more complex. Operators need to ensure bathrooms are clean, internet is functioning, light bulbs are changed. They also must retain existing customers annually and find new ones to replace churn. All of this is vital.

***"IWG is the least risky, best positioned domain expert to help landlords bridge that gap."***

Additionally, a good operator can maximize revenue of a location. At IWG locations, 25% of revenue typically comes from services, while 75% comes from leases. Services include virtual office, hourly bookings of conference rooms or offices, printing, and food and beverage sales. IWG has spent decades refining its ability to maximize service revenues, while smaller operators generate very little of it. This alone justifies the company's 15% fee.

So, IWG goes to landlords with a proposition of converting empty space into monetized space, and they can generate higher revenue per square foot than is typically generated with a traditional 10-year lease. Demand is moving toward that environment. The supply must meet them there if it wants to capitalize on that demand. IWG is the least risky, best positioned domain expert to help landlords bridge that gap.

**G&D:**

Moving to Limbach, can you discuss your thesis and what you've seen change throughout your ownership of the company?

**YN:**

Limbach is a specialty contractor focused on HVAC and other building control systems for mission-critical infrastructure assets such as data centers, hospitals, and biotech research labs. It's a business that historically worked primarily on new construction projects. These projects came with very low margins that were capital intensive, and high margin variability. Recently, the company has been transitioning towards smaller, owner-directed projects that have higher margins, less working capital intensity, and less variability. The company previously had a stretched balance sheet but is in a net cash position. Lastly, the business recently upgraded its leadership with the promotion of a new CEO from within, who engineered the transition away from general contractor work towards these smaller, higher margin, lower variability projects.

Owner direct work not only comes with significantly higher margins but is also shorter in nature which makes it less working capital intensive. The company will continue this transition and redeploy its free cash flow into M&A. This is an industry that is in early stages of consolidation. There are plenty of small operators looking to retire, and there are few natural buyers of these businesses. For this reason, they trade at low valuations of around 4x EBITDA. As Limbach continues shifting the business towards these owner direct projects, and as it deploys its free cashflow into acquisitions at four times EBITDA, free cash flow per share will grow at attractive rates. Better yet, the business quality is also going to improve, as it gets bigger and more diversified.

While Limbach trades for 10x free cash flow, it's public peers trade at double the multiple, despite having worse business mix. I think that's part of the opportunity here. In terms of my history with the company, I got

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involved with it during the pandemic as a special situation. I did well on it. I ended up selling out of the position when the prior management made a few decisions, including a questionable and poorly executed equity raise. I got re-involved as a core position when the former COO was promoted to CEO earlier this year, and I'm really excited to see what he's able to do with the business.

**G&D:**

Are there any lessons you've learned from investment mistakes, and if so, how has your investment philosophy or process changed as a result?

**YN:**

I used to look at valuation first. Now, while I appreciate low multiples, I look at things other than valuation first, such as what the industry structure looks like, what the business quality looks like, and how management behaves. Over time, I've learned that if a stock seems cheap, you better have a good understanding of why that might be and what the market is getting wrong before you buy it. Cheap stocks are usually cheap for good reason. Investor psychology is tough to predict, so buying a low-quality business that can't grow its value and hoping for mean reversion on the multiple is just a very hard game to play. It is much easier to buy a high-quality business that can predictably grow its per share value. Multiple expansion should be just a cherry on top.

***"Over time, I've learned that if a stock seems cheap, you better have a good understanding of why that might be and what the market is getting wrong before you buy it."***

Another important lesson is that if management shows you who they are, believe them the first time. Only invest behind honest and capable management teams because if they've stolen from shareholders once, and that's why the stock is cheap, they're going to burn you too.

Lastly, when the facts or circumstances change, you must be able to change your positioning. Often, investors care more about looking right than protecting capital. It is important to, at times, admit that you were initially wrong on a thesis, or that it may have changed. The market doesn't care what your cost basis in a position is and neither should you when making decisions. The best thing investors can do is position themselves appropriately based on all available information at any given moment.

Those are the ones that come to mind that I've seen repeatedly, both through my own experience and in watching other investors commit mistakes. They are common and recurring.

**G&D:**

What are some of the things you do on a regular basis to improve as an investor?

**YN:**

I read a lot and talk to other investors that have similar philosophies as I do, as well as investors that have different philosophies, different styles, and different strategies. I just try to learn from other people's mistakes and other people's successes. There is value in spending a lot of time thinking deeply about your mistakes, but also your wins. I think you could learn a lot from analyzing your mistakes, which most people do. You could also learn the wrong lessons by not analyzing your wins, and I think it's important to do both.

**G&D:**

Could you elaborate on learning from your successes? What are some things that our readers should be looking for in terms of analyzing their successes?

**YN:**

Sometimes people buy a stock with a certain thesis, and the stock goes up even though the

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thesis didn't at all play out as initially expected. Without analyzing wins as closely as losses, it is possible to walk away with the wrong lessons. It's vital to understand that in certain cases luck was the contributing factor to a win rather than having a good thesis. This way, you don't get sucked into a similar situation where you are once again relying on luck rather than the placement of a good stand-alone bet. Pattern recognition is very important in investing, and we all use it a lot to filter through what to spend time on and what not to. It's important to make sure that we are not inputting flawed mental models into our brains, though we're all susceptible to it.

**G&D:**

Do you have any advice for students looking to break into the investment management industry? Any off the beaten path advice for younger investors who want to learn more about investing?

**YN:**

I think there's no better way than doing. It can be scary to invest a personal account when you are young and inexperienced, because you don't know what to look for in a business or how to construct a portfolio. But take $1,000, $500, $100, whatever you have, and just invest it. Start building a portfolio, learn from your mistakes, learn what works for you, learn what doesn't. No two people are the same. Trying to follow someone else's strategy is not going to work for you. I think it's important to learn from your mistakes, learn from your wins, and just do it. I think everyone should manage their own PA as early as they realize that they want to be an investor long-term.

***"It's vital to understand that in certain cases luck was the contributing factor to a win rather than having a good thesis."***

**G&D:**

What do you like to do for fun outside of investing? Do you have any unique hobbies or passion projects?

**YN:**

I like to play tennis. I also love being on the water - whether it's spending time with family at a lake or the beach. Just seeing or being on or near the water and spending time with my kids, my wife, my parents, and my siblings. Family is everything.

**G&D:**

What are your favorite investing and non-investing books?

**YN:**

For non-investing: Outliers by Malcolm Gladwell. The book makes you think long and hard about nature versus nurture, how much of an impact you can have on your kids as a parent and how much luck plays in anyone's successes or failures. It is just an awesome book to kind of highlight all those things. For investing, I'll give you a business book and then one about pure investing. For business: Shoe Dog. It's such a fun read. It shows you the grit it takes to build a real business from the ground up. From a pure investing standpoint, I'll go with The Little Book That Beats the Market by Joel Greenblatt. It's so simple, yet so profound. Early on, if you hit me over the head with it, I probably wouldn't have known everything that he was saying, but now I just think back about how obvious it is and I think anyone who's starting to invest should read it.

