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# Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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Issue XXIX

Winter 2017



**Michael  
Blitzer '04**

**Guy  
Shanon '99**

## Kingstown Capital Management

Michael Blitzer and Guy Shanon are the Managing Partners of Kingstown Capital, a value-oriented investment partnership that focuses on special situation securities across the capital structure. The firm was founded in 2006 with strategic backing from Gotham Capital and currently manages \$1.8B. Michael and Guy both hold

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**Rupal Bhansali**

## Rupal Bhansali of Ariel Investments

Rupal J. Bhansali is executive vice president of Ariel Investments, a money management firm headquartered in

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## Simeon Wallis of ValorBridge Partners

ValorBridge Partners, a private holding company founded in 2004, owns, operates or is an active investor in several private companies; it is also a passive investor

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**Simeon Wallis**



**Jared  
Friedberg '99**

## Jared Friedberg of Mercator

Jared Friedberg is the Founder & Portfolio Manager of the Mercator Fund and the Managing Partner of Sycamore Advisors. Jared was previously Co-Founder and

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## Studness Capital Management



**Charles  
Studness PhD '63**



**Roy  
Studness '06**

Charles began his career teaching

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## Welcome to Graham & Doddsville



Meredith Trivedi, the Heilbrunn Center Director. Meredith skillfully 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. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.



Professor Bruce Greenwald, the Faculty Co-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.

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We are pleased to bring you the 29<sup>th</sup> 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 fortunate to speak with seven investors from five firms who provide a range of perspectives and investment approaches. All of these investors benefit from applying fundamental research to specialized investment areas that other funds cannot explore.

**Michael Blitzer '04 and Guy Shanon '99** of Kingstown Capital Management return to discuss the benefit of longer time-horizons in special situation investing. The team discusses the evolution of Kingstown's strategy since our last interview in 2010. Additionally, they share insights regarding complicated and overlooked situations, including international privatizations.

**Rupal Bhansali** of Ariel Investments shares her perspective on applying fundamental value in-

vesting to international opportunities. The CIO of International & Global Equities applies the lessons of Warren Buffett as well as George Soros, whose concept of reflexivity is critical for understanding financial crises.

**Simeon Wallis** of Valor-Bridge Partners discusses the unique opportunity to redeploy cash flows from the company's primary portfolio company, ApolloMD, into public and private investments. This flexibility allows the organization to beneficially allocate capital to the most attractive opportunities and to share valuable insights across asset classes.

**Jared Friedberg '99** of Mercator shares how a family office can use its permanent capital to benefit from special situations and long-term compounders. Additionally, the company can creatively invest across the capital structure, to find value "obscured by complexity."

**Charles Studness and Roy Studness '06** of Studness Capital Management demonstrate the benefits of investing in negatively correlated industries: utilities and banks. The

family of investors combine their industry specializations to invest opportunistically in these two domains.

Lastly, we continue to bring you pitches from current students at CBS. CSIMA's Investment Ideas Club provides CBS students the opportunity to practice crafting and delivering investment pitches. In this issue, we feature ideas from the 2017 Heilbrunn Center for Graham & Dodd Investing Stock Challenge and the 2016 Darden @ Virginia Investing Challenge. Zach Rieger '17, Alexander Levy '17, Abheek Bhattacharya '18, Harsh Jhaveri '18, and Ryan Kelly '18 share their ideas for Foot Locker (FL), Axalta Coating System (AXTA), and Cardtronics (CATM).

As always, we thank our interviewees for contributing their time and insights not only to us, but to the investment community as a whole, and we thank you for reading.

- G&Dsville Editors



**Prem Watsa and Ajit Jain pose for a picture at the 26th Annual Graham & Dodd Breakfast**



**Regina Pitaro '82 with Professor Bruce Greenwald enjoying the G&D Breakfast, held at The Pierre Hotel**



## 26th Annual Graham & Dodd Breakfast— October 28, 2016 at The Pierre Hotel



**Columbia Business School Dean Glenn Hubbard addresses the crowd**



**Professor Bruce Greenwald, Prem Watsa, and VJ Dowling share their views at the G&D Breakfast**



**Professors Tano Santos and Kent Daniel in discussion at the G&D Breakfast**



**Ajit Jain and Mario Gabelli '67 pose for a picture**



**The crowd listens to Professor Bruce Greenwald, Prem Watsa, and VJ Dowling discuss this year's theme: *Finding Value Through Specialization***



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## Kingstown Capital Management

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**Guy  
Shanon '99**



**Michael  
Blitzer '04**

**MBAs from Columbia Business School where they participated in the Value Investing Program and have taught Applied Value Investing as adjunct faculty. Michael currently serves on the Executive Advisory Board of the Heibrunn Center.**

### Graham & Doddsville

**(G&D):** How did you both meet and how did the fund get started?

**Michael Blitzer (MB):** Guy and I have known each other for a very long time. We both went to CBS. I was '04, Guy was '99. We didn't know each other while we were at Columbia, but at that point AVI [Applied Value Investing] was a very small network.

**Guy Shanon (GS):** So everyone knew each other from different years.

**MB:** Guy's class had six people. They were the only six people at Columbia who were interested in value investing – it was 1999. There was no AVI. The program really grew from there.

**GS:** Our initial investors and employees came from that network of students and professors.

**G&D:** We last spoke with you in 2010. How has the fund changed since then and what have you both learned?

**GS:** The fund has grown but the strategy and portfolio structure are exactly the same. We still run a long-biased and concentrated portfolio of special situation securities across the capital structure.

Most of these securities are in the \$1B to \$10B enterprise value range for both equities and debt, though credit securities can be smaller. Being bigger also gives us research resources and access we just didn't have when smaller, and the structure of the industry is making it harder for very small funds every year.

**G&D:** Why have you focused on that particular size?

**GS:** I think one of the things we learned is that it is not so easy to make money with super small caps. You see a lot of questionable management teams and very low quality businesses which have not become bigger for what are usually good reasons. Then of course you have all of the extreme technical aspects, like if liquidity dries up that makes it even harder. Yes, there are sometimes great opportunities, and we look at small caps all the time, but they aren't giving it away by any means, and focusing exclusively can be a tough way to make money over long periods of time.

We don't think of ourselves as a big fund, and we think we can make the best risk-adjusted returns in the size range we currently target. The current portfolio runs the gamut from \$300mm in market cap to \$50B, so the range is wide and we look at everything. But the sweet spot tends to be this middle range which are small enough to still experience the technical factors that often lead to security mispricings but large enough to have quality of business and management. This size also tends to have a larger pipeline of the special situation categories we track like spin-

offs and distressed debt.

**MB:** Also, there's a big, timely debate right now about active versus passive investing. Passive has come into a lot of popularity. When we started twelve years ago, we maintained the premise that the markets are very efficient. Our strategy is to be exclusively focused on very small pockets of inefficiency within what is, generally, a very efficient market. We have to have the flexibility to go after companies that are smaller than \$10B or \$20B

**GS:** And don't have twenty sell-side analysts covering them.

**G&D:** As the number of special-situation funds grew, how has this impacted Kingstown? Have you been able to maintain an advantage?

**MB:** The longer we do this, duration of capital and time horizon has actually become more and more of a competitive edge. We've always defined the strategy as kind of having a medium-term time horizon, generally one to three years. These securities tend to have larger mispricings. A typical example is a situation that has a known or likely catalyst but unknown timing—you know it will happen sometime in the next three years, but it could be tomorrow or it could be years from now. Given the structure of the hedge fund industry and the structure of capital, this sort of patience becomes harder and harder over time unless you align yourself with long-term capital. So we're clearly shorter-term focused than a private equity firm. But

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there are very few investors in the public markets right now who can take a one to two to three-year time horizon. Most can hardly take a month or a week. To take advantage of most of the mispricing, particularly in the special situation space, you have to have that kind of runway. Also there is a lot of capital coming out of event-driven strategies, which overlap somewhat with what we do, this is very good for us.

**GS:** In the past twelve years since we started, time horizons have become a lot shorter. As students at Columbia and with the value-oriented internships you've had, you might not fully appreciate the low tolerance for volatility. If you go to some of these large multi-strat funds, time and volatility are very relevant because they're running massive amounts of capital. In fact, they've attracted so many assets because they manage volatility so tightly. If you went to work there as analysts and you drew down a couple of percent in a month, you get stopped out. But then what do you do with that cash? You have to find another trade tomorrow – is that better than staying with the business you owned the day before? It just feeds the volatility. I think the fact that we only focus on very specific special situation categories also makes us unique. We don't do risk-arb for example. We are just looking at certain areas where we know there are chronic mispricings. A lot of fire directed into a small area. That is what we do. And we have been doing it for a while and it works, and we get better at it every year.

**MB:** In addition to size and duration of time horizon, it's also been concentration. We run a fairly concentrated and flexible mandate where we look across industry, geography, and capital structure. We think it is also a big advantage that we can evaluate the risk-reward across these different areas and pick our spots very precisely. Then obviously we combine all of this with what we like to think is a fairly deep research process. But you can only do that level of research if you're concentrated. When you group it together, these things differentiated the firm initially and have been consistent through the life of the business.

**“...risk and volatility are very different. A lot of the returns that we've made have been either averaging down or buying things that were down.”**

**G&D:** How did you develop and cultivate an investor base that allows for your strategy?

**GS:** From the start, we've been very conscious of the importance of having the right partners. I think it mostly came from some humility. We understood that it is very hard to beat the market and you need help from your structure and partners. You have to match the duration of your capital with your investments. Going back ten years, we've turned down money from people that didn't share this

approach. We've never had a formal IR effort. You end up with a certain type of partner by way of hiring a professional marketing person. We have personal relationships with all of our partners. We spend a lot of time talking to them about how they think about investing. Not surprisingly, most of our partners have a value bias in their portfolios. But investment philosophy aside, a direct relationship with partners creates more transparency for them and keeps the alignment of interests very close; sometimes having a marketing person between us inserts another agenda into the mix. We think our approach is best for our partners' returns over the long run.

**MB:** It's just taken time and a lot of energy invested in getting to know our partners and how they think about investing. We've gone through periods where, for many years, we didn't talk to anyone about new capital. We also learned by watching what didn't work for other funds. But ultimately this has led to a small group of partners who have stuck with us over time. And with less time spent on marketing and investor relations, there is invariably more time spent on investing and the portfolio.

**G&D:** Going back to volatility, how do you think about risk in your investments and how do you exit positions that are going against you?

**MB:** We mostly define risk as permanent impairment, which I think is very different than most people who view it in terms of volatility. We take the approach that risk and



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volatility are very different. A lot of the returns that we've made have been either averaging down or buying things that were down. On a short-term basis, it's very challenging to time tops and bottoms. I think a lot of people have failed doing that. One of the approaches of having a longer-term strategy and longer-term capital is that you can withstand those periods of volatility and take a view over a number of years.

Having said that, being very patient and permanent impairment often become the same thing eventually. We take the approach here that we are re-underwriting every single position every single day. If the facts change, we have to be intellectually honest and reevaluate that, otherwise you are just hoping. It's a combination of research and portfolio management.

**GS:** It's easier said than done, but when something is going against you, you have to fight off the urge to ignore bad news. As Mike said, be brutally honest with yourself whether or not what you thought was going to happen actually did happen or is happening.

Over the years, a lot of our former students have asked us about starting funds and how we would evaluate somebody who is starting a new fund. I think there are three parts. There's being a good analyst, and then there's being a good portfolio manager, which is actually a pretty different skill set. Then there's the third part, which is temperament. The big intangible. There are a lot of people who have one of the three or two of the three,

but it's very hard to have three of the three because it's a mixture of a bunch of personality traits that are not often on the same gene. But you need all three.

Part of temperament is being able to be self-critical. Many people in this industry have been very successful all their lives. They have always been at the top 10% of everything they have done. All of a sudden, a position is going against you and you have to really break it down and be honest with yourself. Or you have to take a view that is vastly different from what the "smart" people are saying, what your smart friends who are making money this year are saying. A lot of people have never done that before. You have to be very critical and skeptical all the time, but also know when not to be. And how you go about that has a big impact on performance over time.

**MB:** You have to put up walls and blinders to eliminate behavioral biases when these things happen. Of course, when something goes against you in a meaningful way, the market is usually not that wrong. At the very least, it's down for a reason. Stepping back and understanding what that reason is. I think the only way to do that is through a constant re-underwriting process and a diligent research process.

**G&D:** Do you have any formalized systems or processes in place to eliminate these biases when making tough decisions, like a "pre-mortem"?

**GS:** Thinking, Fast and Slow is

a great book. We've both read it. I read it over and over and I'm still learning, it's not exactly beach reading. But we don't have any formal framework. Anyone who says that they do, that's more of a marketing gimmick. We're very aware of the behavioral stuff, it's important. It is possible that managing our own behavior effectively is the single most important thing we do as investors in public markets at the end of the day.

**MB:** Also the analysts here know that they're not going to do well unless they start with the risks and the downside. Before we figure out how much we can make in an idea, we have to discuss what all the possible risks are that may or may not happen. I am not sure if I would call that a "pre-mortem."

**GS:** Pre-Mortem? We see that term a lot, it's part of a checklist that people interviewing for jobs have decided they need to have in anything they write, it has become part of hedge fund analyst culture, like it's some kind of innovation. But really it's common sense—if you are going to put a substantial amount of your net worth at risk, wouldn't you think through how it could go terribly wrong, and what the first signs of that would be? The answer is yes, and it's probably a good idea to write it down.

**MB:** It's also a little naïve. When most people have lost money, us included, it is often not from any of the twenty possible risks you listed in advance. When the bad outcome happens, you'd be

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shocked how often it was related to something that wasn't on your original list.

For us, this is why it all comes back to valuation. Being a good investor requires you not only to be wrong in ways you didn't anticipate and still not lose a lot of money. I think the only way to do that is to buy things very, very cheaply. For most investments that haven't worked, we have been very wrong on a number of things and still not taken a large impairment.

**GS:** I think that's called "margin of safety." The closest thing we have to a formalized process is our emphasis on written memos. For any position of a decent size, we write very detailed memos. We date them and we update them, so that six months or eighteen months later we can go back and see what we thought was going to happen. From a psychological standpoint, you can play all kinds of games if your investment ideas are all in your head, which is bad for performance.

**MB:** It also makes you refine your thinking. By writing something down you are forced to focus your thoughts in a way that verbally you cannot.

**GS:** Yes many times I have had this experience: I decide I like something, then I write down the bull and bear cases for it, go back to it a few times over several days, adding things, and then I think, you know what, I don't like this so much anymore. Writing things down brings more precision to your thinking and helps in the

process of weighting factors. Often we all have very similar information, but the rub is, how do you weight it differently in a decision to get better outcomes, that is the Kahneman stuff too. You should get better at that every year and as you live through more things. But then again, you don't want to be over-influenced by an unusually good or bad experience, because outcomes are more like the mean than the exception—again, Kahneman.

**G&D:** Would you mind walking us through an investment from the screening and search process to actually putting capital to work?

**GS:** As we discussed earlier, our view has always been that the markets are very efficient. They get more efficient every year. There are lots of smart people out there working on lots of names. We have to ask ourselves, "Well, how are we going to make money in a market that is generally efficient? How are we going to do it consistently?" Anybody could do it for a short period of time.

We have to look in places where there is chronic mispricing. You have to keep looking in those places over and over again. You have to keep the fund size small because the bigger you get, the fewer places you can look. All we do is look at a couple of areas of special situations. We look at every spin off. We look at every bankruptcy or stressed credit. We look at every rights offering. We look at every privatization. Anyone can get a list of these, but we are really, really looking at

them, pulling the threads for a thesis that might be missed by most others.

If you just keep looking at these categories and you own the good ones, unlevered and at good valuations, and you can be a little patient, you have a good chance of outperforming in the market.

***"...we want to be right there on the front line. If one of our investments is not working, we can be decisive and we can make a decision that we can live with."***

How does an idea go from there to the portfolio? I think we are unique in that we screen for situation first, not valuation. What you might find is that a lot of value guys will just look at the new lows list. There are reasons that's dangerous, the biggest being value traps.

First, we look at the situation and see if there is somebody stampeding out of the stock or bond. Do we understand why? Yield breaks are good examples. Every time a yield equity or credit is downgraded, there are obviously structural reasons why people have to sell. That will pique our interest.

Then we'll start looking at valuation on an absolute basis, to the enterprise. We don't use relative valuation here. If the valuation on an absolute basis is cheap, then we start doing fundamental research,

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which includes a lot of primary research. And the primary research is something we have gotten better at over time, it's something you only improve at by doing over and over and figuring out ways to gather but also prioritize information.

If it's a liquid equity, we're not in a rush to buy it. We'll have a fully blown research process first. We've met with management, interviewed a large number of former employees, done a lot of work on business competitors. We'll do that before we own it.

Credit is different because it's such a choppy market. Sometimes we'll own credit when we're pretty sure it's good. We're 90% sure, but we have to take advantage of the liquidity at that moment and then we'll backfill our work. You also have more structural and legal protections here if you are wrong. Generally, we're fundamentally driven and we know the investments very well before we buy them.

**G&D:** Is a position fully sized at this point in the process?

**GS:** A lot of times what we're doing is averaging down because we own something and it's the exact opposite of momentum. So we save room to average down.

I think we are also unique because Mike and I work on the names with the analysts. The two of us are intimately familiar with everything in the portfolio. I think that's important because at a lot of funds, if a name goes against the portfolio manager and he or she is reminded they just don't know much about it.

Then they look to the analyst and ask, "Is the analyst good?" Then they start thinking about the idea in the context of the analyst. "How has the analyst done recently?" This actually reduces to a kind of momentum that analysts get inside funds, which influences investment decisions and is kind of crazy when you step back and think about it. We are trying to reduce the behavioral stuff between us and the idea, and want to be right there on the front line. We want to be fully informed and decisive. We don't have to wait for a committee meeting or consider the internal politics of an investment decision, because we have neither of those.

**G&D:** Do you have an investment idea you want to share?

**MB:** Our largest position right now is Adient (ADNT). ADNT is the largest manufacturer of auto seating in the world and virtually every auto company is a customer. Johnson Controls (JCI) spun out the company in October of last year. From an initial search process, it's an example of something that struck our interest given the structure and nature of the spin off. It was a much smaller subsidiary, it was in a different industry, and it was an underinvested business of the parent.

It's also a very misunderstood business. Like many of its auto part competitors, it's viewed as a very low quality and cyclical business and thus not favored by JCI investors. This bias along with a lot of forced selling, because it is no longer part of the S&P 500, pushed

valuation to approximately 4x to 5x earnings late in 2016. But, if you look at the company, there are many competitive barriers to entry in an industry dominated by two main players and the business is actually more of a high-return just-in-time logistics provider and supplier than an old-line manufacturing company. The prior Vice Chairman of JCI is the new CEO of ADNT. He has a very significant compensation package that he converted from JCI that we think aligns well with future growth opportunities.

Incidentally, one of the biggest knocks against ADNT and a lot of the auto companies is the disruption and potential change in the industry. But ADNT is a big beneficiary of the move to autonomous vehicles. Number one, they have a position with every single manufacturer. So, regardless of how market share changes with autonomous driving technology, they're—bad pun—going to have a seat at the table. ADNT and Lear (LEA) control a majority of the global market. As these vehicles become more autonomous over time, one of the big differentiators is going to be the interior package, and seating is the biggest component of that.

We like the business a lot. In an equity market that generally is pretty fairly to over-valued, it's unusual to get an above average business for a third to a quarter of the S&P P/E multiple. But I think it also fits in well to what Guy was saying about the search process: how the name was identified, what we like about it, why it was

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Elizabeth Gao '17, Maria Muller '17, and Maryam Badakhshi '17 celebrate at the The Heilbrunn Center for Graham & Dodd Investing Stock Challenge

mispriced, and how that flows through the process.