**G&D:**

Thank you, Yaron.

**YN:**

Thank you for the time.

# Value Creators Capital

Kevin Fogarty

Kevin Nichols

**Kevin Fogarty is the Founder and CEO. He has 29 years of investment experience and was formerly with Dupont Capital for 19 years. In 2016, Kevin launched the Value Creators concentrated portfolios which grew to over $1 billion in assets while outperforming their benchmarks since inception. Before joining Dupont Capital, Kevin was the Global Head of Telecom Research at Citigroup Asset Management in Stamford, CT. Following business school, he worked as an equity analyst covering consumer, telecommunications, and technology companies at Lehman Brothers and Dean Witter. Kevin holds a BS in Mechanical Engineering from Villanova University and an MBA with Honors from Columbia Business School and is a CFA Charterholder.**

**Kevin Nichols is a Senior Equity Analyst . Before joining Value Creators Capital Kevin worked at DuPont Capital Management on their Global & U.S. Fundamental Equity Team. Additionally, Kevin was an Infantry Officer in the United States Army. While serving in the Army, Kevin was stationed at Fort Campbell, KY, with the 101st Airborne and at Fort Benning, GA, as an Officer Candidate School Instructor.**

**Kevin holds a B.S. in Finance from the Pennsylvania State University and an MBA from Columbia Business School where he is a graduate of the Value Investing Program and is a CFA Charterholder.**

***Editor's Note: This interview took place on October 10th, 2023.***

**G&D:** Thank you both for speaking with us today. Could you start by walking us through your background and how you first got interested in investing?

**Kevin Fogarty (KF):** I grew up in a rural part of western Connecticut where in high school, I had a fairly high level of curiosity for how things worked and also how the world worked. Although I did not know it at the time, my blue-collar upbringing and environment were actually the foundation for my interest in investing. I was fortunate to enjoy a middle-class childhood upbringing and was exposed to a variety of things. My nearby relatives operated family dairy farms; my father was a mason contractor, and I helped him out for a few summers.

My personal interests, however, lied outside of physical work. Because I had excelled in math and science, I studied mechanical engineering in college and started my professional career as an aerospace engineer. At that time, the technology revolution was just beginning with the introduction of the personal computer, local area networks, and more powerful communications networks. I was more interested in trying to understand the forces driving technology, business, and their impact on the world than anything else.

I was drawn to the business news and started researching companies and after saving up a few thousand dollars, I purchased my first shares of personal computer manufacturer Gateway 2000 at its IPO for $15 a share. The company assembled PCs in South Dakota and shipped in signature black and white Holstein cow patterned boxes, and I knew that my engineering company had ordered PCs mail order from them for the entire office. I had no real idea how competitive dynamics worked in this industry, but I was hooked and decided that I needed to find a way to be an analyst and investor.

At that time, I knew I did not have much formal training in investing or finance, and I considered myself to know just enough to be dangerous. I barely knew what a P/E ratio was, let alone a DCF. This realization led to the most important event in my career –

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enrolling in Columbia Business School, where I started my investing journey in January 1994. While at CBS, I decided to enroll in or audit as many investing classes as I could. Like many other students, I had to personally lobby professor Bruce Greenwald for the chance to enroll in his always oversubscribed Security Analysis class. In addition to Professor Greenwald's signature investing class, CBS had a rich history of adjunct professors who were active industry practitioners, and I was fortunate to have been taught by many of these industry experts as well, like Jimmy Rogers, Michael Mauboussin, Paul Johnson, and others. Before CSIMA was formed, I was an officer of what I believe was called the CBS Student Investment Club, where we sponsored several guest speakers and ran a semester-long stock-picking competition. I have to say, things have come a long way since then with the Heilbrunn Center's initiatives, the CSIMA conference, the Pershing Square and Artisan stock pitch challenges, and the excellent Tom Russo-sponsored long-term-oriented 5x5x5 Investment Fund! There is no better place to be than CBS to learn about the world of investing.

**Kevin Nichols (KN):**
I was always intrigued by Wall Street and the Markets, but I was not someone who bought their first stock at 12 or had a passion for investing in my teens. When I was younger, I enjoyed sports, then went to Penn State and did ROTC before serving 5 years in the United States Army. I did not start learning about investing until I was getting ready to leave the Army and decided to get my MBA. I did some research on the career paths available for MBAs and came across Columbia's Value Investing Program, and I began to read all I could about Value Investing. The first two articles that really hooked me were "What has Worked in Investing" from Tweedy Brown, and "Superinvestors of Graham and Doddsville". I actually do not remember how I came across these articles, but once I did, I was hooked. I started learning as much as I could about investing and the markets, and what keeps me coming back each day is the competition aspect: can your ideas, your analysis, your investments beat the market? And that competition is what I think draws many people to investing.

> ***"I had no real idea how competitive dynamics worked in this industry, but I was hooked and decided that I needed to find a way to be an analyst and investor."***

**G&D:**
Who are the investors and mentors that have made the biggest impact on you? What do you like in particular about their approach?

**KF:**
The mentors and investors who have had the greatest impact on my investment approach have been my parents, Berkshire Hathaway (both Warren Buffet and Charlie Munger), Bruce Greenwald, and, more recently, the writings of Will Thorndike.

The key attribute I learned from my parents and studying Berkshire is PATIENCE. It is an uncommon trait and very difficult to maintain, especially in the fast-paced, transaction-focused Wall Street environment where many measure performance in days, weeks, and months. Having patience can be a lonely place at times in the investing business. My father is one of the most patient people I know. As a farmer and mason contractor, he showed me how patience and time, especially when performing high quality work overtime and caring about his customers, led to a strong word-of mouth franchise and a successful small business with an excellent reputation.

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The investment influencers for me have been Buffett and Munger. Both have emphasized, much like my parents, a sense of honesty and ethics in their businesses, which ultimately bears fruit over time.  Although patience is a key ingredient, the 3 things I have learned most from Buffet and Munger are:  1) the concept of a competitive advantage or economic moat, 2) sustainability or durability of the franchise, and 3) the importance of capital allocation.

Bruce Greenwald's coursework and his book "Competition Demystified" have significantly influenced my approach. He provides an excellent framework for analyzing the three factors listed above and offers insights into both the sources of competitive advantages and their sustainability over time, including potential vulnerabilities. The framework he outlines is invaluable in helping assess and quantify franchise strength, durability, and sustainability.