**G&D:** How concerned are you about the auto cycle and where we sit today?

**GS:** That's the bear argument, but there are two parts to it. First, the industry is cyclical in general. Then there's the idea of a SAAR Wall. That is the classic bear argument. We don't think SAAR is going to plummet. There are a lot of people with short term trades based on where SAAR will move. We think SAAR levels out at around 17 million in the United States, but quite possibly more. Regardless, ADNT can make a lot of money with SAAR just sitting where it is right now or if it falls somewhat. ADNT also makes a good amount of revenue outside of the U.S. The dynamics of production in Europe are different. There are reasons to think that production can grow in Europe. Also, even the skeptics say that China is going to grow car sales for a long time, and ADNT is generating a good amount of its cash flow from China.

***"There is no investment is without risk. But paying 4x earnings eliminates a lot risk."***

The other interesting wrinkle is the growth in content per vehicle. In an extreme case, they can triple content per car in some markets over the next five or so years. Even if unit volume decreases, it's possible ADNT can actually grow sales.

They are also making real progress selling seats into non-car markets, like trains and planes.

**MB:** Units aside, the trend for interiors is towards bigger cars and higher value content. That's all to the benefit of seating. If you look at autonomous concept vehicles, the entire dash and driver display is stripped out, and the interior is basically four high-end seats like a living room. Unless people start sleeping or standing in cars, ADNT will be a beneficiary of this change. Adient also has a pretty significant opportunity to go into adjacent markets, whether it's train or aerospace or more industrial applications. They historically have not been able to invest in these areas because of capital constraints while under the JCI umbrella.

On the unit volume issue, at least in North America, there are cycles, but the growth over time is still up and to the right. It is a function of cars on the road and population. The common mistake is to look at units pre-financial crisis, which was nearly ten years ago now, and to think that SAAR has to go back to that number. But there are so many more people and units required at this point. If you look at it on a replacement cycle basis, it's unclear that even the current level of units can sustain that demand.

Yes, it is certainly a risk. There is certainly a cyclical component. But the geographic diversification and the significant tailwinds they have in content and technology and where cars are moving are major pluses.

**GS:** The reason the opportunity exists is exactly related to your question about the cycle. If you went to your PM at most hedge funds until very recently maybe, you would be told that you can't be long auto because SAAR is "peakish," in fact can you come back with some shorts here. Maybe we get some bad numbers on SAAR over the next several quarters – we aren't saying that won't happen. But this is a business that should grow sales over the next five years. As a private business that is how it would be thought of, and we try to think about it that way within the practical limits of being a public market investor.

We do have this moderately hedged because of Trump Risk. We could start having issues with Mexico or China where the Chinese get mad at us and try to penalize us with auto somehow. And, as Mike was saying before, it's always the thing that you didn't see coming.

**G&D:** Now that ADNT is independent, how will this impact the business?

**MB:** We think ADNT is going to generate \$9 in earnings this year. Their margins are a lot lower than Lear's despite the fact that ADNT is significantly bigger and there are real benefits of scale in this business which favors large global platforms supplying very large customers. These lower margins just relate to under-investment in the business while controlled by the prior parent. Management has a plan over the next couple of years to at least match Lear's margins, which at current

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volumes would take them from \$9 to \$12 or \$13 a share or more. This was a stock that got as low as \$45 in November and is still only \$60 today. I think it's a unique example of being able to purchase something with a pretty attractive growth opportunity at a mid-single digit earnings multiple.

**G&D:** Lear and Adient control most of this market. What does the competition between the two of them look like?

**MB:** It's been very rational. The good news is that they're both big public companies. They both have margin targets. It's also a business where very few awards switch between the two of them. The incumbent has such a significant advantage in this industry because winning business requires you to spend a significant amount of capital and build your plant within the physical confines of your customer. When work is re-bid, the incumbent is always going to be at a cost advantage.

The only time you see platforms switch is if there's a move in location or a massive re-engineering of the platform. Traditionally, most of the significant competition has been on new platforms. Even then, there has either been enough business to go around or the share has come out of smaller players. Outside of North America, the majority of seating is still done in-house, so there's still a big opportunity to outsource more to both Lear and Adient.

**GS:** Returns on capital for both companies are OK over a cycle, and these businesses and

the industry have changed so it's not clear that the future will look just like the past if unit volume goes down with respect to profitability – it's quite possible return on capital prospectively is much better, which does wonders for a stock price.

**MB:** Seating is one of the better auto supply businesses to be in, but there have also not been stand-alone businesses historically. Pre-financial crisis, these businesses were grouped together with a bunch of lower-quality, lower-return businesses like interiors or metals or other commodities. We are in a unique situation where you have two seating-focused companies and everyone assumes their performance is temporary and cyclical because these types of companies have never been able to sustain returns for very long. But it has always been the other businesses that have taken them down in past cycles.

**GS:** The other interesting thing is that this is a very low gross margin business, which if you were a new value investor, you might say, "Oh, that sucks, it's a bad business." But it's actually pretty good because the gross margin is mostly low because most of the costs are passed through to the customer, yet it discourages other competitors from getting into the business. With two companies that control a majority of the business in a low gross margin industry, there is not a screaming siren saying "Come compete with us." The seat, in part because it's so safety-centric, is a very important part of the car and it's also not a big part of the

cost, which also discourages the OEM from trying to kill them on price and creates some stickiness.

**MB:** There is no investment that is without risk. But paying 4x earnings eliminates a lot of risk.

**G&D:** You mentioned hedging this investment. Can you talk specifically about this and also Kingstown's overall shorting strategy?

**GS:** Our short exposure is generally zero to 25%. The majority of our hedging is where we think we can isolate industry risk. We want to be very specific, we're not looking to hedge the volatility of a particular name. We're looking to tease out some exposure that may worry us. Usually you can't do it, that's why we don't do a lot of them.

For ADNT, some of the things that we worry about will also hammer Lear and some other auto part suppliers, so we're short a couple of them. But we still have a very meaningful net exposure to ADNT.

**G&D:** Is there a component to your short book that is not paired with your longs?

**GS:** We do some alpha shorts, but we don't do a lot. We don't have a formal process for it. Sometimes in our work on longs we find something that is a screaming short. We've actually made a good amount of money in absolute terms on our shorts over time. Because, unlike a long-short fund, where you're under constant pressure to maintain a certain short exposure, we don't have to keep loading the short book

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## Kingstown Capital Management

with God knows what. If we think something is ridiculous and we're trembling with greed, we'll do it. Otherwise, we'll just do nothing. That's kind of how we think about it.

**G&D:** You tend to look for things that you feel have bottomed-out but you've also mention that timing is incredibly difficult. How do try to manage these two elements?

**GS:** We're not an algorithmic strategy, so the answer is that we just don't know and we just do our best. Sometimes we bought something all the way down and we just have to stop. Sometimes we buy something and it goes up 50% and it was small, because we never got the chance to make it big. Both bad scenarios. After doing it for a while, we just assume it all averages out. We're not going to own something unless there's some reason to think it's really misunderstood or really overlooked, and we are confident the market is wrong, that's the bottom line.

**MB:** You have to use valuation as an anchor. That's not to mean something like ADNT, trading at \$60 and 5x earnings can't go to \$45 and 4x. Things can always get cheaper, but Joel Greenblatt used to say that it's more binary. Things are either cheap or they are not. And if its cheap you should just buy it. If you can make a lot of money and you have a significant hurdle that you're reaching for, it should be pretty clear. Back to Guy's point, that doesn't mean you never can lose.

**GS:** When we say "bottomed out," we mean more sentiment

than valuation.

**G&D:** Could we talk more about privatizations and some of the unique features? Perhaps talking about specific ideas and case studies would be helpful.

**GS:** Privatizations are interesting for a couple of reasons. First, they're usually state-owned enterprises, which means that they've been poorly run. So there are usually opportunities once you get a real corporate governance structure and management incentives. Then they can take out a ton of costs or do things that should have been done ten years earlier. That is not always the case, but if you look at ten privatizations, you're going to find one or two like that.

Second, they tend to be unlevered because they were owned by the government. We hate financial leverage. We have no leverage on the portfolio. We're usually carrying net cash and most of the companies in the portfolio are not levered so that really should help us in any kind of downturn.

Third, these tend to be strong, monopoly-type businesses. It's the railroad, it's the mail delivery system, it's the electric companies.

**G&D:** The stock exchange?

**GS:** Yeah, it's companies that are incumbents because they were originally funded by the state. The international aspect is very tough. You have the currency issues. But more importantly, you're always the guy who knows the least. You're the idiot foreigner who

doesn't necessarily understand the culture and, by the time you hear about something, everybody in the country has heard about it. The bar for us to invest internationally is definitely higher.

**MB:** Sometimes you have some interesting incentives. If I take my tech company public, I want to get the highest valuation possible, because my net worth goes up. When the state owns the business, they don't necessarily care that much about the IPO valuation. They just want people to say that the privatization worked out well and the stock price went up after the IPO. It doesn't really matter what the base point is.

They're similar to spin offs in that you often have a non-economic seller, a misunderstood situation, and a number of catalysts, that Guy mentioned, for future improvement.

I don't think we want to talk about the specific name, but an investment we made recently was in a railroad company in Japan with a monopoly business in a certain part of the country. The government priced the IPO artificially low because the entire purpose and mandate for this privatization was to spur local retail ownership in the stock market which is currently very low. Their primary goal was not to raise the most money possible. The primary goal was to spur investment in the stock market by locals and to have a successful track record so they could do this again in the future.

Then you take a business that

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## Kingstown Capital Management

was being run for no profit historically, because the mandate was just to allow for cheap travel. Now, with a profit maximizing management and aligned incentives, it can lead to a business with much better economics in the future than existed in the past. But some overlook this opportunity and other privatizations because all you can see is the historical performance.

**G&D:** Outside of not finding the right valuation, what are examples of privatizations that are not good investing opportunities?

**MB:** There are big differences in the businesses that are privatized. Buying a monopoly railroad in a specific country with no competition is very different than buying the state owned oil company. Even though it may be the only oil company in the country, it still operates in a globally competitive industry.

It basically comes down to how much control the government has over it and whether the market is local or global. The last thing is related to the incentives of the government and the new management team. In the past, there have been privatizations that were vehicles for governments to raise capital from foreigners, but still maintain most of the economics without shareholders benefiting.

**G&D:** Do you have any advice for students and other people entering the industry?

**GS:** I have two pieces of advice: One, I would say it's a

good idea to listen more. Analysts in this business, they get to a meeting with management and so much of it is about promoting themselves.

***“...unlike most other professions, there's no specific experience required. My advice for MBAs is to appreciate how much you don't know...”***

Let's face it, what are you taught at Columbia or any other business school? You're taught to network and to promote yourself. Students and former students view every interaction as a way to show how smart they are. People actually spend so much of their energy in a meeting talking but very little listening. I've had so many experiences where someone comes out of a meeting and only absorbs 20% of what was said, and it should be closer to 80%. Instead of thinking about your next question or insightful observation, just listen.

It may lead to something else that is useful even months later, or stick in your head forever. These are simple things but if you want to become a good analyst, you can benefit very much from doing it. It also helps in the rest of your life. I tell myself there is going to be a test after every meeting and I need to retain like my life depends on it. It really works. Listen with your ears, not with your mouth!

Two, for interviews, we meet hundreds of people who share investment ideas and they all sound exactly the same. It's very rare that somebody comes into a meeting with some kind of actual insight. You get a unique insight because you have been thinking about this information differently or you found new information through primary research. You visited 25 stores, you met some customers, you filed a FOIA request, whatever. And it led to some kind of insight. If you can do that, you're going to have a lot more success than most of the candidates will.

Any monkey can generate EBITDA multiples and slap them on slides with bullets. More kids are going to undergraduate business school than ever before. There are thousands and thousands of people who know Excel and have taken Finance. You are not going to set yourself apart that way or be successful, and even when you get the job, these are the kinds of things you have to keep doing and get better and better at.

**MB:** It's a weird industry because unlike most other professions, there's no specific experience required. My advice even for MBAs is to appreciate how much you don't know and to find a place where you can learn but also where you share a common investment philosophy. If you don't have a common philosophy with the fund and a real passion for investing, it's not going to work. You can't fake passion and fit.

Also, given the popularity of hedge funds over the past

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## Kingstown Capital Management

decade, a lot of people have come into this industry because it's the next logical step or the way to become wealthy. It's what Investment Banking was before that. So it has attracted very high performing individuals many of whom have never experienced a setback or disappointment. But, this business humbles people very quickly and how you deal with these initial setbacks will determine success or failure. So we end up focusing on and asking about these disappointments when we interview these high performing candidates that go from the Ivy League to bulge bracket Wall Street firms then to hedge funds. The setbacks and how they have learned to think about risk and reward and their lives in general are what differentiate people in our experience.

The only other thing that we tell every person that we've hired, no matter how old or experienced he or she is, is that you have to bring a notebook to every single meeting and you have to write everything down. You'd be shocked how few people do that and how helpful it can be. You'll never miss something and if you do exactly what your boss wants you to do, it'll put you in the top 10% right out of the gate.

**GS:** Are you guys writing this down?

**G&D:** Thank you for your time.

## Rupal Bhansali

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**Rupal Bhansali**

Chicago, Illinois with offices in New York and Sydney. The firm offers six no-load mutual funds for individual investors and defined contribution plans as well as separately managed accounts for institutions and high-net worth individuals. As chief investment officer and portfolio manager of Ariel's multi-billion dollar international and global equity strategies, she oversees Ariel's New York based global equities research team.

Rupal joined Ariel in 2011 after spending 10 years with MacKay Shields, where she was senior managing director, portfolio manager and head of international equities. Prior to that, she spent 5 years at Oppenheimer Capital, where she managed international and global equity portfolios and was promoted to co-head of international equities. Additionally, she has held various roles at other financial services firms since she began her career in 1989, including Soros Fund Management.

In 2009, *Forbes International Investment Report* named her a "Global Guru," and in 2015, *Barron's* recognized her as a "Global Contrarian." Rupal is a frequent guest on premier shows such as Bloomberg, CNBC Squawk Box and Fox Business News. She is also a sought-after speaker at prestigious industry conferences including the

CFA Institute, Morningstar and Schwab.

Fluent in several Indian languages including Hindi, Rupal earned a Bachelor of Commerce in accounting and finance, as well as a Master of Commerce in international finance and banking from the University of Mumbai. She later earned an MBA in finance from the University of Rochester, where she was a Rotary Foundation Scholar.

**Graham & Doddsville (G&D):** Rupal, thank you for joining us today. Would you mind starting with an overview of your background and how you became interested in investing and got into professional money management?

**Rupal Bhansali (RB):** My background is unusual in that I have worked on both the sell-side and the buy-side, in investment banking and in investment management, on the long-only side and the long-short side, on developed markets as well as those that are emerging. I have researched scores of sectors and thousands of companies and covered close to 50 countries over the years. My varied, hands-on experiences over the past 25 years have helped me understand the ins and outs of investing from a very deep and broad perspective.

I got interested in investing because I grew up in a family of bankers and brokers. From a young age, I knew I wanted to be in finance, and that gave me a head start. I studied

accounting at age fourteen. Looking back, one of my best decisions was to start working, not only during summer breaks but also when school was in session. I did a lot of apprenticeships in finance—whatever I could get my hands on. I worked on leasing, project finance, foreign exchange, investment banking, stockbroking. Ironically, the one thing I could not get my hands on was investment management. Entering this profession is a "Catch 22." If you don't have the experience, you can't get in; of course, if you can't get in, you don't have the experience!

I was fortunate to get my break a few years after I finished my MBA. My graduation coincided with a nasty recession in 1992 so I took any job I could just to stay afloat. Luckily my job involved covering emerging markets on the sell-side and I knew if I worked hard it could prove to be my launch pad to the buy-side. At the time there was not much published research on emerging markets so I was a jack of all trades—researching ideas and writing up notes at night and pitching ideas to clients by day. Soros Fund Management was one of my clients and they liked my work and asked if I wanted to join them—I obviously jumped at the opportunity. That's how my career in investment management started out.

**G&D:** What do you think has allowed you to have a successful investment career?

**RB:** In every job throughout my career, I tried to have varied work experience and ensured I learned something

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different. For example, in my job working on leasing in undergrad, I learned how to identify when an APR is being manipulated by adjusting the residual value.

At Soros, I learned a lot about risk management and downside protection, because in the hedge-fund world, there's just much more intensity and rigor around that compared to the traditional long-only world. Because I covered emerging markets for such a long time in my career—and grew up in one—I learned a lot about dealing with crises. The one constant about emerging markets is that there's always something going wrong somewhere in the world. Your antennae go up for those events.

Covering crises in emerging markets really helped my clients in a year like 2008, when developed markets had their big financial crisis after a very long time. I had seen that playbook before and we were able to do very well by our clients and protect them during that crash. The markets were down 43%; we were down 24%. I remember getting phone calls from our clients asking "are your performance numbers correct—have you guys made some calculation error?" Turns out our performance was such an outlier amongst what they were seeing, they thought our stellar performance must have been a typo!

The other thing that was very helpful, and something that I think all investors should find a way to harness, is the power of osmosis in this profession. You really learn on the job and

from other people. Investment management and equity research are not things you can teach; they have to be learned. When you work among smart, talented people, you become smarter yourself. I chose to work in some great organizations where people were so talented that it rubbed off on me. You rub off on other people and you become a person who can make others around you better.

I'm always surprised that students spend so much time figuring out which college to attend, but when it comes to work, they don't do as much homework on their prospective employers and the people who work there. It becomes a passive exercise of looking at what job postings are available as opposed to an active exercise of finding out, "Where do I want to work and how do I get admission to my dream firm?" Figure out the kind of investment firm, philosophy and culture you want to be part of and then try to work yourself into it, as opposed to waiting for it to happen to you.

***"I'm always surprised that students spend so much time figuring out which college to attend, but...they don't do as much homework on their prospective employers and the people who work there."***

Keep in mind that investing

and learning are cumulative in nature. That foundational, formative experience is critical. You don't want to end up in the wrong place in your early years. I've seen a lot of careers end up in a dead end because people didn't choose well early on.

**G&D:** You talked about crises and how you were able to benefit from past episodes you've seen around the world. Was there something in particular that happened in the past that allowed you to see the financial crisis coming before it occurred or was it more about how you positioned yourself once you were in the center of the storm?

**RB:** Oh, no! When it comes to risk management and protecting a portfolio, it has to be a preemptive strike. There's not much you can do after the fact. You always have to be on the lookout for things that can go wrong **before** they actually go wrong. Frankly, we could see things going wrong as early as 2006 and we took proactive action in our client portfolios. We sold off a lot of our banking stocks well before people became aware of the mess in mortgages and the subprime housing loan crisis. I think that these things are a confluence of many developments brewing over time—they don't happen overnight. The Lehman bankruptcy may appear to be the catalyst but it was actually the culmination of a lot of things that happened prior. The Lehman downfall feels like a shock catalyst because in that one stark moment the systemic risk became glaringly obvious to all. But the risk was

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there all along, and it was building over many, many months, even years. You can actually see it coming if you're on the lookout for it. This allows you to prepare for it instead of being blindsided.

The challenge though is that you pay the price for such proactive risk management with inferior performance, until the risks you are worried about actually manifest themselves. If the time gap is too wide, your clients can fire you in the interim. You need courage to stay the course even if the very clients in whose interests you are acting don't see it that way at the time. Being a contrarian is not easy, but it is right.

**G&D:** What exactly did you see coming that others didn't?

**RB:** My prior experience working in various facets of finance helped me smoke out potential rip-offs. Here is one example. I remember talking to a marquee financial institution whose stock was a market favorite because they were generating tremendous fee income which investors loved and put a high multiple on. On further investigation, I found that a lot of those fees were generated by promoting closed-end real-estate funds to investors. Knowing real estate was overvalued and illiquid, I was curious why anybody would want to buy a closed end fund that itself was an illiquid vehicle! Nonetheless the company was clearly seeing a lot of demand and the facts didn't square with common sense. And that is the first clue to a scam—something does not add up. So I read the prospectus to check the fine

print, and lo and behold, they were assuming very high exit multiples on the real estate they had acquired in the terminal year of their forecast and that obviously worked out to a high IRR (internal rate of return) on the investment. They were touting this high IRR to unsophisticated retail investors who did not know or understand the difference between a forecasted IRR and an actual one. I knew this was not a sustainable business model and avoided the stock despite its apparently high growth and ROE. The stock was among the first to collapse in the financial crisis as they could no longer palm off the expensive real estate they had overpaid for at a profit and in fact had to book large losses. By the way, this is the power of fundamental research—a quantitative model cannot uncover these types of questionable business practices.

Additionally, we saw that too many people in banking were focused on VAR, or value-at-risk. Value-at-risk is a statistical construct that always appears very low when things are benign. So, if you don't understand the context, you will be misled. It's not that regulators, rating agencies, investment banks, and even investors, were not paying attention to risk. But they were being academic as opposed to practical, and single-dimensional instead of multi-faceted, and that led them to looking at a single and wrong risk metric—VAR.

We looked at other metrics and saw that leverage on balance sheets was increasing on an absolute basis, and the

off-balance sheet leverage was even greater. Investors also fell for a recency bias and assumed the ratio of non-performing loans would remain low due to benign conditions—this is a classic example of circular logic. Now most businesses can afford to make some mistakes and not have to pay too much for them. However, in the world of banking and insurance, you can't make a big mistake because you have a lot of leverage on the balance sheet. A small mistake is automatically multiplied and magnified into a big mistake through the power of leverage. And a big mistake becomes a mega mistake. If your equity is very small, you're going to get wiped out. At that point, equity is nothing but a binary option with a very, very high strike price because there are a lot of claims ahead of you. And that binary option may expire worthless!

***“Investors [in banks] fell for a recency bias and assumed the ratio of non-performing loans would remain low due to benign conditions—this is a classic example of circular logic.”***

Risk assessment boils down to looking at the right things in the right way. We were relying on the power of good research. It's not about finding the answers, it's about asking the right questions. That's what led us to understand that there was way more risk in the system and in individual banks

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than the market understood, so we actually got out of our positions and protected our clients. We didn't own a single bank that went under, and that's from our first rule of investing: instead of focusing on making money, first try not to lose it.

**G&D:** Who has made the greatest impact on your career?

**RB:** My earliest influence was my father who is now a retired stock broker and investor. He unknowingly gave me my first taste of equity markets because he used to work from his home office which doubled up as my bedroom. I grew up listening to stock stories and was exposed to contrarian investing, because he was an independent thinker. He marches to his own tune in most things in life and investing was no exception.

Remarkably, my father had the foresight to know that if his kids were going to be independent minded, they had to be given independence. He made sure there was no "helicopter parenting" imposed on us. Making decisions, including and especially tough investment decisions, comes easy to me because I have had to make and be responsible for my decisions my whole life.

The things that I learned from observing his investing career is: a) how *important* it is to be a contrarian to make money in markets, and b) how hard it is to be a contrarian. I saw the triumph of being a contrarian but also, the tribulations. It's not for everyone because it requires a great deal of fortitude to go against the

grain. It also takes patience. In fact, in investing, stomach and stamina are more important than smarts or spunk.

Finally, it was not my father's successes alone, but rather his ups and downs that have also shaped my investment thinking. I'm a big believer that failure teaches you more than success. It's what you get wrong, not just what you get right that matters in investing.

***"With every company we look at, our attitude is: 'You're not good enough for us. You are too risky.' We are thinking about all the things that can go wrong."***

The second influential person was George Soros. Before I joined Soros Fund Management, I had not understood the role of behavior and psychology and the notion of reflexivity in markets. Markets are not just made up of stocks, but of people. Their reflexive reactions can cause movements in stocks and a divorce from fundamentals. If people have not read Soros' book on reflexivity, *The Alchemy of Finance*, it's not a bad idea to read it. Although I don't agree with everything that he says in the book, it is an interesting perspective.

I know a lot of people talk about Warren Buffett, so I won't mention him being an influence because it's obvious. I was convinced that Buffett's way of investing is universal

and applies everywhere—so I applied his intrinsic value investing approach to international markets. My investment track record is testament that it absolutely works abroad as well.

Other individuals that were among my biggest influences and deserve my utmost gratitude are all my former and current bosses. They were all very demanding and expected a lot of me, but frankly, I would not have it any other way. If you're a high achiever, you want to make sure you have a boss that doesn't cut you slack, but holds you to a high standard and gets the best out of you. That's the contrarian in me talking—most people want the path of least resistance and prefer compliments to critique and easy wins instead of tough challenges. But going for the opposite will make you way better!

**G&D:** If you were to look at your process and how you invest, what sets you apart from others in the profession?

**RB:** I think the single biggest difference is in what we look for. I feel that most long-only managers think about what can go right and how much the stock can go up. By contrast, with our approach we first think about what can go wrong and how much can the stock go down. We pay more attention to risk management because risk is the permanent impairment of capital. That's what I think is really different about us, that we think about risk before we think about returns.

For most people, risk is an

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afterthought. For us, it's a preemptive strike. We try to avoid risk and eliminate it from the get-go because if you don't swim in shark infested waters, the chances of you being bitten by a shark are very low.

If you think about the motivation of a typical analyst at a traditional long-only shop—it is to pitch an idea to your portfolio manager to buy. Obviously, your modus operandi is to look for things to like about that business because that's what you want to tell your portfolio manager, so that he or she puts it into the portfolio. This conventional process automatically creates a blind spot in one's research because instead of first thinking about what can go wrong, you're now thinking about what can go right. That creates a confirmation bias. You're looking for things to like and if you find them, you're going to like it.

In our process on the other hand, we are actually looking to reject, not to select. That means that with every company we look at, our attitude is: "You're not good enough for us. You are too risky." We are thinking about all the things that can go wrong. Generally speaking, about two-thirds of the companies in our universe tend to get eliminated based on risk.

With the third or so that remain, we find that about half of them are companies that we judge to have low risk and good returns, but so does the market. These companies are unlikely to be a source of alpha generation because what you

think and what the market thinks, happens to be the same – a.k.a., it's a consensus view and already in the price. That said, because we look at thousands of companies and only need to own a handful, there are enough companies with low risk that have compelling returns and growth profiles that are not well understood by the markets.

That's where we find our sweet spot and do a much deeper dive to understand what that risk and reward look like, and quantify it in an investment write-up and financial model. I want to underscore that we don't waste our intellectual firepower on the "obvious" high-quality businesses but use it to identify the "not so obvious" quality businesses.

***"Many people pooh-poohed us when we bought Microsoft about five years ago and didn't buy Apple. Through our contrarian lens, we saw Microsoft as an enterprise staple and knew it deserved the multiple of a consumer staple."***

Let me give you an example. A lot of people love to own consumer staples. I mean, who doesn't? Warren Buffett of course, has talked about how they are such great franchises. They have moats. But all this is very obvious and well known.

Frankly, I find a lot of consumer staples around the world to be very expensive. Just because the quality of the business is good and you are not taking business risk, does not mean you're allowed to take valuation risk. Risk is risk. It doesn't matter in what form it comes—you're still going to lose money if you're overpaying.

On the other hand, we found a number of technology companies that are great companies but overlooked. Microsoft comes to mind. Many people pooh-poohed us when we bought the stock about five years ago and didn't buy Apple. Through our contrarian lens, we saw Microsoft as an *enterprise staple* and knew it deserved the multiple of a *consumer staple*.

If you go to any enterprise, you will find that people use Outlook, Word, PowerPoint, Excel. I know a lot of college students and non-professionals like to use the Apple software and Apple gadgets, but in the corporate world, Windows and Office 365 rules. They have the leading enterprise app ecosystem, so it's very sticky and results in a recurring revenue stream. In our book, Microsoft was an enterprise staple but the market viewed it as a high risk and volatile technology company that was losing out to Apple and Google. Both were false notions as the latter only succeeded in the consumer market and made no inroads into the enterprise market where Microsoft rules. As our thesis was borne out, we made our clients a lot of returns and with low risk. That's the power of doing research in a

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different non-consensus way.

**G&D:** When you are screening for risk, what types of risk are most important?

**RB:** Risk is not statistical metrics such as beta or standard deviation or tracking error. I know that's what's taught in the CFA & MBA programs but as a practitioner I can tell you that is not the definition of risk. For an intrinsic value investor, risk is losing money permanently.

That said, the word, "permanently," is very important. You can always have short-term volatility—i.e., you can lose money temporarily, but not permanently. A lot of people confuse short-term volatility and long-term risk. People are so afraid of volatility that a contrarian investor can actually take advantage of this behavioral bias and still avoid risk.

We think of risk in the underlying business. For example, if you're a pharmaceutical company with a single product, even if that product is very successful, when the patent expires and you have nothing to show for a successor, you're a very binary company. You could make great profits today, covering your cost of capital, generating lots of free cash flow; that is a low risk company, financially speaking. But because it's single product and it has no successor drugs or pipeline, it's actually a highly binary and risky business, so we would eliminate it.

Also, risk is very different in different industries. Certain

industries are exposed to regulatory risk. Telecommunications is a great example. Even though it's a low-risk business with subscription revenue and services in high demand, there's a great deal of risk from regulatory intervention.

You can also have a lot of disruption risk and most investors are vigilant about this risk in, say, the technology sector. Another industry that was very exposed to this risk, but not perceived by investors as such, lost investors a lot of money when it materialized. That industry is retailing. As we know, brick and mortar has moved to e-commerce. That proved very disruptive to retailers. By paying attention to business risk, we avoided owning value traps and saved our clients money. When it comes to risk management, a dollar saved is a dollar earned.

**G&D:** Would you mind sharing some current investment ideas?

**RB:** China Mobile (CHL) is a leading wireless carrier in China. Think of it as a Verizon times four because they have over 750 million subscribers. China Mobile enjoys a whopping 66% market share in the country, which obviously makes it dominant. They have installed the 4G network well ahead of their peers and are in the early innings of Chinese consumers migrating towards smartphones.

If you think about the playbook in the U.S., about a decade ago, we were still using feature phones to mostly make voice calls, and we were not using data plans. Data was really SMS

texting and we certainly weren't using video. Most of us in the U.S. now have a smartphone as opposed to a feature phone. Think about China as America eight years ago. The usage of data is extremely low today, but we think it's going to go up a lot.

Monthly phone bills in the U.S. are around \$60. In China, the equivalent bill would be closer to \$10. The GDP per capita is different in the two countries, but in China you don't have as many fixed lines as in the U.S.. For people in China, their cell phone is often their sole access to the internet, to e-commerce, to watching video, etc. You can see why we believe the monthly bill has significant headroom to grow.

Despite these compelling prospects, the company's valuations are quite attractive. The market is implying a low single-digit growth rate in earnings, but we are focusing on the double-digit growth rates in free cash flows. Currently, the company is making large upfront investments in the network, but in the future such capital expenditures will fall. It is similar to the cable TV companies in the U.S.—they are cash machines. The beauty of China Mobile is almost one-third of its market cap is sitting in cash, but they are looking to increase their low dividend payout ratio of about 45%.

The reason why we think the market doesn't agree with our assessment is that historically, some EM governments—the Chinese government in particular—have had a history of intervening and preventing the industry from earning

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## Rupal Bhansali



Finalists Zach Rieger '17, Alexander Levy '17, Eric Laidlow '17, and Marc Grow '17 celebrate with Geoffrey Hulme (middle) after the The Heilbrunn Center for Graham & Dodd Investing Stock Challenge

super-normal returns. That's something that the market is unduly concerned about, but in our opinion, even if they earn normal returns, that's good enough for us.

We love the fact that it holds net cash, which provides a margin of safety in a world that has gone on a debt binge. We love the fact that it's well positioned from a network perspective and from a consumer preference perspective. They don't take shortcuts in investing in the network at the expense of generating free cash flows. They do both and that's why it's a high quality business. The low valuation gives us a good upside-downside ratio.

**G&D:** How do you think about country risk in China? China has this habit of rotating its preference among its state-owned enterprises. How do you think about this problem where even though it's an oligopoly and it is government controlled, we don't know which of the three mobile players the government may prefer on any given day?

**RB:** Sometimes when government policies align with what the company wants to accomplish, it stops being a risk; it's a source of return. One of the drivers behind the opportunity in China Mobile developed precisely because of what you just referenced. The government forced China Mobile to invest in a proprietary 3G network, and because they forced this, the country suffered because nobody in the world made handsets which were compatible with that network. This is why the iPhone got to

China so late.

The government learned from that mistake and they allowed China Mobile to develop a variant of the standard 4G which is much more in line with the global standards. As a result, the equipment and handset costs came down and made the service much more affordable. You're absolutely right, government intervention was a risk, but once that risk is behind you, you don't want to double count it.

**G&D:** Thank you. Any other ideas you would like to share?

**RB:** We are also positive on Michelin. Many high-end cars are fitted with Michelin tires or brands owned by them. One thing you will find about tires is that they have pricing power. A pair of good tires can easily cost you a couple of hundred bucks.

***"We are also positive on Michelin. Many high-end cars are fitted with Michelin tires or brands owned by them. One thing you will find about tires is that they have pricing power."***

Tires appear to be a low-tech product. But if that is the case, how are there only four players in the world making tires, when there are dozens that can make cars? It suggests that there's a high barrier to entry. Indeed, the Chinese and the Indians make a lot of low-

end and retreaded tires. The reason why those low-end tires don't end up hurting the high-end and mid-end tires is that a tire is very crucial to achieve high fuel efficiency and safety. The emission standards and the fuel efficiency standards in the developed world keep increasing.

There are a couple of ways to crack the code on improving fuel efficiency. You can obviously try to reduce the weight of the car, you can improve the engine efficiency and clearly there's a lot of effort that goes into it. But physics has its limits. The humble tire came to the rescue. If you have good air pressure in the tire, that alone can make a remarkable difference in fuel efficiency.

Michelin is not well understood as a company because for years, being a French company, it was family-owned, and managed in a patriarchal way. A couple of years ago, the company appointed professional leadership that has been trying to improve manufacturing efficiency and addressing a bloated cost structure. The stock had sold off because the street was very concerned about an imminent downturn in the auto industry. It is true we are closer to the peak than the trough and we admit that the auto industry is cyclical. But what is misunderstood is that tires are an after-market product. It doesn't matter if new cars are not sold; as long as you drive, you need to replace your tires. It's a consumable. When investors mistakenly threw this baby out with the bathwater, we picked it up.

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## Rupal Bhansali

**G&D:** What advice would you give those interested in the investment management profession and what specific advice do you have for women in the industry?

**RB:** First and foremost, investment management is learned on the job. You cannot learn it from a textbook. You cannot learn it from reading Warren Buffett's annual letters. If you tried selling your degree on eBay, nobody would pay you a dime for it. But if you apply what you have learned, then your employer and clients will pay you for it. Knowledge is *what you pay for*, application of knowledge is *what you get paid for*.

I think that too many people think that just by getting a degree or reading a lot of the literature they know investing. But, it's about the rubber meeting the road. This is like a sport. You don't learn swimming by reading about swimming. You don't learn how to become better at baseball by reading about it. You actually have to do it.

So my biggest career advice for students is to start working. You are going to learn on the job so make sure that you work in the right place. It should be a place that appeals to your investment sensibility and philosophy, because without the right platform and your peer group around you, it just doesn't happen. This is about osmosis. Start working as soon as you can because that's where your education and training really begins. It's not in the classroom.

The other thing I would call out is that a love of reading is a

prerequisite to success in this profession. You should read a wide range of topics, not just finance. When you're researching businesses, it's not just about numbers, it's about business and management strategy. It's about understanding change as opposed to the status quo.

I hope this advice helps both genders but I think it applies more to women. One of the things that I always did was to raise my hand. I never shirked from taking on more responsibility, even though there were times when I had no idea how I would fulfill it. Raising your hand is a big deal. I remember in the late 1990s, when I was working at Oppenheimer Capital, we lost the person on our team covering Japan. I raised my hand and was given the responsibility, knowing fully well that it was one of the hardest markets to cover. Mind you I never spoke Japanese and prior to that I had never covered Japan. As it turned out, we did spectacularly well in Japan that year, which I attribute to hard work as well some rookie luck!

In a country like America, if you work hard and you work smart, there is nothing that is beyond you. Don't hold yourself back. Don't think you can only cover something that you know. Take on a challenge. You may not know exactly how you're going to overcome that challenge, but if you don't give yourself the opportunity to test yourself, you'll never know whether you could have been successful or not. "Raise your hand," is my most fervent advice to women.

Also, I am very fortunate that I have a life partner who knows that my career is very important to me. I did not have to make sacrifices that I know many others might have to make if they don't have that kind of support. For women, in particular, because this is a very demanding profession, make sure that you set expectations with your friends and family and build a support system around you.

**G&D:** Thank you so much, it has been a pleasure.



Simeon Wallis

## Simeon Wallis

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in a select few private companies as well as opportunistically invests in publicly traded securities.

**Atlanta, GA-based ApolloMD is ValorBridge's original portfolio company. ApolloMD is a multispecialty physician services company that provides emergency medicine, hospitalist, anesthesia and radiology services to hospitals, health centers and surgery centers across the United States. It is one of the most successful firms in the physician services outsourcing industry, as evidenced by its history of strong organic growth.**

**Simeon Wallis currently serves as Investment Director at ValorBridge Partners. At ValorBridge, he is responsible for our research process, investment origination and due diligence. He is also a member of the portfolio management team and serves as a board member for several of ValorBridge's companies. Prior to ValorBridge, Simeon advised value-oriented hedge funds and asset managers with security analysis. He helped manage Lateef Investment Management's multi-billion dollar concentrated portfolio in San Francisco and was an analyst with Cramer Rosenthal McGlynn, Evercore Asset Management, and Gabelli & Co. in New York. Simeon has been a guest lecturer at the Columbia Business School in its Value Investing program.**

**He earned his MBA from The Wharton School of the University of Pennsylvania with a concentration in Finance and his undergraduate degree in History, from Duke University, cum laude.**

**Graham & Doddsville (G&D):** Thank you for joining us Simeon. We really appreciate your time. Could you tell us about your background and how you ended up at ValorBridge?

**Simeon Wallis (SW):** I grew up in Manhattan. My father had worked on Wall Street but had left by the time I was born. I always grew up with him investing on the side. We had a family business, which was a small chain of retail apparel stores, which, in retrospect, was not a good business. I learned that entrepreneurship is filled with highs and lows, and our family finances reflected that. My father's investing was a huge benefit—that always stuck with me.

Growing up I had exposure to investing with friends whose parents were on Wall Street. I was one of those kids at 10 years old who enjoyed stock-picking contests. The first time I started paying close attention to the market was at 13 years old when I received shares in Disney as a gift and followed Disney for the next decade.

I went to Duke for undergrad and majored in history. Duke is a liberal arts school, with no undergraduate business school, but it had what was essentially a minor, called a certificate in Markets & Management, that provided exposure to the

business world and investing.

During my semester studying abroad in Australia, I walked into a bookstore and came across a book, which would shape my world view. That book was *Den of Thieves* by James B. Stewart, a Wall Street Journal reporter at the time. *Den of Thieves* recounted the great insider trading scandals of the 1980s, and in doing so, detailed the history of activism, the corporate raiders, the use of the highly leveraged finance, Drexel Burnham Lambert, and Michael Milken. That really resonated with me. I believe part of the fascination was growing up in New York with those familiar names, but also the idea of mixing business and history, and understanding how things came to be within the business world.

Afterwards, I immersed myself in different aspects of business history. Within my Markets & Management program, my thesis analyzed the leveraged buyout phenomenon through the early 1990s, using KKR's bid for RJR Nabisco as the lens; there was an outstanding book, *Barbarians at the Gate*, by Bryan Burroughs and John Helyar. My paper evaluated the market for corporate control, basically activism in today's vernacular. I was intrigued with how business and history intersected, and how history could translate into future investments. I learned that the context behind events deeply matters.

Coming out of Duke, I worked in management consulting for nearly three years in Atlanta. I then returned to New York to work on private-market investments in earlier-stage

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## Simeon Wallis

technology with a venture fund, named Dawntreader. It provided a very different experience in terms of analyzing smaller companies, where managing cash flow was critical and management had a “make or break” impact.

However, I realized that I was not exclusively a venture investor at heart and chose to pursue my MBA at Wharton before returning to the public side of investing.