Finally, over the past 25+ years, I have analyzed many sectors, starting with the telecommunications industry (which generally has poor capital allocation) and moving on to industrials/ consumer sector (which have extremely variable performances with several excellent examples and some that are spectacularly value-destructive). I have learned that capital allocation is a significant driver of long-term value creation. This concept of assessing the reinvestment rate on retained earnings/free cash flow is something Buffet has preached for decades. However, Will Thorndike's book "Outsiders" provides some of the best historical case studies in one place, notably comparing Henry Singleton with Jack Welch of GE. As you could probably guess, Buffet's annual reports, "Competition Demystified", and "Outsiders" are required readings for the Value Creators Team.  The most important concept from these mentors and investors is summarized in the following quote from Buffet, which is also prominently mentioned in Will Thorndike's "Outsiders", and well worth mentioning again: "The heads of many companies are not skilled in capital allocation. Their inadequacy is not surprising.  Most bosses rise to the top because they have excelled in areas such as marketing, production, engineering, administration, or sometimes institutional politics. Once they become CEOs, they now make capital allocation decisions, a critical job that they may have never tackled, and which is not easily mastered.  To stretch the point, it's as if the final step for a highly talented musician was not to perform at Carnegie Hall, but instead to be named Chairman of the Federal Reserve."  I cannot emphasize enough the significance of this as a long-term driver of value creation. Buffet further points out that "after 10 years on the job, a CEO whose company annually retains earnings equal to 10 percent of net worth will have been responsible for the deployment of more than 60 percent of all the capital at work in the business."  Obviously, the inescapable mathematics of the above demonstrates the impact that capital allocation will have on ultimate value creation over time.

*"The 3 things I have learned most from Buffet and Munger are: 1) the concept of a competitive advantage or economic moat, 2) sustainability or durability of the franchise, and 3) the importance of capital allocation."*

**KN:**
First and foremost, the greatest mentor I have

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had has been Kevin Fogarty. He really gave me my first opportunity, and although relatively short, my entire career has been with him. I feel extremely fortunate that Kevin's style of investing and temperament has meshed really well with what I look for in an investor and a boss.

Second, I owe a lot to my Applied Value Investing professors, Mark Cooper, and Jon Luft. I thought AVI was the best class I took at Columbia. Both Mark and Jon were not just great practitioners; they have consistently maintained contact with alumni of their classes, fostering continuous learning and helping us all become better investors even after graduating from CBS.

Third, the folks at Clearbridge Investments, where I did my summer internship during my time at CBS, specifically Chuck Harris and Matt Lilling. I thought the entire firm was great, but Matt was instrumental in helping me get the internship. He took a lot of time before my internship to get me up to speed and prepared for the summer. Meanwhile, Chuck, one of the most unique people you will meet in the industry, took a lot of time and effort to involve me in the research process. He even met with me early on to coach me and provide feedback on my research project.

Finally, Bruce Greenwald, for all the same reasons most people cite, but I was fortunate enough to be one of Bruce's TAs during his final year at CBS. The personality aspect that stands out about Bruce is that he never tries to appease anybody. He is always willing to give feedback on ideas and ask very challenging questions to everyone, whether he's addressing Seth Klarman, Li Lu, or the students in his class. The amazing thing about Bruce is that he is always trying to learn and understand the markets better. He has very strong opinions, but he is not dogmatic about them. If he is proven wrong, he is willing to change his opinions. Now, to be fair, the burden of truth required is quite high, but if you meet that burden of proof, he will change his mind.

***"Buffet further points out that 'after 10 years on the job, a CEO whose company annually retains earnings equal to 10 percent of net worth will have been responsible for the deployment of more than 60 percent of all the capital at work in the business.'"***

**G&D:**
Excellent, thank you for that. I know you two have some changes happening in your professional career. Can you please give us an update?

**KF:**
Yes, sure. I've been at DuPont Capital for the last 19 years. About seven summers ago, I launched a value creator's strategy, which includes both a large-cap and a mid-cap strategy. This philosophy was developed, refined, and implemented in the industrial group where I worked as a global industrial analyst. I launched the strategy as a much broader strategy, benchmarking it against the S&P 500 large-cap and the S&P 400 mid-cap indices, with the exact same philosophy that I had been using within DuPont for the preceding 12 years.

It was part of a core satellite strategy that the head of equities felt comfortable funding, aiming to enhance alpha generation from DuPont Capital's overall equity strategy. The strategy started off great. We began marketing it, I'd say, about three or four years in, and started attracting many clients, gaining a lot of traction. As of July of this year, we manage about a billion dollars in the strategy, both with internal and external funds. In late July of this year, DuPont Capital's parent company, Corteva, made a strategic decision that effectively ended DuPont Capital's ability to manage external assets.

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## Value Creators Capital

It was a non-strategic business, the pension plan's external money management business, and they chose to simplify their entire equity operations. They are now helping the value creators team transition to find a new partner committed to long-term client management of the portfolios. To harness the great track record that we've generated in the past, and we think we can continue to generate in the future, we have started our own firm, Value Creators Capital Management. We are in the fundraising mode and searching for a suitable partner.

**KN:**
From July until now, we've been investing while simultaneously trying to start our own firm, which has been very challenging. However, we have had a lot of support from DuPont Capital along the way.

**G&D:**
It sounds like a challenge, but also a great opportunity. You get to retain your successful track record and IP, as you start fundraising for Value Creators Capital. I know you're keeping the same investment philosophy, which is rooted in the Graham and Dodd value investing principles. Could you delve a little deeper into your investment process?

**KF:**
Sure. I should start at the beginning to put my investment process in proper perspective. When I got out of business school, the easiest place to get training back then was to work for the sell-side as a research analyst. In that role, they'll train you, and you can learn the ropes. I started out at Dean Witter, and then went to Lehman Brothers during the dawn of the internet and telecom revolution. As an engineer that knew a little bit about technology, there was just massive demand for research analysts with my background. I ended up specializing in telecommunications, leveraging my engineering background, and getting my first job on the buy-side doing telecom research, which was everything I specialized in on the sell-side.

I eventually became global head of telecom at Citigroup Global Asset Management. My conclusion after doing that for about five years was that this is probably the worst industry, structurally, for creating value that you can have. In a lot of geographies, there's massive competition, and the regulators want that. There is very little pricing power for the most part. There is not a lot of free cash flow, and often, free cashflow gets blown on the bleeding edge of technology. And so, in many ways, this industry is the antithesis of everything you're going to hear about our strategy in terms of franchise power, pricing power, rational competition, and spending the firm's capital and free cashflow carefully and wisely.