After business school, I worked for Mario Gabelli '67 covering autos, trucks, heavy equipment manufacturers, and the whole value chain. The value chain encompassed the parts suppliers, the global original equipment manufacturers, aftermarket parts distributors, and auto retailers. Autos and trucks were one of the first industries that Mario followed. I was literally 40 years behind him, and essentially, was challenged to win any arguments about the subject with him.

From there, I joined Evercore Asset Management, which was a start-up launched by four ex-Sanford Bernstein buy-side investors, who had received funding from Evercore Partners to build an institutional investment management business. It was a very intellectually and analytically intense place in a great way. It was very thorough research. If we were three years earlier or three years later, it would have been a tremendous success, but when we launched the small-cap value and small- and mid-cap value long-only products in early 2006, the business timing was completely wrong. Because the timing was poor,

the business never really got the legs underneath it, and eventually it was folded. It remains a lesson that randomness and luck, such as timing, can play a huge role not just in investing, but in careers.

After Evercore, I moved to Cramer Rosenthal McGlynn, which is a more established value manager. There were about 20 analysts, and it was roughly \$10B in assets under management when I joined. CRM was mostly long-only with a small long-short product at the time, and looked for businesses that were undergoing change. That change would be difficult to model, or may not have been appreciated in sell-side models, so these were neglected ideas. Often these were value opportunities, names that maybe didn't screen well, but occasionally an analyst could find interesting angles to gather insights.

***“I was intrigued with how business and history intersected, and how history could translate into future investments. I learned that the context behind events deeply matters.”***

After a few years at Cramer Rosenthal McGlynn, I received an opportunity to work with a friend at a 40-year old firm in the Bay Area. This was a concentrated fund, 15 to 20 names. There were three investment professionals. I was the fourth, and assets under

management were about \$3B at the time and rose to \$4B. It wasn't a good cultural fit. My wife and I moved back to New York, where I worked on projects for several small cap managers—Wynnefield Capital, Candace King and Amelia Weir at Paradigm Capital Management, and Ken Shubin Stein at Spencer Capital—before connecting with ValorBridge, which was based in Atlanta. I joined in May 2013 and I worked remotely in New York for several years before relocating to Atlanta last summer.

ValorBridge is a private holding company. It was started by accomplished entrepreneurs and operators who built successful private healthcare businesses. The operating companies generate excess cash that we use to make either investments in private healthcare companies where we feel we have some competitive advantage from our understanding of specific customers and pockets of opportunity, or we make long-term investments that would diversify away from healthcare into businesses with comfortable risk-reward profiles.

We also invest in publicly traded companies, depending upon our projected return profile. We can move our capital back and forth between public and private markets because it's all internal capital. We're not a general partner to any outside investors, and there are only two situations where we are a limited partner in another fund. Over time, my role has evolved from being pure public markets within ValorBridge to straddling both,

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and when need be, stepping into an operating role. We believe our differentiation is wearing several hats—operators, public equity investors, private market investors—where we take our knowledge in the private companies and apply it to public companies and vice versa.

**G&D:** That's a great overview. Could you talk more about the academic work you did regarding activism and the implications of that today?

**SW:** A professor named Michael Jensen coined the term “the market of corporate control,” which is an academic way of saying the actions of corporate raiders and activists. He believed in the efficient markets perspective that all assets are properly valued in free markets, including corporate assets. My perspective was different in that I believed there were times when the market for corporate control and activism were beneficial to most stakeholders involved; however, in the 1980s, there were points when I believed it was detrimental.

An example when it was detrimental was when corporate raiders used greenmail. Carl Icahn was known as one of the leading protagonists; greenmail was when a raider would buy a stake in a company, threaten a hostile take-over, and management would lever the company up in order to pay the greenmailer off to go away, all at a premium to other stockholders. What the remaining stockholders were left with was a highly levered

business that had not been improved with all of the debt issued. It's the worst of all worlds. In good situations—and there were many—an outside investor would come in and say, “You're essentially in four different businesses. There's very little synergy between any of them.”

It's a reflection of the conglomeration movement of the 1960s and into the 1970s. The company and its stakeholders were generally better off spinning off the assets or putting the assets into the hands of those who would value it more highly via divestitures, and use the cash to find one or two businesses to grow.

In situations when activists came in with a mindset focused on capital allocation and long-term value creation, it was incredibly beneficial. In breaking up companies, the assets went to owners that either understood those businesses better, or you're able to take capital and give it to those who can grow their businesses in healthy ways. I don't believe one could definitely say that activism on the whole was good or bad. There were benefits and trade-offs. I would argue that the good instances greatly benefitted the U.S. economy over the long term.

**G&D:** Interestingly, there's an adjunct professor at Columbia, Jeff Gramm '03, who wrote a book about a lot of these same issues.

**SW:** Was that *Dear Chairman*?

**G&D:** Exactly, *Dear Chairman: Boardroom Battles and the Rise*

*of Shareholder Activism.*

Could you walk us through the big lessons you learned throughout your career and how you apply those to public and private markets today?

**SW:** Mario had a pool of fifteen to twenty analysts who would sit around a table every morning and he would Socratically ask us about our coverage universe. I followed the automotive value chain, the heavy-truck manufacturers, such as PACCAR and Navistar. I also covered heavy-equipment manufacturers, such as Caterpillar, as well as agricultural equipment companies, such as John Deere. What unites that coverage universe was they shared common parts manufacturers. They had a common supply chain but different distribution. What I learned was there were a variety of business models within a specific industry. The business models had different margin profiles, different capital intensities, different growth opportunities, and therefore they needed to be valued differently. I started to think more horizontally about the nuances of understanding a different business model as opposed to the conventional wisdom of categorizing companies by industries.

Mario's known for his acronym “PMV,” private market value, which is a sum of the parts of a business based upon what an intelligent buyer would pay to acquire that business. In addition to thinking about the balance sheet, we looked for hidden assets or off-balance sheet liabilities, and put that all together to understand the

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real value to the owner. To think about businesses that way was very valuable because having a differentiated perspective is one of the few ways to outperform peers and the market over time.

For example, John Deere had manufacturing operations and a finance business, Deere Finance, which provided dealers and end customers financing. Screening on Bloomberg or CapIQ, Deere would show significant debt and appear levered; however, diving into the SEC filings, an analyst would realize those are two separate businesses. The finance arm could be valued as a finance company, such as at book value or determine what an intelligent buyer would pay for that portfolio of assets.

Then one would evaluate the capital structure of the manufacturing business. Often there would be net cash as opposed to net debt, and an analyst could decide what is the right multiple to pay on its mid-cycle operating earnings or EBITDA. So by valuing one part of Deere on book value and another on operating earnings plus the net cash, an investor could derive a valuation materially different relative to where the market was valuing it, especially if the market looked at it on a P/E ratio basis. Deconstructing businesses and valuing them with the appropriate methods based upon the attributes of the underlying business models proved tremendously valuable.

The other big lesson from Mario was understanding the unit economics of the business. Let's say we were looking at one of the Big Three auto

manufacturers. We'd compare the fully loaded labor costs or healthcare benefits to retirees per car that the consumer is paying for, yet not receiving any value from. That's a competitive disadvantage relative to another company that spends that same amount on what drives future value for the company, such as R&D.

***"I don't believe one could definitely say that activism on the whole was good or bad...I would argue that the good instances greatly benefitted the U.S. economy over the long term."***

At Gabelli, we invested time analyzing on a per-unit basis of value creation or, alternatively, we would determine what an acquirer would pay for that unit of value. Mario found industries that were consolidating and determined how an acquirer would define value. For instance, in the cable industry, he'd ask, "What's the enterprise value per subscriber that's in the subscriber network, and where should it be?" He found huge disparities between the current market value of a subscriber and the takeover value on a per-subscriber basis. If there was a large spread, that was really appealing. This EV and transaction value per subscriber could be used to value any subscription business model.

**G&D:** Can you provide some comments from your experience at Evercore?

**SW:** At Evercore, I worked for Andrew Moloff, a portfolio manager who, better than anyone I've known, persistently questioned his analysts to help them understand what the key drivers to an investment were. He was a teacher. Andrew's approach was comparable to what I would eventually learn in studying Lean management as the "5 Why's" by going through ideas with the analysts through repeated questions to understand what the investment controversy was, often better than management understood it.

The methodology was very similar to Rich Pzena or Andrew Wellington at Lyrical where the analysis is driving toward deriving normalized earnings in five years based upon the capital structure and margin profile of the business. The objective is to understand whether the reason the stock price is currently depressed is based upon a temporary factor or a structural change that would be difficult to fix. It was a great lesson in understanding the questions "What's the right valuation?" And "What are the right earnings to assume in a normalization process?"

**G&D:** Your team can invest in the public market, in private market investments, and reinvest funds back into the underlying business itself. How do you decide where to allocate capital?

**SW:** We do a back of the envelope IRR calculation,

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thinking five years out. On the public side, our holding period might be three to five years. It might be on the early side of that five-year IRR. Price will be a component of the process. With the private investments, we actually expect to hold longer than five years; there's more opportunity to influence the outcome because we're going to have more control.

Additionally, we can invest anywhere in the capital structure. We can provide capital as debt, mezzanine securities, or common equity. We have a lot more flexibility in our ability to mitigate risk on the private side. The tradeoff is, of course, that it's not liquid. If we're in the public markets and we realize we made a mistake, you can just sell. However, on the private side, we have to invest significant time to exert influence and affect change.

For private investments, we concentrate on the compounding of intrinsic value through owner earnings growth. It's more of a growth perspective and operating perspective, whereas on the public side, we are more of a price-sensitive investor, where we're looking to double our money over three years. A bigger driver of that in our public investments is the normalization of the earnings multiple, as opposed to growth of earnings or cash flow. There are two levers to returns—the earnings or free cash flow and the multiple. On the private side we focus on growing cash flows. On the public side, we tend to focus on situations where we expect that the multiple will rise to some level where it historically had been

as earnings will probably revert back to a normal level.

**G&D:** Are there times when you're comparing the public and private opportunities side-by-side? Is there a certain amount of capital that you want to allocate to each part of the market?

**SW:** We ask ourselves, "What's our opportunity cost? What's the risk-reward from being in the public markets versus private markets? What is our IRR in the public markets and the private markets?" One of the advantages of being in the private markets is by definition they're less efficient. They've become far more efficient because now 100 private equity firms will look at the same deal, but proprietary deals still come through relationships.

In the public markets, there's nothing proprietary. Today it is harder to find compelling opportunities for us given valuations. Whereas on the private side, we can find one-off opportunities that might be more compelling. For example, there could be times when our own portfolio companies can make a tuck-in acquisition and pay 3x trailing twelve month pretax earnings, adjusted for amortization. It's hard to beat that. That's inherently (with no growth) a 33% pretax return. Then add growth or cost reductions from synergies, and return on capital can rise to 80% or 100% quickly. It's difficult to find those opportunities in the public markets, but if we were in 2009-10, and we were to see great valuations combined with ample liquidity, then that's

incredibly appealing.

In the private markets, there's a deal process. Deals can take two or three months, at a minimum. They can take six to nine months with the due diligence and negotiations. It's slower than public market investing, and valuations can still move during the process. We look at IRR based upon our opportunity set.

**G&D:** What does a typical private market investment look like for ValorBridge?

**SW:** On the private side, I'll break it into healthcare and non-healthcare. The two founders of ValorBridge, Chris and Beau Durham, have a background in healthcare. Both have law degrees and Beau also has an MBA, but they both ended up going into healthcare over time.

Within healthcare, we are far more comfortable finding earlier-stage companies that are attacking a market niche where we see a big opportunity based upon our knowledge of the healthcare industry. We can leverage our existing relationships, such as our relationships with hospital systems, to accelerate the growth of these smaller companies. In the last year, we purchased a hospital out of bankruptcy, where we were already a service provider in that facility. We own a web-based scheduling company for emergency rooms that functions similarly to OpenTable with a comparable value proposition. A patient gets hurt, knows that s/he should go to the ER, goes onto the local hospital's website and schedules a time to go into the

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ER (assuming the injury isn't life or death), and can go home to rest on his/her couch in front of the TV as opposed to sitting in the emergency room for 4-5 hours. We own the majority of a tele-health or mobile health company. We can leverage a network of doctors with whom we already have relationships. Due to these capabilities, we're willing to invest in earlier stage healthcare companies.

For our non-healthcare investments, these are in more established businesses that should grow free cash flow at nice levels for owners based upon our research that the management team is far superior to its competitors'. We directly own stakes in an industrial distribution and service company for gas stations and fuel depots. We own a sizeable stake in a company that buys distressed consumer credit portfolios from issuing banks that are in charge-offs, where we can purchase them for pennies on the dollar and manage the collections process. I consider this an investing business at its core. We own passive stakes in other companies, such as an industrial gas distribution company and the largest manufacturer of wine bottle closures in the world. In our established company investments, we focus on EBIT somewhere between \$1 million and \$10 million. We target companies with well-laid out growth opportunity, where there's nice organic growth and potential for tuck-in acquisitions. We seek businesses run by highly skilled owner-operators within their niche and who think about the world in a similar way to us.

We're less willing to go with a startup or a very young team in that type of situation.

**G&D:** At what point do you begin considering exit opportunities? How do these factor into the IRR consideration?

**SW:** Our perspective going into an investment is that we wouldn't invest in any business that we wouldn't be comfortable holding for a very long term, at the very least, longer than the typical private equity fund's investment cycle. We won't buy with a perspective of when or if to exit. That said, we're all rational capitalists. We're approached all the time about acquisitions of a portfolio company, and if we receive an offer that is extraordinarily compelling, we have no problem consummating that transaction. But the bar is high. Very rarely do you find buyers who are willing to pay up for five years' worth of free cash flow growth and place a fair multiple on something five years from now.

**G&D:** How much leverage does ValorBridge employ?

**SW:** I believe private equity investors understand this aspect well while a far smaller percentage of companies in the public markets truly appreciate this. Leverage should reflect the cyclicity of the business' cash flows looking full cycle, especially at the trough, not just the most recent few years' or trailing twelve months' EBITDA. Leverage magnifies returns—good and bad—to the equity holder. The more stable the business, the more leverage it can carry.

Therefore, in sustainable growth businesses, profitable growth accrues more and more to the shareholder.

Look at John Malone and look at the team at TransDigm. What they understand is that if an investor considers how enterprise value compounds over time, with the appropriate leverage structure, equity compounds even faster over time to the owner, assuming returns greater than the cost of capital. Liberty and Transdigm can run at higher levels of leverage because in cable and in aftermarket aerospace, the revenue growth doesn't have to be fast. Modest organic revenue growth, combined with operating leverage works to have an extraordinary impact on the per-share growth of equity.

At the same time, in more cyclical businesses, it's pretty foolish to employ even a moderate amount of leverage. These cyclical businesses are often asset-intensive and have greater operating leverage. What's helpful to me is to understand the reason for the leverage—is it to fund operations of a capital-intensive business or is it to create a more efficient capital structure for the equity holder? Not appreciating this is how an investor ends up in trouble. We realized that with our businesses, with the more cyclical ones, we will be overcapitalized with equity at points in time. Given our inability to accurately predict changes in demand, we're comfortable with the overcapitalization because it's our capital that's on the line.

There are other businesses

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where we can run at 3.5x EBITDA and feel pretty comfortable with the growth in that business, knowing the pipeline and competitive positioning. It's dependent on taking a long-term view of the variability of unlevered free cash flow.

**G&D:** When you decide to invest in a business but have a variety of options of where to invest in the capital structure, how does your team make that decision?

**SW:** Mezzanine financing has been the initial way we've established a relationship to help us understand whether we like management and to determine their ability to run a business. Often we can provide mezzanine capital at terms below what the company could receive from a traditional mezzanine lender. We might charge 200 or 300 basis points below market; but to establish that relationship, it's still a good coupon for us. We're collateralized well. In the capital structure we're above the CEO and the founders who own common equity so that helps us to get insight into how they run the business.

Later, we would have additional discussions about keeping the mezzanine piece, but also investing in the equity to help facilitate growth, or do a swap. It's the "crawl, walk, run" perspective of establishing a relationship. If we do like each other, then we're happy to help them grow by providing additional forms of capital, whether that's preferred or common equity.

**G&D:** How often, when you are providing mezzanine

financing and testing the waters, do you determine that you don't want to invest the equity?

**SW:** Very rarely. It might have happened once in the four years that I've been here. It reflects the due diligence process that we do with management before making the mezzanine investment. We won't go into a situation to provide mezzanine financing where we don't like the management team. There are one or two situations where we've done both mezzanine and equity at the same time, and the mezzanine ends up protecting the equity if things go sideways for some period. We protect the equity slice with the mezzanine because there are going to be convertible features for capturing equity if there is a restructuring.

***"We seek businesses run by highly skilled owner-operators within their niche and who think about the world in a similar way to us."***

**G&D:** How do you and your team properly incent the operators?

**SW:** Our best situations have been when management has not taken very much capital—in the form of equity—off the table. Reducing equity stakes is usually a yellow flag, if not a red flag, for us. More often than not, management had a different shareholder that wanted to exit, and

management wanted to stay engaged in the business. They're just looking for a different partner.

We can install incentives that focus them on profitably growing the business over time so that the owners will see very good rates of return on their capital. We don't want to come in and buy 80% of a company and have management take too much skin out of the game.

It speaks to one of the mental models that we use in both private and public markets. I call it the "3 P's". We think about price, process, and people. The people part is tied to incentives. The price is tied to the IRR, or if it's an acquisition or internal capital project, what's our return on investment. The process part is thinking about the competitive advantage that we see. 3Ps is really IRR/ROIC, competitive advantage, and incentives.

**G&D:** How much do the private and public investments influence one another in terms of lessons learned or themes?

**SW:** They influence each other greatly. A mental model we use, which we first employed on the private side, is a deep understanding of the "drivers of value creation for the equity holder"—three of the four are operating drivers and the fourth relates to capital allocation.

On the private/operating side there are three drivers of profitable growth—the first is revenue growth, or gross profit dollar growth for certain types of businesses. The

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## Simeon Wallis

second is operating margin expansion and the third is reducing the capital intensity of the business, often reflected in improvements in working capital turns. For the public companies, we add a fourth driver: shareholder yield.

Shareholder yield is often revealed in the Financing section on the Statement of Cash Flows. Is money flowing out of the business, and is it paying off debt and reducing the share count? Or is money being brought into the business, increasing debt, and raising share count? It's traditionally been owner-friendly when you reduce the amount of capital in the business.

We also use another mental model that started with how we work with our private companies, but has transferred to evaluating public companies and their management teams. We uncreatively call it "VSD": Vision-Strategy-Drivers. John Wooden famously used a pyramid to explain his drivers of success. We borrowed that. Vision would be at the top of the pyramid, Strategy would support the vision and the Drivers would be the base, supporting strategy.

For our established companies, we want them to have a ten-year, high-level vision that helps employees, key suppliers and customers, as well as the board, have a good sense of where our management team is taking the company. It motivates employees that they are part of a special company. It distinguishes us in our customers' eyes because we're seen as more aggressive in addressing their needs than

competitors. This leverages the concept of starting with the end in mind.

The Strategy answers the question "How are we going to achieve our vision?" Namely, it identifies what are the key operational items the company will need to execute on, what are the key capital and operational investments that will have to be made to support the executing the priorities, how competitors are likely to react and what are the trade-offs that will have to be made, since everything has an opportunity cost.

Lastly, the Drivers are the critical activities that management will focus on and that can be measured in order to execute the strategy. As we developed this framework, we saw how it is applicable to evaluating publicly traded companies, especially in conversations with management. If a management team can't credibly and lucidly describe how they are allocating their key resources toward specific objectives that they want to achieve over the medium to long term, I believe any investment thesis beyond reversion of the earnings multiple is difficult to make. This is particularly true for compounders.

The last few years I've guest lectured at Columbia in the Value Investing Program in Chris Begg's section of Security Analysis. I use 3G's Ambev investment and Heico as case studies—from annual reports, interviews, shareholder letters and articles, one could clearly see where management was taking those companies using the

VSD framework.

We put more faith in excellent managers than many traditional investors, especially value investors. Management, in our belief, matters more the longer a position is held. In our opinion, the premium the market pays for outstanding management relative to average management is frequently too narrow.

On the public side, we typically buy what we believe is the best management team in an out-of-favor industry. We have deeper conviction that they're going to make owner-friendly decisions and less likely to impair capital. It's also a belief that management can make a difference in key situations. That comes from operating companies, allocating capital, and serving on boards overseeing executives. The difference can be dramatic particularly the decisiveness and focus on the critical few decisions and inputs that can have disproportionate impact on profitability and sustainability of the returns on capital.

**G&D:** How do you evaluate a management team when you're trying to look at so many different options in the public space? What tools do you use?

**SW:** I don't want to visit or speak with management until I've thoroughly researched them and the investment controversy. I want to avoid their influence in how I approach thinking about the business. I want them to address my critical questions and I need to spend time to determine what those are beforehand.

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A great executive can simplify the business and her thought processes in her communications. She remains consistent in how she talks about the business and what she is focused on. She communicates in easy-to-understand terms devoid of company and industry jargon. Decisive in actions, makes difficult decisions quickly and is candid about industry conditions. She is honest and transparent in communications. I determine this by reading ten to fifteen years' worth of shareholder letters, interviews, and conference call transcripts.

I ask, "Is the management team focused on the key drivers of the business? Do they understand what their relative competitive advantage is? Its source? Are they focused on the same metrics year after year?" This sense of what to do and why do it is internalized. One lesson I've learned in operations is that it's very difficult to manage and influence employees. Simplifying and creating clarity in terms of where a business is headed and what matters enables organizations to take actions more quickly and to be more responsive to changing dynamics. Great managers understand a business creates value satisfying customers or adapting to the marketplace, not at the headquarters. The frontline people need to understand what management is thinking because they reflect management's thought process around what matters. Clear communications and incentives are the best way to do that.

Great managers understand their relative competitive

advantage and focus the business' resources in that area. A great example is GEICO and Berkshire. Buffett understood that the direct-to-consumer model enabled the company to avoid higher cost distribution than competitors. As a result, he could 1) invest some of the savings in lower prices for customers and 2) increase spending on customer acquisition in the form of advertising that GEICO was a better value proposition for consumers.

***"Our best situations have been when management has not taken very much capital—in the form of equity—off the table. Reducing equity stakes is usually a yellow flag, if not a red flag, for us."***

If he was thinking short-term, GEICO's advertising budget would have grown at a far slower pace than it has. But Buffett sees the tie between the competitive advantage and the long-term value of an additional policy holder to GEICO's intrinsic value.

I'm sure many value investors have been fooled when management teams say the right things. After William Thorndike published *The Outsiders*, value and fundamental investors were telling management teams, "You have to read this book. This is the way to do it." The management teams listened and spouted out, "Buying back

shares. Returns on capital." I believe that ultimately burned many fundamental value investors because management lacked a true understanding for why the actions of *The Outsiders* mattered. As Seth Klarman has said, you either get value investing or you don't. This was the same thing—it wasn't internalized. An investor who sat down with management probably could have determined this if they applied the "5 Whys" line of questioning to why this approach to capital deployment was correct.

After looking over longer periods of communication to assess authenticity, I focus on the proxy filing to evaluate incentives. Performance-based compensation tied to return on invested capital and free-cash flow growth are great. Ignoring the balance sheet or capital base is a red flag. Adjusted EBITDA is a negative for that reason. Adjusted EPS is even worse.

**G&D:** Can you talk a bit about the types of companies that you're looking at for the public portfolio?

**SW:** On the public side, we're value investors. We focus on buying companies that are at modest valuations relative to either their normalized earnings or normalized free cash flow, three to five years out from now. We'll place a modest multiple on that profit or free cash flow, credit management for share repurchases if that's part of the company's history and determine, given our expectations, whether we could double our money in three years or quadruple it

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Geoff Hulme presents the winner, Zach Rieger '17, and runner-up, Alexander Levy '17, of the The Heilbrunn Center for Graham & Dodd Investing Stock Challenge

over five years.

Since our capital is more permanent, we take a longer time horizon. We tend not to trade around our positions. We focus on industries that don't have structural change, where demand may be cyclical, yet the product or service that's offered is a necessity. We seek returns on capital or returns on equity over a cycle that are slightly above average. We're not trying to outsmart the market, just take advantage of swings in the psychology of others by being more patient. We look through what the investment controversy is in order to determine whether it is temporary or structural.

We're buying companies that we believe have a competitive advantage, are the lowest cost operator, and/or have the best management team in their industry. We look at the margin profile and return on capital within the industry to see who's at the higher end. We'll look at the unit economics and productivity metrics, such as revenue per employee or profit per employee to compare quality of operators in an industry.

In some situations, all of these will align, where the investment controversy is temporary and we can look past it. We'll buy the best manager and we are willing to pay a turn or two more on earnings for the better management team, as we believe over the long-term, they'll out-execute competitors and the profitable earnings growth will be there. The multiple premium may expand.

**G&D:** It seems like a lot of your analysis regarding management is comparative across companies within a certain industry. Does that require your team to focus on a certain number of industries that you know better than others? Do you tend to compare management across verticals?

**SW:** We probably haven't consciously compared management teams across different industries. We focus on business models. For example, it is better to compare the unit economics and performance of the CEO of AutoZone to the CEO of an auto manufacturer or to the CEO of an industrial distributor? I'd argue it is the latter. If we're looking at a management team that's in a distribution business, we believe we understand what the right incentives should be.

We'll use that information with our private companies too. We'll say, "If I understand the business model dynamics in public companies and the two or three things that matter, how can I apply that knowledge to some of the private companies, where I'm not confident that industry management teams are thinking that way?"

Once we understand certain industries or business models, these fall into our circle of competence. There are complexities to the business, but the complexities in most situations don't dictate the outcome; the 80/20 rule usually applies. Once we understand the core pieces of information and levers in the business model, we get

comfortable quickly. Then we're just seeking to understand the idiosyncrasies.

For example, on the public and on the private side, we've invested in insurance companies. There are niche aspects of insurance companies, and there are different types of insurers, but at its core, an insurance company has certain traits. It's about risk transfer. It's about assessing how well a company has priced and managed risk. Insurance companies are just a pool of capital. A policyholder is giving capital upfront in return for the promise that it will receive a payoff if an event occurs. There are nuances, but at its core an insurance company and financial services firms are not inherently very different.

Some of the industrial businesses that we've been involved in, or even consumer packaged goods, often take a commodity, process that commodity and sell the output in a brand. Commodity to value-add. A skilled investor needs to understand the operating dynamics of that type of business. Brands are about trust. So it is important to understand how the brand is perceived by its customers and potential users, not what the company says itself.

We're willing to admit that there's a pretty large "too-hard" pile relative to the time we want to spend. There is an opportunity cost for time and we want it to be high enough so that only ideas that can meet our self-imposed return hurdles can make it through. There are certain businesses where if we can't get our head

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around it relatively quickly, it's just not worth our time.

If we give up some of the opportunity set, that's just a tradeoff in how we do business. We want to try to keep things relatively simple. We pick our spots. We would rather benefit from the fear and greed psychology that is reflected in the multiples that others will pay for quality, well-managed businesses, than to try to get complex situations right.

**G&D:** How do you size positions and how do you determine the composition of the public portfolio overall?

**SW:** In our public portfolio, in a steady state, we'd have about fifteen positions, of which the top five would be over 50%. Because we are not constrained by the expectations of volatility or concentration risk, we can be more aggressive in allocating to positions where we think the risk-reward is more compelling or let our winners run a little bit more.

One core practice at ValorBridge is to determine where we can align our relative strengths with what we see as institutional weaknesses in different aspects of investing. For example, private and public investors almost never have a fluid flow of information and communications between them.

How can we put ourselves in the middle and use the information from the private side with public companies, and vice versa?

Institutional investors typically want to see certain items, such as benchmark weightings. We don't care about that because this is our capital. We want the best IRRs, and we're willing to hold longer term and look like an ugly stepchild.

***"Great managers understand a business creates value satisfying customers or adapting to the marketplace, not at the headquarters."***

We try to use what we perceive as disadvantages in the system to our benefit. Where we have a weakness, we just try not to be there. We don't have 20 analysts, but we can go after companies that the sell-side hasn't focused on much, or invest in opportunities that U.S. investors may not consider.

For example, we owned Norbord, a Canadian-listed company that had a disproportionate share of its operations and profits tied to the housing rebound in the U.S.

**G&D:** Does this also allow you to be more involved in small-cap companies?

**SW:** Yes. At the low end, we've invested in market caps between \$150 million and \$300 million. We do want some level of liquidity.

Twice we conducted due diligence with the thought of becoming activist; those were

sub-\$100 million market cap companies and we passed on both. We've owned companies with \$100B market caps because we felt the concerns were over short-term issues.

**G&D:** You mentioned activism, which occurs on the private side often. How does your internal team approach that regarding public investments? Do you look for specific activist opportunities?

**SW:** You mentioned private equity, and there are many cases where public equity investors will say they take a "private equity approach" to investing because they employ a long-term holding period and after significant fundamental research. I believe that perspective is off the mark. Value creation in the private equity business model comes from the willingness to engage at a board level and control two key things. First is having significant influence over capital allocation decisions, and second is having significant influence over the management team, including picking the C-suite and the incentives that are implemented. In the public markets, this only occurs if an investor joins the board for several years.

The firms that I believe have executed this "private equity in the public markets" model effectively are ValueAct in mid-to-large cap companies and in small caps, it's Wynnefield Capital. Wynnefield, which flies below the radar, has been around for about 25 years with phenomenal returns. Nelson Obus and Max Batzer have done a really tremendous job.

To do this effectively, a firm

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has to devote the resources to be involved three to five years at a board level. That's the right mindset. We try to determine how we can have an impact on operating improvements, incentives, and capital allocation decisions. At the same time, we have to be willing to accept a lack of liquidity because that's a trade-off for joining the board.

We haven't found the right situation where we've been able to partner with a management team where they wanted to bring in a concentrated investor to help build the business in the public markets. In one situation we considered, it was an industry executive that had followed the target company for years, knew that the existing management was ruining the business, and sought capital to help effectuate change. We came close as the valuation was incredibly compelling if we could change management, but we passed due to our research. We realized that the business was inappropriately levered, and the more work we did on the operations and capital structure, the more we became uncomfortable with existing management's ability to generate ample cash to service the debt. We didn't think our new management team would have the time and balance sheet necessary to realize the company's intrinsic value.

When we look at small caps, we're looking for good managers who would be good partners, as opposed to an antagonistic situation where we'd become activists. It's really special situations where we have someone in place that

we know would be an ally to help us run the business. Down the road, there might be a real opportunity for us to exert that type of influence. But given current multiples and debt levels, it's probably not very fruitful now.

**G&D:** Would you like to talk about some past public market investment ideas?

**SW:** On the public ideas, one that ended up being very fruitful for us and is representative of our approach was the title insurance company Fidelity National Financial (FNF) in 2013. FNF operates in a relatively consolidated industry. It provides a necessary service unless there are legal changes to eradicate title insurance, which we didn't see on the horizon. Bill Foley ran the company, and if you look at his track record, it is very similar to John Malone's at Liberty. Foley has deftly used the public markets to buy and sell assets, timing the markets very well to create significant value for his shareholders. He's willing to run with some leverage and make very difficult decisions very quickly. He simplified his business. He very much fit the profile of what we were looking for. It was pattern recognition. He's created, I believe, close to \$40B worth of enterprise value from deals and compounded returns for shareholders at very high rates.

He built a company called Fidelity National Information Systems which he eventually spun out. He has used a tracking stock for his financial crisis-era investments, FNF Ventures (FNFV), to highlight value and repurchased shares

when FNFV traded below intrinsic value. He acquired previously spun-out technology businesses when valuations were depressed, and he's spinning that out again as Black Knight Financial Systems. That's one of those structural aspects that we try to take advantage of. Many investors are wedded to how financial models look in spreadsheets. Yet our operating experience has taught us that business is not linear and often value creation doesn't model well.

We bought FNF at 8x to 10x our estimates of normalized earnings, and we received all of Foley's capital allocation prowess for free. We held FNF for about two-and-a-half years and when we started to sell the publicly traded portfolio, we exited FNF. With the spin-off of FNFV and other maneuvers, FNF was a very good investment for us.

Foley represents another aspect that we look for with managers, which is managers from outside of an industry, who can apply what they've learned from outside that industry to the new industry. That allows the manager to do things that are different from the conventional wisdom. Foley's background was in the military. He has a law degree. He eventually bought a title insurer out of bankruptcy, and then proceeded to roll up the industry. It was a very different perspective from the traditional, slow-moving insurance company competitors and the executives who grew up in the industry.

**G&D:** Any current holdings or ideas?

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**SW:** Currently we don't have any investments in the public market. One thing that's been on our radar is another insurance company, Assurant (AIZ). Assurant has been a quirky, niche insurer that has consistently evolved the products and services that it's insuring. Occasionally it becomes very cheap when investors believe that a line of business AIZ is in is about to fall off a cliff. Management has been very good capital allocators, knowing to repurchase shares when investors price in Armageddon and to increase the dividend when investors are not concerned. Over the last decade, AIZ had been an aggressive cannibal of its own shares, as share count has declined greatly when AIZ traded below book value.

About two years ago, the chief of strategy, Alan Colberg, was promoted to CEO. Colberg came from outside the industry. He was an ex-Bain partner who possessed a materially different perspective for growth, and quickly made difficult decisions to exit legacy businesses that were structurally challenged; Assurant received good value in exiting them.

An investor could follow Colberg's playbook, which was taken out of one of Bain's published books, *Profit from the Core*. He focused on providing additional services to existing customers in highly profitable niches, where he could make tuck-in acquisitions and use capital to grow in a relatively low-risk way. When we normalized for the different segments of the business, the upside when we were looking

at it, about 18 months ago, was a double. The stock price was around \$65, and we thought it could be worth upwards of \$125 to \$130, looking out several years. The process is still going on. Assurant is about \$95 a share now, and we believe that there's still upside. We haven't allocated much into the public markets recently because we've had some private opportunities that are more compelling.

***"A second piece of critical advice I have is the importance of removing one's ego. Ego is the driving force behind most intelligent people's mistakes."***

**G&D:** Is that more a consideration of how good the private deals are, or are you just not seeing adequate returns in the public markets?

**SW:** It's the latter. Generally, we haven't seen compelling valuations. As I mentioned, in the last year we purchased a hospital we knew out of bankruptcy. Several portfolio companies had reinvestment opportunities at rates well above what we could receive in the public markets. In the public markets, we're looking to double our money every three years. We generally don't like when there's a very levered balance sheet. What's been cheap the last few years is where there's been some balance sheet concern in addition to being in a commodity business. That's

not the right risk for us.

On the private side, valuations are not great either, but occasionally we find ideas from proprietary deal flow or provide capital to our operating companies for tuck-in acquisitions at 3x pretax profit. As I mentioned before, that's hard to beat.

**G&D:** That definitely sounds compelling. Do you have any advice for students?

**SW:** For students who want to get into this business, the business is changing significantly on the public side. I see parallels between what's occurring with the traditional retailers and the threats posed to asset managers and hedge funds. Competition is emerging from low-cost sources and technology; for retailers, the threats are the Costcos, Dollar Trees and Aldis of the world, and for investment firms, low-cost passive vehicles such as ETFs and index funds. It's also coming through technology-driven interaction with the end user, whether it's Amazon and the Internet-based direct-to-consumer business models in retail, or quants, factor-based investing, and robo-advisors with computer-driven investing models for the traditional investment firms.

These competitive threats may result in fewer analyst opportunities; anyone who wants to join our industry needs to be 100% committed to it, and eat, sleep, drink, and breathe investing, and understand their own personal points of differentiation for a potential employer. Our industry attracts a concentration of type-A driven

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people because of the financial rewards it traditionally offered. The past may not reflect the future, so someone considering an analyst role has to be comfortable that salaries may decline. I believe it's just being cognizant that there has to be a true love for investing.

A second piece of critical advice I have is the importance of removing one's ego. Ego is the driving force behind most intelligent people's mistakes. To quote Ryan Holiday, "Ego is the enemy." It's a desire not to look wrong in front of peers. It's uncommon that the simple question that's in the back of others' minds is asked publicly. Nobody wants to look like they didn't get an investment absolutely right. The more that a person can take ego out of the decision-making, I believe the further a person will go in this business.

Understanding as early as possible what the most important question to ask that identifies the critical few data points or research topics that your superior—PM or senior analyst—focuses on will go a long way. Invariably, your boss, and to whom he or she reports, are your customers and if you make your customers happy, you'll be successful. The better you can make them look, the better you'll look.

The mistakes that I've made have been not focusing my attention around getting the right information quickly so that I could have a deeper and more productive conversation.

**G&D:** Do you have any thoughts on what the industry looks like when the shift from

active to passive settles down a bit?

**SW:** I still don't know whether this is secular or cyclical and I believe we'll learn this when stock prices decline 30% or 50%. Traditional active managers need to demonstrate their value through significant outperformance to justify their fees over the full cycle. If they can outperform in that environment, it will benefit the industry. If there's not that significant gap between what an index and what active management is able to generate during a downturn, then fee pressures will continue.

The cost structures of twenty or more analysts, a full sales team, and all the compliance is just not realistic unless the firm has hundreds of billions in AUM. I envision the industry ending up with more boutique managers that have between three and seven investment professionals, including PMs, who may have a little bit more compensation at risk. They'll carry lower overhead and be able to compete more on fees. For investment management firms the incremental dollar that comes in really flows to the bottom line. There's significant operating leverage. Assets have been trending down for active managers. Cost structures have to decline to mitigate the impact and labor is a large percentage of the cost base.

I don't know how valuable the tenth or twentieth analyst on the team, who covers a tiny slice of the market, really is, especially when much of the initial financial analysis can be done better with computer

analytics. The value over time will come from the qualitative insights that drive performance.

For example, the ability to ask specific questions of management teams, of industry consultants, of expert networks, that will have a lot more value going forward than the financial model. Active managers need to focus on the opportunities that won't score well on factor models but where there's a high probability of market-beating returns.

***"We want the best IRRs, and we're willing to hold longer term and look like an ugly stepchild."***

**G&D:** You mentioned cultural mismatch earlier. Any thoughts on that subject for students?

**SW:** Culture is the most important thing to understand about a company, and to understand about one's self. Everyone should understand his or her strengths and weaknesses, and seek environments that allow strengths to thrive. There's a self-awareness component, and perhaps I didn't have enough self-awareness earlier in my career.

Every organization is political and understanding the politics of people and personalities is critical. Coming back to the difficult situation that I placed myself in, the nature of that organization was that there were strong egos. I tried to

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overcome other people's egos by arguing my perspective with objective, quantitative data; that wasn't how arguments were won in that organization. I should have done a better job of finding former employees who had worked there to get a better sense of how decisions were made, and the relationship between senior management and others in the organization. There wasn't an investment style difference, but there was a research difference, whereas at Evercore, I believed there was an emphasis placed on very deep-dive research, which tended to be very quantitative and analytical. Why is this number volatile? Why is that changing? Let's go back four annual reports, make all the adjustments, normalize it, and understand what was going on in the spreadsheet, and let that analysis drive qualitative questions.

The San Francisco situation was a very small team. There's a dichotomy in how organizations will handle differences of opinion—some say, "Culturally, we want to have a diversity of thought and opinion.

While others will take the other side. "We want to make sure everybody is exactly on the same page when thinking about this." I misread the situation. I thought it was the former, and it was more the latter. My strengths did not align with what they wanted for how their team was constructed. It comes down to culture and how much research you can do on your own strengths and weaknesses that tie into that culture. If there's not a good fit, even if

it's a great opportunity, it's probably not the right opportunity.

**G&D:** That's excellent. Thank you so much again for your time.



Zach Rieger '17

Zach is a second-year MBA student at Columbia Business School. He spent his summer internship at Owl Creek Asset Management. Prior to CBS, Zach worked in private equity at PineBridge Investments after spending two years in BAML's technology investment banking group. He holds a BA from the University of Pennsylvania.