*"My conclusion after doing [telecom research] for about five years was that this is probably the worst industry, structurally, for creating value that you can have... often your universe and your world as a sell-side analyst is defined by the industries you cover."*

That maybe sets the tone. It was a phenomenal experience in terms of learning where not to invest. The other thing, and this does tie into our strategy, is that being on the sell-side, often your universe and your world is very small. If you're the automotive analyst, you're interested in who the best automotive is. When you're an investor, even for your personal account or your family wealth, you're not looking to find the best automotive company, you're looking to try to find the best company on the planet. I think the whole sell-side, and even parts of the bigger buy-side organizations, can tend to get a little bit of tunnel vision,

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when trying to find the best long-term values.

***"When you're an investor, even for your personal account or your family wealth, you're not looking to find the best automotive company, you're looking to try to find the best company on the planet."***

With that said, our strategy is bottom-up, stock-by-stock, and it has five key pillars. First, we look for companies that have a favorable competitive environment, which means rational competition – duopoly, oligopoly, monopoly. This often means a more consolidated industry, certainly not startups, and it has to have some kind of franchise strength, which speaks directly to Bruce Greenwald's book "Competition Demystified". Second, there needs to be a reasonable fundamental growth outlook. For instance, you may have a rational industry, but if it's a dying industry like tobacco, then it's really not that attractive to us.

Those are the first two pillars - a durable franchise that has some kind of sustainability to growth. The other three pieces of the strategy are intertwined. The third is a cliché, but it's important - an excellent management team. Everyone says that, but we mean something a little more comprehensive when we say it. We mean a management team that's not only really good at their existing operations, improving efficiency, thinking about enhancing and defending the franchise every single day, but also very good stewards of capital. Because, if we're invested, it's our capital. That's extremely important, and it's a critical part of what we mean when we say, "an excellent management team". The fourth element is this concept of free cash flow. We're looking for companies that have above average free cash flow through the cycle on a normalized basis. That's really important that you have superior free cash flow generating abilities, because it leads to the fifth major piece of strategy, which we think is the biggest differentiator. It's capital allocation decisions, with that free cash flow, that are well aligned with shareholder value creation. And, again, those three are all intertwined. If you don't have free cash flow, then there's no free cash to invest, and management can't do anything to create additional value if there's no free cash flow to begin with. So, you kind of need all three of those ingredients on top of a great durable franchise.

That's the concept and the investment strategy. Our challenge lies in finding these five characteristics at a reasonable price. Sometimes, when a company checks all the boxes, it's already been discovered and is appropriately valued. Right now, we've gone through about 200 companies with this process, modeling them and estimating an intrinsic value and range. From there, we build a portfolio around that. Sometimes, we find a great franchise that is undiscovered and on sale. Other times, they're too expensive, and we simply have to wait.

**KN:**
I would add to the capital allocation piece that companies are more sophisticated now on how they talk to investors. Many companies, for better or worse, try very hard to use certain language they know investors are looking for so the challenge for investors is to look through the words and to see what companies have actually done. You can go and search their transcripts, and they always say their capital allocation priorities are X, and they always mention organic investment and return to shareholders. But for us, it's understanding what that type of organic investment or M&A can contribute to future earnings, or what type of shareholder returns are they doing. For instance, we have some companies that will buy back stock no matter

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their valuations, and that's not too interesting to us. It can be good or bad, but the best companies generally will buy back when their intrinsic value is depressed and not buy back when it's overvalued. On the other hand, a lot of companies will pay a nominal dividend. That’s their choice, but you'll ask some of these companies, "Why do you pay the dividend?" and they don't have a great explanation.  A great explanation would be, we want to return capital to shareholders, and we don't have any use for M&A, we don't have any organic investments to spend it on, and our share price is too expensive.

***"There are a lot of nuances to these capital allocation decisions... you have to go much deeper than that to understand where the value's coming from."***

An example of somebody who does it really well is Costco. They can't really do M&A, their share price is 34x PE, and they invest as much as they need in organic growth, and so they return a special dividend. Some companies will say, "Oh, we give a dividend because our share class likes it”, or “our shareholders like the dividend, so we can stay within certain funds." In other words, it’s a capital allocation decision they're making just to attract certain shareholders, without necessarily adding any intrinsic value to the company. There are a lot of nuances to these capital allocation decisions, and if you just list them and say, "these are our priorities," you have to go much deeper than that to understand where the value's coming from.

**G&D:**
Can you talk a little bit more about the intersection between “industries with reasonable growth outlook” and “capital allocation?”

**KN:**
Well, on capital allocation in static or dying industries, some investors might be attracted to it. For instance, opportunities like Altria might appeal to some investors. But for us, when we're trying to hold something for five or ten years, the secular growth of the industry has to support the capital allocation decisions to make that investment attractive to us.

**KF:**
To summarize this piece on the reinvestment of free cash flow: I've yet to see a finance book discuss this, but this can be a source of significant value creation. I actually named the strategies “Value Creators” because of this potential to enhance shareholder value with the right reinvestment at high returns. As Kevin hinted, it varies for each company. There's no one-size-fits-all. For a niche industrial company like AMETEK that can acquire complementary products and integrate them, it's beneficial. But for a firm like Costco, bolting on a fluid power company wouldn't be the right move.

For companies like automotive parts retailers and off-price retailers, including dollar stores, they often allocate a fair amount of capital to share buybacks. Typically, they repurchase shares at mid-teen multiples, which yields a reasonably good return. It’s a good choice for them. On the other hand, with Costco trading at over 30 times, their repurchasing of shares isn’t particularly value-accretive. So, it really depends. The best companies we've come across, and those that we invest in our portfolio, are unemotional and dynamic around this process. Many companies on Wall Street, such as General Electric (pre-Larry Culp era and during the Jack Welch and Jeffrey Immelt years), prioritized M&A. They were empire builders at any and all costs.

It was sad to see them destroy value year in and year out by overpaying for strategic acquisitions that the investment bankers loved to sell them. It’s what’s gotten them into

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the mess they're coming out of now. That's really the antithesis of our investment process. You have to ask yourself, "what are your returns on that M&A? What are your real cash on cash returns?" If you knew that, would you invest your family office, your intergenerational wealth in this endeavor? Those are the questions that we really like companies to be asking of themselves before they commit capital to anything.

**KN:**
When evaluating a company's return on M&A, especially for an acquisitive company, you can assess their past returns. Companies disclose their acquisition costs and, with GAPP accounting adjustments, it's possible to discern their actual returns based on goodwill adjustments. Take, for instance, Middleby. They claimed high returns, but a look into their history of acquisitions revealed they were achieving just around 6-7% returns, which isn't that attractive. They attempted a roll-up strategy, which really didn't align with our interests. We prioritize companies that show an unleveraged return of 10-20% on acquisitions, aiming for a cash return on their investment within about four years.

**KF:**
Whenever a company we're interested in makes an acquisition, we use a specific acquisition model to assess it. We don't even look at the slide deck, which usually talks about accretion to earnings by year X, synergies, etc. Instead, we invert the question and ask: if a company is spending a billion dollars, what do we need to believe for them to get a 10% cash on cash return? In other words, if a company is going to give up a billion dollars, how are we going to get a stream of $100 million on the billion after tax, after working capital, after capital spending, after synergies, after all else. If that doesn't add up to us, then it doesn't really seem like great capital allocation. This is one way we evaluate capital allocation skill.

**G&D:**
That was a great explanation. Thank you for that. So, is that 10% the threshold you use to assess management's skill in terms of allocating capital?

**KN:**
Yes, at a minimum. We set a 10% threshold based on a perspective Bruce Greenwald shared with me during my time at CBS. While many prefer using WACC, it's important to remember that retained earnings and free cash flow belong to the investors. So, what's the minimum acceptable return for an equity investor? That's why we set our bar at 10%, and it is not just the threshold – we expect companies to surpass it.

We avoid WACC, because its value can vary. Most companies we study reinvest retained earnings without altering their capital structure. They might have existing debt, but they usually don't accrue more for initiatives. Our 10% standard is our market-beating benchmark.

**KF:**
Agreed - we use that as a rough hurdle. And again, when evaluating, it's more along the lines of, "what would you have to believe for them to actually meet that or exceed that?" That often gives us a clearer picture of what's achievable. For instance, if you'd have to believe that the cost structure has to change into best in class, never before seen in the history of this business, then that gives us a lot of insight.

**KN:**
And just to add, once you've done this analysis, that is when you can talk to management and say, "we saw this acquisition, and this is the math we got for it. Can you please explain what we're missing because it doesn't look that attractive to us?" We can gain a lot of insights from what they say and how they respond to that question.

**G&D:**
That's very helpful. Considering your extensive background in telecoms, how do you manage sector or industry concentration in your portfolio? And how do you decide on the active weights for each

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sector you invest in to control portfolio risk?

**KF:**
We do have very wide bands. We take very significant sector bets in the portfolio. There are several sectors that we have zero investments in, such as utilities. And then we're very underweight materials, traditional banks, and the telecom piece of communication services. A few reasons for this are that a lot of companies in those industries don't have free cash flows, are in hyper-competitive markets, or they're not necessarily good allocators of capital. Therefore, they don't necessarily have a superior above average value creating ability . These companies may appear cheap in the short run, moving in and out of favor, trading up and down, but we're looking for very long-term above average value creation per share. Those sectors just don't meet the criteria.

Regarding controlling risk, our large cap portfolio comprises about 45 names, representing our top picks. We do concentrate the portfolio on the very, very best - those that strongly meet our criteria and have great upside potential as well. We want to take as much risk as we can, but we are cognizant of risk adjusted returns, and that's why the portfolio does have some balance in it.

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**KN:**
Just to add to that – we are aware of the risk metrics, like beta, but we never manage the portfolio to them. Because of our process, we haven't had to. We're not making all the bets in information technology or financials. We have found great investments in 8 or 9 of the 11 sectors.

By focusing on the 8 or 9 sectors, we have really tamped down our risk. We also look at our active weight share, because being at DuPont, like most long only managers, we were judged against a benchmark. And so, when we're thinking about sizing, our largest positions in large-cap were about 350 basis points active-weight, and we really had no position under about a 100 basis points in large

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-cap. On the other hand, in mid-cap, our largest position was about 400 or 500, but that's because there are fewer names to spread basis points across, and because S&P 400 is a very different benchmark from the S&P 500. Different investors do it different ways, but that's the way we've done it and been successful with it.

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**G&D:**
Have there been any noteworthy lessons that you've learned over the past few years? Any areas and topics you've changed your mind on?

**KN:**
There have been hundreds, but each lesson is generally minor, and you slowly evolve as you make more mistakes or learn more lessons. I think the thing that I have changed my mind on most is the importance of concentration. I know people look at investors like Ackman or Joel Greenblatt and want to do a 6-10 stock super concentrated portfolio, and I thought that was the best way too. But through the last 5 years, I have seen that a lot of times you do not know when things will work out and having 40-50 names has worked out well for us. I think we may be able to get a little more concentrated, but I am not convinced that a 6-10 stock portfolio is best, especially when most professional investors are measured on an annual return basis. In your own PA, where you are the only client, it is a different story. Ultimately, many clients claim to be super long term, but most investors are comped on annual performance, so if you underperform for 2-3yrs, it is very hard to survive.

In school I did the same screens as everyone else - looking for the 'Magic Formula' to identify low P/E, high ROIC companies - but I have changed on this. I still think that valuation is very important, but I do not mind paying slightly more for better quality companies. In general, those high-quality companies have outperformed our expectations, when lower quality companies have generally underperformed.

> ***"The thing that I have changed my mind on most is the importance of concentration… having 40-50 names has worked out well for us."***

**G&D:**
Anything noteworthy to touch on regarding valuation?

**KN:**
Something Kevin points out to us often, and I think it is something very important to think about, is that a valuation through fundamental analysis is ultimately just a Point Estimate, with a number of inputs and assumptions. So, it's important to not only consider your point estimate, but also its sensitivities to your inputs. I am not just talking about throwing in a sensitivity table as an afterthought into your pitches. For example, given a company with

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15% normalized margins, you should understand the drivers behind what would make normalized margins move to 18% or 12%. Then, you should understand the signals that would make you change your mind when that company approaches your target. In the end, instead of selling and potentially missing 30-40% more upside, you can gauge if your original estimates were too low, and the company is actually sustainable above your original estimate. We have seen this a number of times with companies we own, such as ODFL, CPRT and AAPL. If we had just sold these companies at our point estimate, then we would have missed a lot of upside. It is also important to understand if change is a sustainable, secular change or just something cyclical.

Another thing I would recommend is to not get caught up in stories. Lots of companies spend a lot of time and effort to tell their story, but I believe that every qualitative decision should eventually show up in the financials. So, look back at the history of what a company has said and assess whether they made their targets or whether it showed up in the financials.

**G&D:**
Could we speak a little bit about AMETEK? As you both described, it's a niche industrial company with returns focused capital location strategy and pedigree.

**KF:**
Yes, definitely. AMETEK has several niche-y industrial companies. Their products are usually pieces that are critical to their customers, and they don’t have a lot of direct competition. One example of this is, and it is not going to sound very sexy, but they make motors for commercial vacuum cleaners. This sounds like a commodity, but there are not many people that make these components, and there are not that many people who really want to get into this business. Because of this, it is very specialized, and the cost of the component is often a very small percentage of the customer's total product or operational cost. Given this dynamic, they usually have a great ability to manage price versus manufacturing costs. They are an extremely efficiently run company, and they are highly incentivized to generate good returns in their core business, as well as good returns in any business they acquire.