## Foot Locker (NYSE: FL)—Short 2017 The Heilbrunn Center for Investing Stock Challenge—1st Place Finish

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### Recommendation

Recommend a short on Foot Locker (FL) with a price target of \$55, offering 20%+ downside from today's price of \$69.

### Business Description

Foot Locker ("FL" or "the Company") is the largest specialty retailer for athletic footwear in North America and has benefited from secular trends towards more casual footwear and healthy lifestyle. The Company has 3,401 stores globally with ~13mm square footage and FY 2015 revenue of \$7.4Bn. FL operates a number of different concepts including Foot Locker, Champs Sports, Lady Foot Locker, Eastbay, Six:02, and Runner's Point. Each concept has a different target customer and slightly different inventory mix but footwear represents 82% of revenue. FL also has a very concentrated supply base with Nike representing 73% of revenue and the rest primarily coming from Adidas, Under Armour and a few other players.

### Investment Thesis

#### 1) Key Suppliers Such as Nike and Under Armour Want to Grow Their Direct to Consumer

##### ("DTC") Business

Foot Locker's largest supplier is Nike, with 73% of sales. Nike is increasingly trying to grow their direct to consumer business due to the higher margins, which puts it in direct conflict with Foot Locker. Foot Locker's key advantage vs. e-commerce is the exclusive inventory they have, which may slowly be evaporated away as Nike attempts to use that inventory for their DTC business. In order to reach their \$16Bn DTC goal by 2020, NKE needs to grow 20% per year, implying that there will be a lot of pressure to enhance and grow this business from management.

#### 2) Average Sale Prices ("ASPs") are plateauing / declining for Nike Basketball Shoes

Basketball shoes have seen a major increase since 2010, which has generated much of the success at Nike and Foot Locker. The trend towards basketball shoes as a fashion item helped to increase the ASP at Foot Locker as basketball shoes are ~14% premium to casual sneakers and 38% premium to running sneakers sold at Foot Locker. The key driver of this basketball trend has been the growth and popularity of Jordan Brand sneakers. Nike also has a number of other superstars in its stable including LeBron James, Kobe Bryant and Kevin Durant. However, over the past year the sneakers for these stars have not been as popular and other brands have taken some market share, driving down ASPs.

On top of the issue with basketball sneakers declining in popularity, Nike has lost market share with the resurgence of Adidas and Puma and emergence of Under Armour in the sneaker space. Nike has started to see a deceleration in both unit growth and ASPs over the last four quarters. The ASP growth is largely explained by lackluster performance in basketball shoes, as a few of the marquee shoes (LeBron's, KD9, etc.) were not as successful as anticipated. The decline in unit growth is likely explained by market share losses as

Current Capitalization		
Share Price	1/20/17	\$69.14
DSO		134.0
<b>Market Capitalization</b>		<b>\$9,265</b>
Plus: Debt		128
Less: Cash		(865)
<b>Enterprise Value</b>		<b>\$8,528</b>

Trading Statistics	
52 Week Low - High	\$50.90 - \$79.43
Avg. Daily Volume (\$ in mms)	\$79
Short Interest as % of Float	6.4%
Dividend Yield	1.7%
Net Debt / 2016E EBITDA	(0.6x)

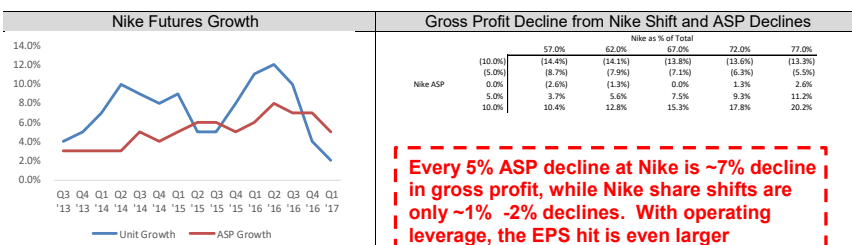
Summary Valuation			
	2016E	2017E	2018E
<b>Base Case</b>			
EV / EBITDA	7.5x	7.9x	8.0x
Price / Earnings	14.8x	15.3x	15.2x
FCF Yield	5.8%	5.8%	5.8%
<b>Consensus</b>			
EV / EBITDA	7.3x	6.8x	6.5x
Price / Earnings	14.5x	13.2x	12.0x
Price / Earnings (ex. Cash)	13.0x	11.8x	10.8x

vs. Consensus			
	2016E	2017E	2018E
Revenue - ZDR	\$7,690	\$7,806	\$7,923
Revenue - Consensus	\$7,778	\$8,147	\$8,531
% Difference from Consensus	(1.1%)	(4.2%)	(7.1%)
EBITDA - ZDR	\$1,143	\$1,085	\$1,066
EBITDA - Consensus	\$1,168	\$1,251	\$1,319
% Difference from Consensus	(2.1%)	(13.3%)	(19.2%)
EPS - ZDR	\$4.67	\$4.53	\$4.55
EPS - Consensus	\$4.76	\$5.24	\$5.74
% Difference from Consensus	(1.9%)	(13.5%)	(20.8%)

## Foot Locker (FL)—Short (Continued from previous page)

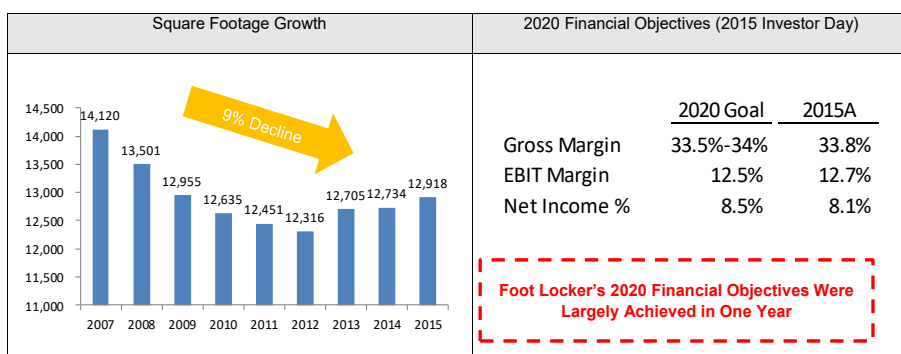
Adidas and Under Armour have taken share in the space. Both of these have important impacts to FL's P&L:

- Nike ASPs are ~32% higher than Adidas and other shoes (calculated by taking the top sellers on Footlocker.com and averaging for both Nike and Adidas) so the decline in Nike share hurts Foot Locker's gross margin dollars ~1.3% for every 5% Nike loses.
- More importantly, a decline in ASPs (due to mix shift) in Nike more directly hurts Foot Locker, and every 5% ASP decline is ~7% in gross profit dollars.
- FL's cost structure is largely fixed, so these declines fall almost entirely to the bottom line.



### 3) Foot Locker Store Base is Mature and Efficiently Run, Leaving Little Room for Growth Upside

Foot Locker's revenue growth has largely come from ASP increases as they have shrunk the store base. Foot Locker is also a mall-based retailer, facing general industry headwinds on mall traffic. While the Company has been able to succeed despite these headwinds, and remains a destination for many shoppers, there is only so much FL can do to maintain traffic and volume momentum going forward.



"I think it will be hard for them to grow at the same rate as they have been after 6 years of topline gains. They are run pretty efficiently, when the economy was in rough shape we managed a lot of the costs and got very efficient...but I think mid-single digit growth is going to be really hard, low single digit is more likely." – Former President and CEO of Foot Locker

### 4.) Border Adjustment Tax Could Provide Meaningful Downside and Erode Foot Locker's Profitability

Nike is responsible for 73% of Foot Locker's sales and manufactures a majority of their footwear overseas. Under proposed new tax reform, imported goods would not be deducted from COGS, materially increasing Nike's overall COGS. Given their dominance in the relationship, this would likely be passed on entirely to Foot Locker, who would then have to pass on to the customer or eat the cost increase. This provides meaningful downside, as certain scenarios would erode most of FL's profits.

2017E EPS					
Border Tax Adjustment Increase to COGS					
	0.0%	5.0%	10.0%	15.0%	20.0%
Corporate	\$5.93	\$4.48	\$3.03	\$1.58	\$0.13
Tax	\$5.58	\$4.22	\$2.85	\$1.49	\$0.12
Rate	\$5.23	\$3.95	\$2.67	\$1.40	\$0.12
	\$4.88	\$3.69	\$2.50	\$1.30	\$0.11
	\$4.53	\$3.42	\$2.32	\$1.21	\$0.10

### Valuation

Base Case Return Potential: FY '17 EPS of \$4.53 at 12x EPS is \$55 (20% downside)

Bear Case Return Potential: FY '17 EPS of \$4.33 at 10x EPS is \$43 (37% downside)

Bull Case Return Potential: FY '17 EPS of \$5.93 at 15x EPS is \$89 (30% upside)

There is additional downside from the border adjustment tax, but that is not baked into the operating assumptions at this point as it is not clear what tax reform will look like. This is a key part of the on-going thesis.

### Key Risks

**Secularly Growing Industry:** Foot Locker benefits from the trend towards casual footwear as consumers purchase more and more sneakers. As the largest specialty retailer, they have and will continue to benefit from this trend.

**Clean Balance Sheet + Capital Return:** FL has a net cash position and low Net Debt / EBITDAR which allows free cash flow to go towards share buybacks and dividends

**International Growth Opportunity:** Foot Locker has an opportunity to expand through new stores internationally which should enhance the growth profile vs. a relatively mature store front in the U.S.





Alexander Levy '17

Alexander is a second year MBA student in the Value Investing Program at Columbia Business School. He spent last summer at Arbitr Partners, a New York based hedge fund. Prior to CBS, Alexander spent four years at Morgan Stanley in equity research covering coal, steel, and iron ore. He graduated from Duke University with a degree in political science and is a CFA® charterholder.

## Axalta Coating Systems Ltd. (NYSE: AXTA)—Long 2017 The Heilbrunn Center for Investing Stock Challenge—2nd Place

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### Executive Summary

Axalta is an undervalued, misunderstood coatings company with durable competitive advantages that also generates prolific FCF. The market perceives a cyclical chemical company that sells into the economically sensitive auto end market, particularly in the U.S.. On the contrary, only ~32% of sales are to auto OEMS and only ~10-15% of sales are to auto plants in N. America. Axalta's core business (~50% of EBITDA) caters to the more stable auto refinishing market (repair work driven by collisions), where the company's customer base is fragmented and less price sensitive given the importance of flawless refinish work. Axalta occupies a leading position in most of its markets, which are also highly consolidated. Given pricing power, EM exposure, and current end market outlooks, investors can expect GDP+ (3-5%) sales growth.

Capital Structure (\$m)	
Share Price	\$28.75
Diluted Shares	240.1
Market Cap	6,903
Cash	528
Debt	3,482
Net Debt	2,954
Noncontrolling Interest	120
Enterprise Value	9,977
After-Tax Pension Liability	158
Adj. Enterprise Value	10,135

Ongoing cost cutting initiatives are expected to add ~\$200M of EBITDA (~30% of 2013 starting EBITDA) by year-end 2017 following the company's 2013 divestiture by DuPont. Management is streamlining operations in what was formerly a small business lost in a corporate behemoth. Axalta has dramatically improved its leverage profile, with debt almost at target levels of 2.5-3.0x EBITDA and no maturities until 2020. Purchase accounting obscures the company's true economic earnings power by inflating depreciation and amortization and depressing GAAP ROIC due to the re-marking of assets after the company's sale. Investors are currently able to buy a stake in a durable franchise with a tangible ROIC of ~20%+ at an attractive 8%+ levered free cash flow yield. My \$35 price target implies ~20% upside and assumes a 6.5% 2018e FCFE yield or ~11.5x EBITDA.

### Company Description

Axalta is a global manufacturer of coating products used to paint or refinish autos. Axalta was formed by The Carlyle Group to acquire DuPont's Performance Coatings business in 2013 and completed its IPO in 2014. Carlyle has since exited its investment, but Berkshire Hathaway currently owns a 9.8% interest. The Performance Coatings segment sells coating solutions to auto refinishing (42% of sales) and industrial (16%) customers. The Transportation Coatings segment sells coatings to OEMs of light (32%) and commercial (10%) vehicles.

### Investment Case: Long

#### Favorable Market Structure

Axalta holds a leading 25% global market share in its core auto refinish end market and a 2nd place 19% share in the auto OEM market. As a result, Axalta has the global reach and scale to serve large global OEMs. The markets in which Axalta operates are also highly consolidated, with 67% of the refinish market and 74% of the OEM market served by the top four players. Increased market concentration reduces competition and increases pricing power. In the OEM market, carmakers looking to retain multiple coating suppliers distribute business broadly to the leading players, reducing internal industry rivalry and price competition.

#### Refinishing Business is a Durable Franchise with Barriers to Entry and Low Cyclicity

Axalta's core refinishing business constitutes ~42% of sales and ~50%+ of EBITDA. The refinishing business has more favorable characteristics than direct to OEM. First, refinishing is less cyclical. Collisions occur regardless of the state of the economy and continue to require repair. Accordingly, refinishing revenue tends to have more recurring or maintenance-like characteristics. Second, the refinishing customer base is extremely fragmented. Axalta sells to ~80k auto body shops that have very little pricing power over a consolidated stable of coating suppliers. While there is a trend toward multi-shop operators (MSOs), it is unlikely to lead to major changes in market dynamics given the long runway for consolidation. In addition, as a market leader, Axalta is well positioned with MSOs, meaning the company will likely pick up market share.

Third, coating refinishing makes up only ~5-10% of the total cost of an auto repair. Accordingly, Axalta has flexibility to implement price increases and pass through raw material costs without dramatically affecting end customer costs. Furthermore, refinishing is one of the most critical parts of an auto repair, since the exterior is the most visible part of the car. Any flaws in paint or color matching are generally unacceptable, making quality more important than price. Fourth, through its refinishing business Axalta offers body shop customers not only the actual coating product used but also a range of services. The company provides technical support and training to customers as well as color matching equipment and software. The company has an extensive library of 4m color variations. As mentioned above, successful color matching is imperative. These services deepen relationships and make switching more difficult, risky, and time consuming for customers.

#### OEM Business Has Healthy Competitive Dynamics

While more competitive than refinishing given the smaller customer base, there are several factors that help

## Axalta Coating Systems Ltd. (AXTA)—Long (Continued from previous page)

protect returns in Axalta's OEM business. First, the high level of market concentration (see above) helps with pricing power. Second, coatings are only ~1% of the total cost of a car, meaning OEMs are not able to win big savings by pressuring coating suppliers. Axalta has been successful in passing through raw material costs. Third, value-added relationships and on-site placement of technical staff at OEMs increase customer stickiness. Some relationships with automakers date back 90 years.

### Exposure to OEM Auto Sales is Geographically Diversified

~32% of total sales are to auto OEMs, but only ~10-15% of sales are to N. American auto plants. As a result, while certainly important, U.S. auto sales are not the dominant earnings driver. The company's OEM portfolio is well diversified, reducing the risks posed by any one region: ~9% of sales are to automakers in EMEA (flat to modestly positive sales outlook), ~5% of sales are into the LatAm OEM market (likely near trough after steep declines in 2014-2016), and ~5% of sales are to Asia Pacific OEMs (~4% expected annual sales growth). In all, ~31% of Axalta's sales are to emerging markets, which are seeing increasing auto penetration, providing a long growth runway.

**Cost Cutting Initiatives Provide Self-Help Route to Higher Earnings; Costs are Highly Variable and Capex Intensity Low**  
Under DuPont, Axalta was not optimally run. Post-LBO, Axalta has two ongoing cost cutting initiatives that have already yielded results but also have more runway. "Fit-for-Growth" and "Axalta Way" are expected to yield ~\$200m in cost cuts by YE 2017, ~\$150m of which should be in place by YE 2016. The results are already tangible, as EBITDA margins have improved to 21.3% YTD vs. 20.3% in 2015, 19.0% in 2014, and 17.5% in 2013. Margins could reach ~22.5% by 2017/2018. In addition, raw materials (~70% oil and gas linked) represent ~50% of cost of sales, meaning half of costs are variable and fluctuate with production levels. As a result, Axalta has some ability to adjust its cost structure with changing demand. Capex intensity is low, with maintenance capex estimated at ~\$60m/year or ~1.5% of sales.

### Recent Currency Headwinds Unlikely to Persist Over Medium to Long Term

A strong USD has been an earnings headwinds for Axalta given ~66% of sales are outside N. America, but these issues should prove transient. The DXY index is near five year highs, meaning Axalta's foreign earnings translate into fewer dollars. 2015 sales fell 6% while actually rising 5% ex-FX. In 2016, the company expects flat sales compared to a 4.5% increase ex-FX. The economic impact of currency fluctuations will be smoothed out over time as FX rates normalize, removing the negative optics of falling or flat headline USD sales.

### Purchase Accounting Obscures Attractive Returns & Robust Free Cash Flow

When Axalta completed its LBO, its assets were re-marked to fair value. While the physical assets remained the same, their book value increased, lowering accounting returns. As a result, GAAP ROIC stands at a mediocre ~9% in 2016e, but removing goodwill and intangibles yields an attractive ~19%/21% ROIC in 2016e/2017e. LBO purchase accounting also inflated D&A, which totaled ~\$320m in 2016e vs. capex of ~\$160m (including only ~\$60m maintenance capex). As a result, FCF runs well in excess of net income, making Axalta appear expensive on a P/E basis. The company trades at 21x 2017e EPS (~5% earnings yield) compared to a more attractive ~7% FCFE yield.

### End of Deleveraging Bodes Well for Capital Deployment & Cleaned Up Balance Sheet Reduces Cyclical Risks

Since the LBO in 2013, Axalta has been working to reduce its leverage to a more prudent level. Starting from an initial 5.6x net debt/EBITDA, the company has reduced leverage to 3.3x TTM EBITDA. Management is targeting net leverage of 2.5-3.0x EBITDA, which will likely be achieved by early to mid-2017. Once this goal is met, management has publicly stated that the company will consider capital returns (dividends or buybacks). In addition, the next debt maturity is not until 2020 and the revolver was extended from 2018 to 2021. Axalta was able to lower its average cost of debt from 4.7% to 4.0%, and interest coverage is healthy at 4.3x EBITDA/interest in 2015, 4.9x in 2016e, and 5.9x in 2017e.

### Room for Continued Accretive Tuck-In M&A

Axalta will likely continue to allocate to tuck-in M&A given the long time horizon of shareholders like Berkshire. The company has spent ~\$104m on acquisitions YTD in 2016 at an implied multiple of ~1x sales and ~5x EBITDA (given acquisition margins roughly in-line with company margins). As a result, M&A can be very accretive given that Axalta trades at ~11x 2016e EBITDA. The company focuses on targets that produce specialized products or offer geographic diversification.

### Valuation

My \$35 price target implies ~20% upside to intrinsic value and is derived from a relative valuation based on FCF and EBITDA checked against a DCF. I apply a 6.5% yield to my estimate of 2018e FCFE, which implies an ~11.5x EBITDA multiple. Peers trade at an average 2018 EBITDA multiple of ~10.5x and 2018 FCFE yield of ~5.5%, including diversified competitors, but coating focused peers (PPG, RPM, Sherwin-Williams, Valspar) trade at 10-12x. In fact, Sherwin-Williams is buying Valspar for 15x 2016e EBITDA or 10.9x post-synergies. I believe that Axalta can also compound intrinsic value over time at 10-12%+ annually given 6.5% FCFE yield, 3-5% sales growth (GDP plus share pick ups in the MSO refinish market, EM growth, and depressed starting points in LatAm, commercial, and energy exposed end markets), and 0-2% earnings growth from M&A and cost cutting.