***"A valuation through fundamental analysis is ultimately just a Point Estimate, with a number of inputs and assumptions... it’s important to not only consider your point estimate, but also its sensitivities to your inputs."***

They've been doing this for the past couple of decades, using the exact same playbook: they look to bolt on businesses similar to what they already own and improve their internal operations. They make these businesses world-class in efficient manufacturing, efficient product development, and efficient distribution. Sometimes they have better global distribution than the companies they are acquiring, and they actually can get synergies from this, but they never pay for them. They are extremely careful and disciplined about what they pay for acquisitions. They have an entire department that is constantly looking for acquisitions. There is an ability to do this at the head office level as well as at the business unit levels. There are incentives for the business unit heads to do acquisitions, but they're extraordinarily disciplined. Some of the best conversations I have had with them are on what companies they have passed on. They do not like to get into bidding wars with private equity or other parties.

They have a very strong ability to walk away from a deal. When you ask them what they walk away from and why, and they are willing to share some information with you about it, they say, "yep, we walked because

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this didn't meet a hurdle rate." That is a signal of a good capital allocator. They have a business that is very tied to energy, and a few years back, when energy prices were extraordinarily depressed and so was the business, they initiated a pretty meaningful stock buyback program. This told us that they are well aware of their intrinsic value, and in times of dislocation, they will act on it.

So again, going back to the dynamic capital allocation process, and asking yourself, where is the best return? You may have an opportunity to buy back shares or do some an M&A, but there is the old adage - the devil you know is better than the devil you don't. So, why would you pay for M&A at some hurdle rate, if the hurdle rate on your own shares is equal or maybe even better? If that is the case, you should buy back your own shares all day long, especially if you are risk adjusting. This is one of the few companies that will dynamically allocate capital appropriately. We also think it's a little bit under the radar. It's not a household name, certainly from the general investing public. Even within industrials, it's sort of a niche-y conglomerate. The management team is not promotional. They are very, very conservative in how they communicate with people, and that really suits our strategy on a lot of metrics. We think there is a long runway ahead for above average value creation.

**G&D:**
It seems like this component is a small piece of the overall total product cost, and this is a consistent theme that has popped up. For instance, TransDigm is a company that has had success with this. Why do you think that strategy works so well?

**KF:**
I think a lot of it comes down to the moat, barriers to entry, or customer captivity. Customer captivity is probably the nicest way to say strong pricing power. Although we are significantly invested in TransDigm as is most likely a poster child for this strategy, I didn't pick TransDigm as a name to share our insights, because I think it's becoming more well-known and more popular, and so it has probably been talked about before in these forums. That being said, I think their overall strategy is a becoming a more popular playbook for value creation. When you think about how global industrials have changed over the last 20 years, I would say that a lot of these industrial behemoths have tried to get rid of their commodity-like products and focus on where there's more value add, where there is an economic advantage or some level of differentiation.

I think a lot of companies have done this under pressure from Wall Street activists and shareholders that want a good return, but you have seen a lot of companies do this over time. Some have done it proactively, probably United Technologies is one example. They split into Carrier and Otis, and they sold off Sikorsky, and they broke themselves up and made themselves more focused and more efficient, trying to really drive value in their focused niches. They can find a home for the more commodity businesses that maybe makes more sense for somebody that could get more scale and drive their flavor of value out of it.

*"Customer captivity is probably the nicest way to say strong pricing power... a lot of these industrial behemoths have tried to get rid of their commodity-like products and focus on where there's more value add, where there is an economic advantage or some level of differentiation."*

**KN:**
Conceptually, a lot of companies talk about being a small piece of

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the overall component of the widget. The vast majority, maybe 90% of that, is not useful, because they are a commodity piece. But, when you're a non-commodity piece, in a small component of a widget, there can be real pricing power there. For instance, let's say the widget is a $100, and the widget maker increases prices by 5%, but you are a $10 piece of that widget. You can increase your prices by 20-25%, while the more commodity parts would not get those prices increases. This is why it is very attractive for folks like AMETEK and some of these other companies that are niche-y.

**KF:**
Yes, and if you look at AMETEK's margin progression over time, it's a drumbeat of very modest margin expansion year in and year out. They have good incremental margins, and they really work hard to keep those incremental margins. So, if you look at the financial history, you can see a very steady, albeit slow, increase in overall consolidated margins.

**G&D:**
Absolutely. Could we turn to Copart? This seems like another business with great margin expansion over the last three years, over 17% compound value growth rate. Could you tell us a little bit more about the story here?

**KF:**
Copart goes back to one of the first things I said about the sell-side. When I first started this strategy, I wanted to be open to any kind of new ideas. I had the industrial lens and a bit of a consumer lens, but I wanted to be open to new areas that could meet our criteria. I had a couple of automotive analysts come in,

> ***"When you're a non-commodity piece, in a small component of a widget, there can be real pricing power there... This is why it is very attractive for folks like AMETEK and some of these other companies that are niche-y."***

experts, 30-years veterans of Wall Street, and asked, "hey, is there anything that meets our criteria on automotive?" There were a few auto parts names that maybe had some niches. The OEMs were a little tough. But, then a couple of them said, "Well, I don't really have anything that's really strong in this universe, but there is this auto salvage industry. We do not really cover them, but you may want to take a look."

I took their advice, and I started digging into the auto salvage industry. There was a little name in there called Copart. There is now a second name, IAA, which was just bought by Ritchie Brothers. However, it turns out that Copart is a family run company that was consolidated and built up over a couple of decades by the family founder. He wrote a book called "Junk to Gold". The culture of the business was strong. He was a veteran, and he was extremely passionate about running this business really, really efficiently. The industry structure kind of evolved into a duopoly, and it had very good returns.

I wondered why sell side investment banks were not covering it, and I knew the answer right away. It's the same reason why they all covered the telecom industry – if you are not self-financing, Wall Street needs you to do deals and transactions and investment banking fees. This particular industry was self-financing. There was so much free cashflow that there was no need for any debt or equity for most of the industry. As a result, Copart was kind of neglected. It had minimal coverage or promotion from the sell-side. When I started running the numbers on it, I thought, "Wow, the returns are phenomenal." More than that, you had a management team that was founder-family operated with a long term view on intergenerational wealth, which impacted the decisions that they

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would make on capital spending. For instance, whether the decision was to open up a new yard, invest in technology, invest more geographically, they were extremely disciplined with their hurdle rates. They also are one of the few companies, even to this day, that thinks like Buffet, as if any investment would be one for the next 50 years.

This company is buying a yard somewhere in a municipality that is going to house all kinds of cars wrecked from a natural disaster or a hurricane. All the cars have got to get towed to some lot, and Copart has these lots, and they have massive, massive market share. This speaks to having a small cost to the customer, which are the insurance companies. The insurance companies just want this problem to go away. They want, when someone calls with a wreck, to get these claims processed, satisfy the customer, get it off our books, figure it out, and move on. To do this, they liquefy the salvaged vehicle, process it and hand over the check and be done with it. That is the insurance companies, and they are not necessarily trying to optimize every last nickel. They are trying to get the transaction done with the least amount of frictional costs that they can.

**KN:**
And it is important to note that Copart never takes ownership of the vehicle. They do not actually take the VINs, they facilitate it. As a result, they are still asset light, aside from the land. They just facilitate the sale between the insurance company, who now owns that vehicle and is selling it to the next person who will take it. These vehicles might even go to other countries, where a salvage vehicle here is not a salvage vehicle there.

**KF:**
Exactly. What I just described is the front end of the business – "okay, you have a wrecked car, and these guys have the yards, they have the systems, they have got the tow trucks, they have got all the processing capability." Now, there is a whole other end of this business, and that is the customers – "Where are these cars going to? What are their relationships?" Copart has an incredible network effect of automobile salvage auctions. They went online with this part of the business about 10 years ago, before anybody else really went crazy online. This gave them access to an entire world of auto rebuilders.

Around the world, you have a lot of foreign countries, where they will take a flooded car or a partially damaged car that we might not be able to get on the road here today without a lot of cost. Those cars are all over emerging market – Eastern Europe, Middle East – where people are much more economically sensitive about just getting any type of reliable automobile. Copart really has built a formidable beachhead into the customer network. They run these auctions on a continuous basis where they take a commission, and they have a superior distribution ability.

Between the two ends of the business, they are taking a commission from the insurance company, and they are taking a commission between the buyer and seller without taking title, without taking any risk. They do it very efficiently and very, very quickly. On top of that, there are only two companies in town that really do this on a large scale . As a result, they have a very, very good industry position, and very efficient operations with a network effect. And finally, they have this family ownership and shareholder alignment initiative that

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***"Copart has an incredible network effect of automobile salvage auctions... They went online with this part of the business about 10 years ago... This gave them access to an entire world of auto rebuilders."***

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is very disciplined in capital allocation. Put it all together, and I think you have an incredibly good franchise and incredibly good runway for above average value creation over the long haul.

**KN:**
And before everyone starts saying, "Oh, but it's trading at 32 times earnings, how can you justify that as value investors?" This gets back to that capital allocation piece, Copart trades at 32x what consensus thinks the next 12 months EPS are. We are looking at four or five years out, and we ask ourselves how much cash can it generate, what can they do with that cash, and what can their earnings be discounted back to today? We are not paying 32 times for it. We would not tell you exact price that we think we are paying for it, but it is definitely not trading at 32x what we think earnings will be That is how we can still justify that.

**KF**:
One of the things that we do with free cash flow, for the types of companies that we feel have earned this right, is give companies credit for reinvesting that free cash flow wisely. What that means is a reasonably decent return on that excess free cash over time. Sometimes, we do not know exactly what it is going to be. In the case of AMETEK, we are reasonably confident it is going to be another niche-y industrial company, if they can find it, and integrate it, and identify it, and not overpay for it. They have a 20-year track record, which says they will continue to do this successfully, but those are the types of companies that we tend to invest in. With Copart, we think they are going to continue to find great opportunities to reinvest their free cash flow at attractive rates.

**KN**:
Because the market is still so big, there are still markets that they are still not in. That leads to the kind of growth-y piece of it, but we're actually putting fundamental analysis and numbers behind that.

**KF**:
In terms of lessons, it might be good to discuss IAA. In this case, we took all the knowledge that I just shared with you on Copart and applied it to the number two player in the industry, IAA. IAA started as KAR, but it was not available to us to buy until it became separated. Once IAA was free and clear to invest without the parent company's involvement, we spent a fair amount of time trying to understand what their game plan was.

> ***"With Copart, we think they are going to continue to find great opportunities to reinvest their free cash flow at attractive rates… there are still markets that they are still not in."***

**KN:**
When talking to management, they always claimed that they were undervalued within KAR. They also said that because they were now a separate company, they could really achieve what Copart has.

**KF:**
Exactly. And there was a massive gap, one of the largest gaps that I have ever come across in the return profile, the margin profile, every possible metric. So, now, the newer IAA management team felt as if they were free to chip away at the gap, they had with Copart. We spent a fair amount of time, had a number of calls with them to understand their strategy, and we believed them. However, we believed them without yet seeing tangible actionable evidence. That was a mistake because it did not work out. They kept on losing share, efficiency was not showing up in the financials.

**KN:**
In fact, it was almost opposite that. We talked to the CFO a number of times, and the results were the opposite of what he was telling us.

**KF:**
Yes, and so that position

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did not work out. Eventually, we got frustrated and bailed. They did get acquired by Ritchie Brothers, and that did not really make sense. In the end, they did get taken out, well under what we thought it could theoretically be valued at.

The lesson learned is what they always say, "Watch what people do and not what they say." Or, on the other hand, wait for more evidence that there really is a change. In other words, if we are going to make a bet based upon a change, there better be a demonstrated track record that supports our bet. And there better be a tangible commitment, not just guidance from the CFO or the person that we are talking to. That commitment has got to run deep, because the CFO may have been telling us what he or she really wanted to do and what they really believed in, but if they did not have the support of the CEO, and the rest of the company, and the board in implementing these changes, then that is not good enough.

**KN:**
Yeah, and so that is a big change. Tying it back to Copart – it is the number one player, but one of the reasons why is that it has the biggest network to reach the sellers, and that just feeds on itself. It is almost like a Facebook effect, where IAA has a strong network, but it is not nearly as good as Copart's network. And, so what we found, and I don't know if this is new in the last 10-20 years, but generally, the top performers stay the top performers. The biggest mistakes we have made is saying, "hey, this is an undervalued cheap company. They could just improve slightly." We have a whole laundry list of companies, and even using what we say are conservative numbers in general, it has not worked out.

*"The lesson learned is what they always say, 'Watch what people do and not what they say.' Or, on the other hand, wait for more evidence that there really is a change."*

**KF**:
And, just to give you an example of that, there are these auto rebuilders that will rebuild a Porsche 911 in Germany or elsewhere. If you go to Copart's website, and there is a certain model of 911 that has been in a wreck and you want to rebuild, you may want to buy this wreck for 20 grand and rebuild it and sell it for 150. It would be nice to look at 80 of these instead of three. So, Copart's has that critical mass and that scale advantage.

As a result, if you are the rebuilder, you want to be a Copart member, which costs fees for an annual membership. There is kind of this networking effect that they have, and this moat, and it does feed upon itself. This makes them very, very strong. It is hard to see anybody wanting to break this up. I mean, the risk is what happens to EVs and what happens when AI controls all of our automotive movements, and there are no wrecks anymore. There will still be natural disasters, but there might not be as many crashes. That is a long-term risk. It is probably a long-ways off before that becomes a serious risk.