### Upside Catalysts

1) Feb 22 analyst day; 2) Cost execution; 3) Hitting leverage target; 4) FX normalization; 5) Commercial vehicle rebound

DCF Summary		Price Target	
WACC	7.5%	2018e NCI Adj. FCFE	544
LT Growth Rate	1.5%	FCFE Yield	6.5%
Terminal EV/EBITDA	10.5x	Target Market Cap	8,375
Terminal FCFE Yield	5.9%	Price Target	\$35
Target Enterprise Value	11,012	2018e Attrib. EBITDA	969
Target Equity Value	8,305	Target EV	11,083
Price Target	\$35	Implied EV/EBITDA	11.4x
Upside/(Downside)	20%		

Summary (\$m)	2013	2014	2015	2016e	2017e	2018e	2019e	2020e
<b>Income Statement</b>								
Revenue	3,987	4,392	4,113	4,092	4,134	4,343	4,520	4,655
EBIT	398	525	528	542	594	654	689	725
D&A	301	309	308	320	320	320	320	320
EBITDA	698	834	835	862	914	974	1,008	1,045
Interest Expense	215	218	197	180	150	146	155	118
Adj. Net Income	64	204	208	266	283	325	342	390
Adj. Diluted EPS	\$0.28	\$0.89	\$0.87	\$1.09	\$1.16	\$1.33	\$1.40	\$1.60
<b>Balance Sheet</b>								
Cash	459	382	485	614	1,053	1,570	2,072	1,773
Total Debt	3,921	3,614	3,442	3,321	3,311	3,299	3,287	2,408
Net Debt	3,462	3,232	2,957	2,707	2,258	1,729	1,215	634
Common Equity	1,143	1,045	1,074	1,380	1,703	2,068	2,450	2,880
Net Debt/EBITDA	5.0x	3.9x	3.5x	3.1x	2.5x	1.8x	1.2x	0.6x
EBITDA/Interest	3.2x	3.8x	4.3x	4.8x	6.1x	6.7x	6.5x	8.8x
<b>Cash Flow Statement</b>								
Cash from Operations	377	251	400	541	632	694	674	722
Capex	(162)	(188)	(138)	(160)	(160)	(145)	(140)	(125)
Free Cash Flow	215	63	262	381	472	549	534	597
Other Cash from Investing	(4,849)	10	(26)	(107)	0	0	0	0
Cash from Financing	5,098	(123)	(75)	(145)	(32)	(32)	(32)	(896)
Change in Cash	459	(77)	103	129	440	517	502	(299)
<b>Key Metrics</b>								
Revenue Growth	NA	10.2%	(6.3%)	(0.5%)	1.0%	5.0%	4.1%	3.0%
EBITDA Growth	NA	19.4%	0.2%	3.2%	6.1%	6.6%	3.5%	3.7%
Gross Margin	33.1%	34.0%	36.9%	37.1%	37.9%	38.2%	38.3%	38.5%
EBITDA Margin	17.5%	19.0%	20.3%	21.1%	22.1%	22.4%	22.3%	22.5%
ROIC	NA	7.3%	7.9%	8.6%	9.3%	10.6%	11.6%	12.6%
Tangible ROIC	NA	16.1%	16.8%	17.8%	18.3%	20.6%	22.6%	24.4%



Abheek Bhattacharya '18

Abheek is a first-year MBA student at Columbia Business School. Prior to CBS, he wrote for the Wall Street Journal in Hong Kong, most recently for its flagship Heard on the Street investment column. He studied philosophy at Yale University.



Harsh Jhaveri '18

Harsh is a first-year MBA student at Columbia Business School. Before that, he worked with Fidelity's venture capital and growth private-equity fund, and Barclays' investment banking team in India. Harsh received a B.S. in Electrical Engineering from Yale University.



Ryan Kelly '18

Ryan is a first-year MBA student at Columbia Business School. Prior to this, he worked as a consultant at Deloitte, most recently in Philadelphia. Ryan holds a B.S. in Finance from Villanova University.

## Cardtronics (NASDAQ: CATM)—Short 2016 Darden @ Virginia Investing Challenge—Finalist

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### Summary

Cardtronics is the world's largest non-bank ATM operator, with over 225,000 ATMs across the U.S., Europe and Australia. The Company typically owns or manages ATMs placed in retail outlets (CVS, Walgreens, etc.) and off-site ATMs for banks. While Cardtronics' primary revenue streams are surcharge fees from customers and interchange fees from banks, it also earns revenue from bank branding on ATMs and management fees. The short thesis for Cardtronics is based on declining cash usage, limited organic and inorganic growth opportunities and the loss of its largest customer (18% of revenue), which will also lead to increased competition in this space. Cardtronics is currently trading close to its 52-week high and is valued at 25x FY16E earnings.

### Investment Thesis

1) Cash usage is on a decline globally, both as consumers switch to debit cards and as digital payments rise. ATM cash withdrawals in the U.S. declined nearly 1% from 2009-2012, based on the latest Federal Reserve data available as of November. According to Accenture, North Americans using cash for transactions will decline from 66% in 2016 to 54% in 2020. Other reports by Euromonitor and McKinsey also highlight similar trends.

- Cardtronics' performance has mirrored the trend in declining cash usage, with same-store cash withdrawal transactions going from 4-8% growth in FY11 to negative growth.
- ATM unit economics have also significantly deteriorated with revenue per ATM decreasing from \$14,335 in FY11 to \$7,534 in FY15, as CATM expands with machines where it only manages the services (and collects a management fee). These have grown from 10% of total ATMs in FY12 to 60% of all ATMs in 9M FY16 and earn ~5% the level of the average Cardtronics ATM.

2) Cardtronics will lose its largest customer in mid-2017, which paves the way for increased competition

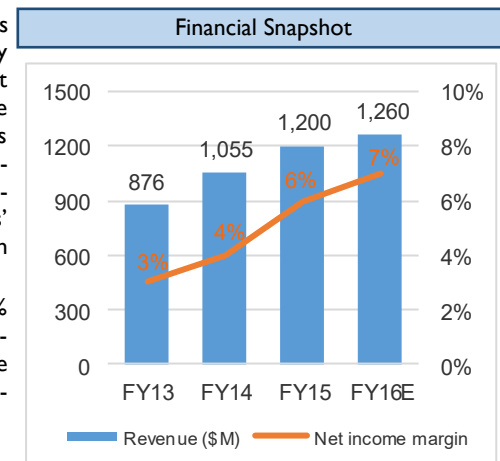
- Cardtronics' largest customer 7-Eleven, which contributed 18% of revenue, has decided to terminate its contract in July 2017. It will switch to FCTI, a company owned by Japan-based Seven Bank, whose biggest shareholder is 7-Eleven's holding company. While the revenue impact from the loss of this contract is known, its impact on profitability is even higher. The 7-Eleven contract likely earns higher margins given 7-Elevens receive higher foot traffic than Cardtronics' other retail locations and that the ATMs in 7-Eleven included a \$50M bank branding fee with Citi.
- Cardtronics' remaining top four retail customers (19% of revenue) have contracts due for renewal in an average of three years. They potentially now have more bargaining power with Cardtronics post the loss of 7-Eleven and can threaten to defect to FCTI.

3) Cardtronics has masked its inability to grow organically

by acquiring 14 companies since 2011. But acquisition opportunities will be limited in the future:

- In its most recent deal, Cardtronics agreed to acquire one of its largest rivals DirectCash (expected closing in January 2017). The \$460M transaction, which included \$205M debt from DirectCash, was funded primarily by cash and additional debt from Cardtronics' existing lenders. Cardtronics' proforma net debt / EBITDA will be 2.6x, close to triggering the 3x covenant on its revolver. Further, Moody's undertook a review of Cardtronics' rating for a downgrade after this transaction announcement. This will prevent Cardtronics from exploring any significant acquisitions in the future.
- Cardtronics' own M&A binge has reduced acquisition opportunities in the future.

Market Metrics	
Share price (11/4/16)	47.4
Diluted shares outstanding (M)	45
<b>Market cap (\$M)</b>	<b>2,145</b>
plus: debt outstanding	519
plus: minority interest	(0)
less: cash and ST investments	60
<b>Enterprise value (\$M)</b>	<b>2,604</b>
52 week high share price (\$)	50.5
52 week low share price (\$)	28.0
FY17E projected EPS	1.87
<b>P/E multiple</b>	<b>25.4x</b>
2yr avg. fwd P/E multiple	21.0x



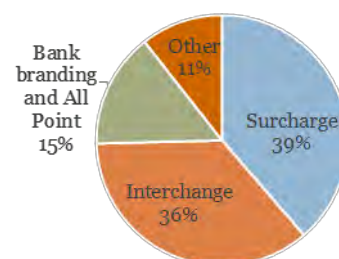


## Cardtronics (CATM)—Short (Continued from previous page)

4) Cardtronics management's interests are misaligned with shareholder interests:

- Management advertises adjusted EBITDA and adjusted net income in all its interactions with shareholders. From the proxy statements, it is evident that their compensation is also linked to these adjusted profitability metrics, allowing them to ignore actual GAAP profitability.
- The CEO currently owns just 0.6% (1% including unvested shares) and the ex-CFO owns 0.2% (0.3% including unvested shares). The ex-CFO retired and has recently been replaced.
- The CEO has sold 51,714 shares (~18% of his ownership) worth \$1.7M in the last two years

Revenue breakup



### Valuation

Based on CATM's 2-year average forward P/E of 21x, we ascribe a 21x multiple to FY19 EPS

**This results in a price target of \$30.3, a 36% downside.**

	Exit multiple				
	19x	20x	21x	22x	23x
Price	27.4	28.9	30.3	31.7	33.2
Downside	(42%)	(39%)	(36%)	(33%)	(30%)

### Catalysts

- The impact of the loss of the 7-Eleven contract on profits will only be understood in the 2<sup>nd</sup> half of 2017
- The remaining 4 of Cardtronics' top 5 customers, which comprised 19% of revenue, will renew—on average—in the next three years. These contracts will be under competitive pressure since FCTI has entered the fray.

### Risks

- Cardtronics may announce another large acquisition.

*Mitigant:* Given that Cardtronics' credit rating was recently reviewed by Moody's for a downgrade and its pro forma net debt / EBITDA position is 2.6x, which is very close to its 3x revolver covenant, it seems unlikely that they will make any major acquisitions in the near future. Further, given that Cardtronics has acquired 14 companies since 2011, there are practically no large acquisition targets remaining.

- Cardtronics may partner with a big bank

*Mitigant:* Partnering with a bank would help Cardtronics earn managed services revenue or a bank-branding fee, but revenue per managed services ATMs is only 5% of the revenue earned from the average Cardtronics ATM. It is also questionable whether banks value a long-term bank-branding relationship with Cardtronics given that Cardtronics is both a competitor and a partner. An example of this is when Chase cancelled its partnership with Cardtronics to manage its off-premise ATMs in 2014.

- Cardtronics expands into emerging markets

*Mitigant:* Regulations regarding ATMs in emerging markets are more stringent, probably the reason why most independent operators have focused on developed markets so far.

\$M unless specified	FY13	FY14	FY15	FY16E	FY17E	FY18E	FY19E
Number of ATMs (#)	72,091	91,440	150,514	200,086	229,871	232,964	239,132
% growth		27%	65%	33%	15%	1%	3%
Revenue per ATM (\$)	11,849	11,021	7,534	6,050	6,050	5,748	5,460
% growth		(7%)	(32%)	(20%)	—	(5%)	(5%)
Revenue	876	1,055	1,200	1,260	1,415	1,359	1,350
% growth		20%	14%	5%	12%	(4%)	(1%)
Gross profit	281	351	417	444	511	492	489
% margin	32%	33%	35%	35%	36%	36%	36%
EBIT	83	105	140	154	146	145	144
% margin	9%	10%	12%	12%	10%	11%	11%
Net profit	24	37	67	85	69	69	68
% margin	3%	4%	6%	7%	5%	5%	5%
Diluted EPS	0.52	0.82	1.48	1.87	1.49	1.46	1.44
% growth		58%	80%	26%	(20%)	(2%)	(1%)



Jared Friedberg '99

## Jared Friedberg

(Continued from page 1)

**Partner of Compass Global Investments LLC, a single-family investment company based in New York. Prior to Compass, Jared was a Principal at Cortec Group, a U.S. middle-market leveraged buyout fund where he was involved in a myriad of industries including healthcare, retail, and value-added manufacturing. Jared has also held positions in the M&A group at Salomon Brothers and in equity research at Brown Brothers Harriman & Co. Jared earned his MBA from Columbia Business School and graduated magna cum laude from the University of Pennsylvania with a B.A. in Diplomatic History.**

### Graham & Doddsville

**(G&D):** Could you tell us about your background? What brought you to investment management? What was the origin of the Mercator Fund?

**Jared Friedberg (JF):** I graduated from Columbia Business School in 1999. I was very interested in learning how to analyze businesses using a value investing philosophy. I focused on finding work in private equity, on the leveraged buyout side. My logic was to see many kinds of businesses in tremendous detail. Coming out of business school, I got a job at Cortec Group, a middle-market leveraged buyout fund. It was a hands-on, operationally focused firm.

Over the course of my seven years there, I had the opportunity to analyze

hundreds of businesses, and to own businesses and be forced to live with those investment decisions; a valuable experience in seeing patterns in investing. You tend to think about risk and the potential for capital impairment differently when you're buying something and putting a lot of debt on it.

What happened afterward was an interesting life event. In 2006, my father-in-law and my wife started the process of setting up a single-family office. My father-in-law was a Latin American industrialist and, starting as early as the 1980s, had been investing in alternative assets. They were essentially taking their holdings and putting them under one roof. Throughout the course of that year, as they were putting the pieces together, I became interested in the family office as a platform for investing. I liked the intellectual honesty that you could bring to bear using that platform and the focus on capital preservation that investing your own capital requires.

At the end of 2006, I left Cortec to help set up the family office. I liked the prospect of having a seat where you are looking at other investment managers, both on the private equity and public sides. You get to see what they're doing well, what you think they're doing incorrectly, where your philosophy jibes with theirs, etc. It was very interesting for me to go from my previous micro-level analysis of companies to thinking more broadly about capital allocation.

As the financial crisis hit in 2008, the family had the good

fortune to be sitting on a lot of cash. We started to consider where to deploy that capital in such a distressed environment. And when we considered the risk positioning of certain managers that we were invested in—both into the crisis and then their business stability and psychology when opportunities presented themselves during the crisis—we found ourselves less than satisfied.

### G&D: How so?

**JF:** Certain managers were reaching for risk too much on the way into the crisis, and not reaching for it enough on the way out. Of course, you don't always know whether that is purely psychology or whether that is driven by a lack of stable capital, or both.

### G&D: So is this when the Mercator Fund came about?

**JF:** Yes, a family office provides a great stable capital base for taking advantage of mispriced opportunities with an uncertain time horizon. So we set up a series of managed accounts for the family, with the mandate of taking my private equity and debt experience, and applying that to public market opportunities.

From the outset, we wanted to be able to invest across the capital structure. It was clear that the opportunities weren't only in equities. We were witnessing some incredible fixed income opportunities at that time. By going higher in the capital structure, we could get access to returns that were very attractive, so we were initially more heavily weighted to fixed income, with the

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rationale being, why take more risk if we don't have to? The other factor central to the strategy relates to my private equity days. If you think about private equity dynamics, a private equity fund raises a pool of capital and they have a time limit to put that to work. You put that money to work or you're out of business as you won't be able to raise the next fund. The incentives are not ideal. We don't have those incentives. We felt that part of being intellectually honest had to be that we didn't have to be fully invested. If we weren't finding compelling opportunities, our strategy was, and is, that we don't have to invest the capital.

**G&D:** So you've been around for eight years and have a solid track record, yet you seem to be quite under the radar.

**JF:** Yes, until very recently we primarily managed capital for the family and some business partners with similar philosophies to ours. And in 2013, we converted the managed accounts into a fund and spun out of the family office. The family remains our largest investor, but now we also have some high net-worth individuals, other family offices, and a couple endowments as investors as well. We are seeking to grow the capital in a gradual, disciplined manner.

**G&D:** How did your background in private equity inform your worldview and your investment process for public securities?

**JF:** When I graduated business school, I had the idea that private equity was a less trafficked area. Then I quickly

realized that when an asset is for sale in the way that private companies are today, there are typically many middle-market buyout funds that are looking at a given opportunity. Proprietary sourcing of deal flow is challenging.

In private equity, you're creating this environment of perfect competition when you're looking at an asset. I realized quickly that in the public market, the competition is sometimes less perfect than I would have expected and sometimes things are out of favor in ways that are irrational. You can take advantage of this dynamic in a very fluid way, which you rarely can in private equity.

**G&D:** What is the Mercator Fund's investment approach?

**JF:** We operate in three asset classes—equities, fixed income, and cash. It is important to us that there be no preset allocation among the three. Within equities, we're really trying to do two things: we're seeking underappreciated compounders, which means something specific to us, and special situations.

In terms of compounders, we're always looking out for systemically important businesses whose existence is critical to their industries. Our markets are developed markets with good legal regimes like the U.S., Canada, and Western Europe, which provides us with multitudes of industries and thousands of publically traded companies to explore. We pay attention to industries, even niche industries, that are growing and where competition is

rational. If we identify a company that is becoming more dominant or growing faster than the industry, especially with pricing power, we continue our work. And if the dynamics we described are resulting from a sustainable competitive advantage that we can identify, that's where we really get excited.

***“In private equity, you’re creating this environment of perfect competition when you’re looking at an asset.”***

Now, within that dynamic, you do not often find those opportunities undervalued. But we don't approach sourcing compounders from a value perspective, we come at it from a quality perspective. We are doing work on opportunities irrespective of the value today. The idea is to create a backlog of businesses that you dream of owning when they are temporarily misunderstood or out of favor.

Special situation equities are more amorphous. We're generally looking for situations where value is obscured by complexity. That can come in a lot of forms; there are scenarios we see repeatedly to help us identify such situations. Let me provide a few examples.

First, liquidations. We recently identified REITs that we thought would be prone to liquidation and got involved with them, owning them into a potential liquidation, and then throughout the process. This

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allowed us to buy groups of quality assets at significant discounts to intrinsic value where that value is realized in an idiosyncratic way. So the correlation to other assets and the markets is limited.

Another area of opportunity is businesses that have assets in one country but are publicly traded in another. For example, we own a U.S. cinema operator with operating and real estate assets in Australia and New Zealand. The complexity makes these assets difficult to own, which has led to a dislocation in value.

We also look to identify hidden assets that do not appear on the balance sheet of a company. For example, we were recently involved with a publicly traded restaurant franchisee, where the market did not appreciate that the company had a right of first refusal to buy other franchisees in their network. This right has tremendous value but is not recognized on the balance sheet.

**G&D:** And what is your approach on the fixed income side?

**JF:** On the fixed income side, we explore distressed opportunities, but our main focus has been on what we call stressed credit, a situation where we feel the bonds are pricing in real risk where we believe the risk is limited. We are looking for areas of stress, and this can come in a lot of forms. It can be idiosyncratic to the company, or our sourcing can also be more macro. For example, during the European crisis in 2011

and 2012, there was a lot of investor fear. The bonds of very stable businesses were trading at attractive yields with what we believed was minimal risk of capital impairment.

Another area we source such opportunities is the publicly traded debt of private companies. We have found the debt of private companies can be particularly interesting as information is not readily available. Just having to get approval from the CFO of the company to get the information removes a lot of the competition of people looking at such opportunities.

***“We rarely make an investment decision that does not have a 12 to 36 month timeline.”***

**G&D:** Across all categories, how do you think about entry points? And how about catalysts and timing?

**JF:** We rarely make an investment decision that does not have a 12 to 36 month timeline. Our stable capital base gives us the flexibility to not be pressured on timing. Even in those situations where there may be a catalyst, we feel like that catalyst being a year or two away often gives us an advantage.

In terms of entry points, we are disciplined about the price levels where we get involved with any investment. We document where we would buy the security at such an attractive discount that we're comfortable making it a predetermined size. If it trades

down, the points at which we're making it larger are also predetermined. The strategy is executed unless the thesis has changed.

We have gravitated to this price discipline because we have also found that it helps us manage our psychology. We use the same discipline when deciding when to trim or exit. When other people are freaking out and an asset is on sale, that's when we want to have the psychological wherewithal to step up and buy it. And the converse, we're reinforcing our psychological wherewithal to sell when others are too sanguine.