**KN:**
Tying it back to Bruce's book – when looking at Copart or IAA, and we did this before we were investing in it, we flipped the auto industry, taking a car from its parts all the way down to its salvage. It gets less competitive as you get further down that value chain. You have massive amounts of parts suppliers to OEMs. You have hundreds of OEMs, then you have the secondary market, which is your CarMax, you have your Lithia Motors, and things like that. Then you have private sales, the auto stores, and then you get Copart. There are higher returns the lower down that funnel you go. You can really map out industries that way and kind see where the value is .

**KF:**
There is this triangle that Kevin’s talking about. It’s kind of a duopoly at the end of, but it is an

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inverted pyramid. At the beginning of the life of cars, there are probably a hundred global automakers, and then there are thousands of people that make auto parts around the world as suppliers. Then, when you get to the end of life of the car, and it gets salvaged, there are two and change in North America. So, it is kind of an inverted pyramid industry-structure wise.

**G&D:**
I think that inverted pyramid is a great way to capture the high barriers to entry. And, as you mentioned, it's a duopoly essentially, so it seems like it checks off a lot of boxes for being a great investment. You did highlight a long-term risk for the company, but is there a near-term risk that you guys would highlight?

**KN:**
Yes, I mean, valuation has very often been a risk. People look at the multiple, and if there is any kind of slowdown in the fundamentals, a slowdown in accident rates, a new technology, less teenagers on the road doing silly things, then that can kind of cause some multiple compression. We do not really try to predict that.

I cannot remember the last time they did a massive buyback. They have a huge amount of cash on their balance sheet. They are net cash. They are extraordinarily patient. They will buy back stock when it becomes really, really attractive. They have done it in the past, so there is some risk of, "Well, what are they going to do with this capital?" We think they are just going to be incredibly patient with it and do the right thing for shareholders, but that is a risk. But the bigger risk is any near-term fundamental pressure from accident rates, causing disruption and the multiple to compress. But again, as Kevin said, we have got our own proprietary earnings estimates five years out, and we do give them some credit for good capital allocation. We think there is still a good amount of upside here and a great amount of above average growth algorithm.

**KN:**
And Kevin just highlights something that is interesting – for the companies, like a Copart or an AMETEK, that are the really, really good ones, there are maybe only four, five, or six in the S&P 500 that can do this. Where, when they have short-term pressures, and have the ability to act in the investor's favor. What I mean by that is they have the ability and will buy back shares. So, you are being compensated for future earnings because they are buying back shares now, which will increase EPS on your behalf. So, you do not even need to take much action because there are companies that will do that for you. Not every company will do that, but when you find those companies, it brings down the risk.

**KF:**
Yeah, there's this concept in industrials. I always ask them, "Can you give me an example of periods when you have invested the capital of the company counter-cyclically?" Which means, when the cycle is terrible, are you leaning into it? Very few companies can do that, or the ability and willingness to actually do it, and Copart is one of them.

**KN:**
Because you have to be conservative on the good times.

> ***"Very few companies can [invest capital counter-cyclically], or have the ability and willingness to actually do it, and Copart is one of them… you need to have a good balance sheet to do that."***

**KF**:
Yeah, and you need to have a good balance sheet to do that, and you need to also have a really good view of your long-term intrinsic value and be willing to act on that. So, very few companies can do that, and they are one of them. We just don't know when that time's going to come, but when it comes, I'm cheering for it. I'd love for the

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multiple to come in and come in hard because I think we are going to be fine.

**G&D:**
Right, yeah. We covered two investment case studies, and you covered IAA as a lesson learned. Do you have any advice for students?

**KF**:
This fundamental analysis world is under a massive amount of pressure from passive, and so, anyone that really wants to go into this world of security analysis or fundamental investing has to have a huge amount of passion for it. You have to really love it. You cannot be going into it just because you heard your friends are going into it, and you think you can do well, because I think this pressure is going to be here for a long, long time. And you really need to have the skills and the fortitude to maybe live through some difficult times in your career. You have to absolutely love what you do. You have to have an incredible thirst for knowledge, curiosity, and ability to adapt. Not change your core principles, but like Kevin said, Bruce Greenwald is very good at doing this – if a thesis is wrong, you may have to eat some crow with the right data and maybe change your mind without taking it personally. Being very unbiased and analytical when the facts change. That would be my biggest advice. And then, a lot of people say this as well – you really have to figure out what your personal philosophy is. What really resonates with you are really good at? And then you have to make sure that is in alignment with the firm that you are in.

*"You need to have a really good view of your long-term intrinsic value and be willing to act on that. Very few companies can do that, and [Copart] is one of them."*

**KN:**
To add, I think we all want you to succeed. All alumni want you to succeed. We need more intellectually honest people on Wall Street. Your first job likely will not be your last job. You want a 30 to 40-year career, and you are not likely going to be at the same job the whole time. So, your first job is your first job. Learn as much as you can. Once you cannot learn anymore, keep moving and do not be afraid to move when it is not working out.

**G&D:**
Walk us through a typical day in the life. How do you allocate your time? Has that time allocation changed over the past few years? What do you do more or less of compared to when you started working in the industry?

**KN:**
I glance at the market headlines in the morning, but the thing that has changed the most is that I spend most of my day trying to understand the long-term fundamentals of a company. Early on, I spent a lot more time reading the Wall Street Journal and New York Times and watching financial news, but ultimately, for me and how we invest, I do not think that adds too much value. Most day-to-day news is just noise, and when you are trying to buy a company and truly hold it for 5-10 years, the vast majority of daily news does not matter.

**G&D:**
What are the things you do on a regular basis to improve as an investor?

**KN:**
The cliché advice is reading, ice baths, meditation, and mindfulness, etc. I do think anything you can do to clear your head and expand your thinking can help. But ultimately, that will be different for everyone, and the one thing that I think separates good investors early on is to study as many companies and industries as possible. Folks like Kevin Fogarty, who have been doing this for almost 30 years, have a vast amount of knowledge and experience to draw from in making decisions. The more time you spend studying and understanding companies and

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journaling about your thoughts in real time, the better you will be. It is great to take victory laps on winners but understand what went wrong on your losers as well.

**G&D:**
What do you like to do for fun outside of investing? Any fun/ unique hobbies?

**KN:**
I really enjoy golfing and watching the Phillies and Eagles, but I also have a 5-year-old son, so most of my free time revolves around supporting him and his activities.

**KF**:
I love traveling with my family, skiing, and waterskiing. I'm a National Ski Patroller and enjoy gardening and making homemade artisan pizzas in my backyard pizza oven.

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