**G&D:** For your stressed credit investments, how do you think about where you want to be in the capital structure?

**JF:** We look across the capital structure of an enterprise. Take the special situation restaurant equity I mentioned before that had a right of first refusal to buy other franchisees. We felt that the equity was undervalued and we would be able to own it for a multi-year period. That company also came to the market to refinance its debt in March 2015. At the time, there was momentary fear affecting credit markets and the company had to settle for a higher interest rate than they expected. We already knew the business and the management, and with minimal risk we could earn an 8.5% return. In a sense, we looked at that and realized that 8.5% is actually more attractive than the double-digit return we're going to get in the equity.

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Zach Rieger '17 presents his winning investment idea at The Heilbrunn Center for Graham & Dodd Investing Challenge

**G&D:** Regarding your quality compounders, how do you determine when they are too expensive? If it's a truly dominant company, wouldn't a ten-year or longer discounted cash flow (DCF) analysis with reasonable scenarios still show upside?

**JF:** We always conduct a DCF on compounders, because it forces you to think through assumptions and about the growth trajectory and drivers of that business. We use a more conservative discount rate to be on the safe side. It boils down to whether we think the compound annual rate of return that we're getting, relative to the uncertainty of all of those assumptions that we just made, is worth the risk.

It's more art than science, but I can tell you if I'm making an assumption on something that's five, six, or seven years out and I'm only getting a mid-to-high single-digit compound annual return, that's not attractive enough for me. We can probably find ways to generate those kinds of returns, taking less risk, elsewhere. We always ask ourselves whether we can get those rates of return elsewhere with greater certainty and less risk.

**G&D:** When you are looking at a special situation or a compounder, do you stack those up against each other or do you have more absolute metrics to judge by?

**JF:** We don't have any high-level preset allocation among our asset classes. Our capital flows to investments where we have a high level of confidence

in the risk of capital impairment we're taking relative to the return we expect. So by definition, every idea is always being compared to the others. This dynamic is also what primarily defines our position sizing decisions. Something with a low risk of capital impairment and with an attractive return is apt to be sized larger than something where both the risk and return are higher.

When we can't find opportunities that meet our criteria, our allocation to cash is going to be larger. This approach has been heavily influenced by the family office emphasis on capital preservation and has allowed us to generate equity-like returns while taking less-than-typical equity risk.

**G&D:** What is your decision process in buying and selling? Do you have a process to guard against thesis drift?

**JF:** We make decisions collectively. We've tried to create an intellectually honest environment. It is not about being the smartest person in the room; we simply want to get to the right answer. Ideally, we protect each other from our own biases.

Before we invest in anything, we've determined the price levels at which we're buying and selling. There's only one real question when the price hits our target, which is: has the thesis changed? If the answer is no, we are selling. This is about forcing yourself to be disciplined. It is not always easy but it is important to have a plan in black and white in front of you.

That said, we're obviously not inflexible, but you can't cheat yourself. That's why we write a memo with the thesis, risks, signposts, etc., explaining why we believe the asset is mispriced. If we are shifting our approach, we have to clearly explain why the thesis has changed—it may be that growth is accelerating or the company has a new development.

I woke up one morning last week to see that one of our European compounders had announced a transformative merger with a complementary business. We went through the process of thinking about what it meant to put the businesses together and what value would be created. The thesis had changed and we couldn't, with a high level of confidence, get to a place where we were nearly as excited about the deal as the market. The intellectually honest thing to do was to sell the position and re-evaluate whether the combined entity met our standards as a compounder.

**G&D:** Can you talk a little bit about how you get a research edge?

**JF:** I think that MBAs often assume that most professional investors conduct a lot of primary research to gain real insights into a business and an industry. But we find it's not always the case. For example, one great way to get an edge is to get off the island: to go to industry conferences and engage with industry participants. The reality is that many investors don't go that extra mile. Let me give you a specific case. We have been

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following the deathcare space since 2014. The industry is primarily made up of funeral home and cemetery operators, which may be the least sexy businesses to be talking about. The industry only has a few public companies and doesn't fit into typical sell-side coverage so few analysts follow it. We attended the largest industry conference and it was pretty clear there was nobody from Wall Street in attendance. The attendees were all funeral home directors and they are usually thrilled to talk to an industry outsider interested in their work. That's where you can begin to develop a research edge, by understanding the dynamics of an industry.

There are also analytical insights from publicly available information. The CDC, for example, reports death statistics weekly and you can learn a lot from tracking such data. Last year was the weakest flu season in five years and, because there is a high correlation between flu severity and number of deaths, funeral homes reported disappointing results. We expected this to happen. We saw other investors extrapolate the results and over-react to what we viewed as temporary and extraordinary circumstances.

This was our chance to own a target in our backlog at our predetermined price. The industry has very attractive underlying fundamentals, is in the middle of major consolidation, and has a couple of high quality companies. We were very excited to initiate an investment when the stock price became dislocated last

year.

**G&D:** Can you discuss the investment in depth?

**JF:** Sure. As I mentioned, we find the underlying fundamentals of the industry to be quite attractive, such as the expected demographic tailwind. The average life expectancy for a person in the U.S. right now is about 80 years, so the average person dying today was born in 1937, which is right in the middle of the Silent Generation, before the Baby Boomer generation. Even though this isn't a cyclical business in the traditional sense, you can imagine the demographic trough we're in right now and the massive upturn Baby Boomer deaths will bring over the next decade.

***"We saw other investors extrapolate the results and over-react to what we viewed as temporary and extraordinary circumstances."***

We spent a lot of time looking at funeral homes and cemeteries to understand the economics of the businesses and how they make money, and found that they can be very high-quality businesses with significant barriers to entry. A quality funeral home in a local town can almost be a monopoly with customer stickiness going back many generations. You're not going to see new funeral homes come and take its business. Even fewer cemeteries pop up because of the land and capital

requirements, and zoning restrictions. Funeral homes and cemeteries also have high fixed costs. Now, if you imagine the incremental volume that's going to be coming through these homes with Baby Boomer deaths, it will be at high incremental margins because these are under-utilized assets. So you have businesses with pricing power, high incremental margins, and demographic tailwinds that are hard to escape.

In addition to organic growth, this is a consolidating industry where 80% of the market is still owned by independent families, mom-and-pop shops. Carriage Services (CSV) is the name we currently find most attractive. The Company owns 170 funeral homes in 28 states and 32 cemeteries in 11 states, so about 200 properties. They're about one-tenth the market cap of the largest player in the space, Service Corporation (SCI), which manages 2,000 properties.

What makes Carriage special in the deathcare space is both the management team and the business model. The management team is really focused on buying best-in-class assets. They do not acquire businesses for the sake of consolidation; they only look for great local businesses with pricing power and attractive local demographics, and great entrepreneurs to run those businesses. Their model is completely decentralized, meaning they're buying these businesses and letting them run on their own. One of the things that attracts these entrepreneurs to sell to Carriage is that they allow the

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homes to maintain their local, family business feel. SCI, on the other hand, is highly centralized, with a corporate top-down approach. In many ways, SCI has its own compounding capability, but we found Carriage's management team to really understand their advantage and utilize it to attract the best assets.

To return to the question about developing a research edge, our research on Carriage focused first on understanding the core business and management team, and second, on understanding the M&A opportunity and how much value that could create. It took us a lot of time to do the diligence and get comfortable around both of these points.

The CEO of Carriage is unconventional in a way that could put some investors off, so understanding his mindset was very important. He founded the company in 1991 and owns 10% of the Company, which is a majority of his wealth, so we feel well-aligned as shareholders. As we spent considerable time doing diligence on the CEO, we concluded that he is misunderstood and is in fact an excellent CEO. He has a great vision, he is a strong leader, and he is a disciplined capital allocator.

On the M&A side, after spending a lot of time talking to people in the industry, you start to understand what it means to have a quality funeral home versus an average one. You start to understand the reputation Carriage has, why it attracts quality assets, and why they're able to buy quality

assets at a reasonable price.

We have actually increased our investment in Carriage, despite buying at a higher price than when we initiated, as we have become more comfortable with the business, the industry, and the management team. We believe Carriage is a better business than the market perceives.

***“The great investors are the ones who have the ability to be independent in their thought.”***

Carriage trades at a price that does not reflect its solid core business and strong industry tailwinds. This, coupled with its excellent management team, unique decentralized consolidation strategy, and disciplined approach to capital allocation, provides us conviction we will compound our capital for years to come.

**G&D:** Is there a fixed income idea you could briefly share with us?

**JF:** Sure. One of our investments that we believe offers a compelling risk-adjusted return is the senior secured 2018 bonds of Soho House, a private British company that operates member clubs across the world primarily for people in creative industries. Members pay a monthly fee and pay to use the club's amenities—restaurants, bars, and meeting rooms. The clubs have approximately 66,000 members and a waitlist of

42,000 potential members. We like the stable, recurring revenue nature of the business. The low churn and growing member and waitlist numbers reflect the high value that the club provides to its members.

We think we have a variant view from many fixed income investors who look at trailing financials that reflect a business that is approximately 7x levered. The company is performing very well and in a major growth phase, having recently opened a number of new houses, so the growth-related expenses understate the company's true earnings power. We believe on normalized earnings, the company is actually levered under 4x, and the current yield of approximately 8% is attractive given the short duration and high quality of the business. As I mentioned, we've found that the public debt of private companies is a good source of opportunities as they can often trade at more attractive yields since their financials are not as easily accessible to all investors.

**G&D:** Any advice for students interested in getting involved in investment management?

**JF:** I would start off with something necessary for a newcomer's personal development. The amount of group think—the influence that people have on each other's beliefs—in this industry is quite surprising to me. I have been disappointed by the lack of independent thought. It's noisy and you've got to find ways to block out that noise.

To a newcomer, I would say that you should do whatever it

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takes to develop your own personal philosophy. It should be something you really can underwrite to and have a high level of confidence with. It should be a philosophy that is evolved enough to block out noise that doesn't make sense to you, but let in things that are helpful to you. The great investors are the ones who have the psychological ability to be independent in their thought. We believe many MBA students underappreciate this.

Related to my private equity background, I believe it is beneficial to have the opportunity to analyze hundreds of businesses and watch how those situations play out. It is central to building your own authentic ideas on how to make money and compound capital over time. I would not be put off by going to a smaller asset management firm where it's an intellectually honest environment and you're going to have the opportunity to wear multiple hats and take on more responsibility.

One of my business school professors told me "culture really, really matters, a culture of mutual respect and intellectual honesty." These are the sorts of things you don't necessarily think about. You may be more focused on the analytics, but you want to work with decent people who you respect and who respect you. I think there is greater opportunity to flourish in an environment like that.

**G&D:** Thank you very much.

## Studness Capital Management

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**Roy Studness '06**



**Charles Studness  
PhD '63**

economics and finance at Baruch College. He then worked at the Federal Reserve in New York before working at several Wall Street brokerage firms as an equity research analyst covering airlines and utilities. In 1979, he founded Studness Research, conducting research on the electric utility industry. In 1984, Charles began managing portfolios invested exclusively in the electric utility industry and since then compiled an annual total return of 16.7% per year through 2015 (compared to the S&P 500 at 11.1% and the utility index at 10.7% during the same period). Charles received BA and MA degrees from the University of Minnesota and a PhD in economics from Columbia University.

Roy began his investment career at First Manhattan Co. after graduating from Columbia Business School in 2006. Roy analyzed a variety of industries, including banks and utilities, during his time at the firm. Roy received his BA from Wesleyan University, JD from Vanderbilt University, and MBA from Columbia University.

In 2016, Roy joined Charles, adding his expertise in the banking industry to Charles's long track record of successfully managing money in the electric utility industry, and banks were added to the portfolios. The two industries work together in

a portfolio because they respond in opposite directions to changes in long-term interest rates. Moreover, stocks of companies in each industry tend to do well in different economic environments, so between the two industries there are usually attractive areas for investment. The bank and utility stocks they target are evaluated on a commingled basis that is grounded in a five-year forecast for all of the companies. Their fund, Studness Capital Management, generated a return of 65.7% in 2016.

**Graham & Doddsville (G&D):** Thank you for taking the time to speak with us today. Could you tell us a little bit about yourselves and what brought you to investing?

**Roy Studness (RS):** I graduated from Columbia Business School in 2006 and was a member of the Value Investing Program. Before business school, I spent a couple of years as a bankruptcy lawyer. Practicing law, I found myself more interested in the investment side of the cases I was working on. Also, growing up with my dad in the investment business certainly added to my interest in investing. So, I decided to pursue my interest in investing and Columbia seemed like a great place to do that. After graduating in 2006, I went to work at First Manhattan Company, a long-only investment management firm in New York. They primarily cater to high-net-worth individuals with a long-term investment horizon. I was a

generalist but tended to work in a couple of different industries, including community banks and utilities. Over the years, I'd talked often about investments with my dad, who has a deep background in the utility world.

**Charles Studness (CS):** After receiving my PhD in economics from Columbia I worked for the Federal Reserve and then began work as an equity research analyst for several brokerage firms covering utilities. Eventually I decided to set up Studness Research which provided research on the electric utility industry to institutional investors and managed money for clients exclusively in utility stocks.

**G&D:** What came from the conversations between the two of you?

**RS:** We realized how well banks and utilities actually fit together in an integrated portfolio. A lot of it is driven by how the two industries respond differently to changes in interest rates.

There is a very high negative correlation between the changes in bank and utility stock prices in response to the 30-year treasury yield. Often, when one industry is attractive, the other tends not to be. If you go into a period of low interest rates, where net interest margins for banks are compressed, bank profitability is reduced and valuations suffer. At the same time, with low interest rates, people seek out yield and they treat utilities as a bond proxy. They're not necessarily

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investing based on the fundamentals of the utilities at that time; they're more trading on yield. In the more recent period – before the recent rally – banks were trading at low levels and utilities were at their highest valuation in 50 years.

We said to ourselves, "Hey, this is a real opportunity. These two industries work really well together." My dad was investing in utilities and had a very good track record, but at the same time, the volatility was increasing due to the persistently low interest rate environment. You could outperform the S&P one year and underperform the following. If you're only in that one industry, you don't have anywhere else to go when things get unattractive without shorting or going to cash. If you have another area to invest with a high negative correlation to interest rates, that could provide an opportunity for better returns. It reduces the risk in the portfolio as well.

Both banks and utilities are highly regulated industries in which there is a large amount of publicly available data. Both provide very critical services. Power and financial systems are necessary for businesses to operate properly. These aren't discretionary businesses. Utilities are regulated monopolies, so that's a unique dynamic. It's a rate case mechanism that sets returns. By contrast, competition is what determines bank outcomes. Banks are regulated, but competition determines winners and losers in that industry.

What we've done is put the two industries together. You can value them on similar metrics, so we have built a lengthy database for both industries. We went back a number of years to get a sense of what the trends are. We built models and ultimately got to a point where we are valuing banks and utilities on an integrated basis. We put the two industries together in January 2016 and produced a total return of approximately 65% in 2016. We are using the same methodology that produced a 13.4% total annual return from 1991-2015 which compares to the S&P at 9.6% and the utility index at 8.9% during that period.

***"We realized how well banks and utilities actually fit together in an integrated portfolio. A lot of it is driven by how the two industries respond differently to changes in interest rates."***

**G&D:** How do you select the best opportunities within these two industries?

**RS:** Essentially, we view our universe as about 100 stocks. There are about 30 electric utilities – the industry has consolidated over the years, so there are not so many of them left. The other 70 are banks, and we focus on those that have a track record of high performance. We exclude the

money center banks like J.P. Morgan and Citigroup. We look for mid-sized banks that have high returns and are growing.

We create a five-year forecast for all of the stocks in our universe and we then run valuations screens, including P/E, total return, dividend discount model, etc. for the forecast period. This results in a ranking of our stock universe for each metric. We then combine these individual metric rankings into a composite ranking based on all of the metrics used. Now that we have the stocks ranked in order of attractiveness, that tells you where you want to be focusing your attention.

The rankings aren't fully risk-adjusted so you can start with number one and say, "Okay, is there a risk here? Are there aspects to this company that mean you don't want to own it for some reason? Is the loan portfolio too risky or are they doing other things that you're not comfortable with?" If so, then you could cross that name off and move on to your next one.

Ultimately this leads to a portfolio of about twelve to thirteen stocks which results in concentrated positions. We don't want to be an index and we want to make sure we're outperforming. In the utility space, if there's only 30 names and you own seventeen of them, you're going to be that industry index anyway and it's going to be hard to outperform. That's why we stay more concentrated.

**G&D:** How do you manage the mix of these two industries

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in the portfolio?

**RS:** We believe in focusing on your most attractive opportunities where we have the most conviction. We invest in whichever stocks are the most attractive at a particular point in time. If numbers one through 30 are all banks, then our portfolio is going to be all banks. The same goes for utilities. If we're at a point where it's a mix, then the portfolio would reflect that. The construction of the portfolio is really driven by the forecasts for all of the stocks and the valuation screens.

Interest rates are important because they can create movement in the stocks we own. We're not trying to forecast interest rates because we think that's not something one can do. We're not making any direct forecasts of interest rates, we don't say "interest rates are going to go up 50 basis points next year." We have our forecast for all of the companies in our universe. There can be an indirect forecast of interest rates within those forecasts but we're not trying to make a big macro call on the interest rates. Investing in the two industries can provide a natural hedge on interest rate changes.

**G&D:** Are there periods of time where the relationship did not hold? Were there abnormalities where that benefit of negative correlation did not exist?

**RS:** It stands up over time but the strength of the negative correlation can change. It's been strong for the last five years. If you went back before that, to the financial crisis, it is

not as strong in those years but still negative. Obviously, that's a rather unique period of time. If you went back further, you'll see another strong correlation before the financial crisis. In general, there is a high negative correlation over the longer period.

***"Investing in the two industries can provide a natural hedge on interest rate changes."***

**G&D:** You mentioned you're not looking to make calls on rates, but a lot of the economics for a bank are driven by rates. How do you address this?

**RS:** At the base level, you want to start with the industry fundamentals and understand the dynamics there. Once you have a sense of where the industry is and what the fundamentals are, then you proceed to the most attractive stocks within that industry.

We are focused on traditional banks, where the primary driver is net interest income. There are banks out there, especially the money center banks, where they have an investment bank or trading arm and there's lots of other moving parts. It's a little hard to understand what's going on or what the real drivers are. We try to focus on banks that derive most of their earnings from net interest income.

**CS:** These are largely single-service companies, much like the utilities. Once you get into the money center banks, they

may own a brokerage firm and are very complicated. The ones that we want are single-service and much simpler in that regard.

**RS:** As far as the banking universe, we're looking at 70 of them. There are over 5,000 banks in the United States. Many of them are small and private. Liquidity is an issue for some of them. It's a consolidating industry. If you went back to the early 2000s, there were over 8,000 banks. The consolidation will continue and there's going to be fewer banks five to ten years from now than there are today. The government has to grant you a charter to form a bank. Normally, there would be this consolidation but there would also be new banks being formed. A management team could sell to a large regional bank at a big multiple and then they could go across the street and set up their own bank. They'd attract clients back and do it all over again. But that hasn't really been happening over the last nine years because only a handful of new charters have been granted. The result has been accelerated consolidation since the financial crisis.

**G&D:** How does the ongoing trend of consolidation affect your investing outlook? Do you view M&A as a beneficial driver for banks?

**RS:** It's a consolidating industry so there's been lots of M&A and there's going to be more M&A. One might rather own the seller than the buyer because the premium would accrue to the seller. The banks that we're looking at are performing at the high end of

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the industry so they tend not to be the target or receive a shareholder activist letter requesting a bank be sold. Some of them are better off on their own because they're going to generate a better return over several years than if someone gives them an immediate premium. Up until recently, a lot of people didn't have the resources to provide an adequate premium for the higher performing banks.

For banks we target, M&A can also be a part of their strategy. If they have the capital and a sufficient stock currency, they can make the transactions accretive. But you want to look at what's happening to tangible book value per share. Are we still compounding that? Is that still going up? There are banks out there who do these transactions and they become bigger, but the tangible book value over three or four years is exactly the same. It hasn't gone anywhere. You just look around and ask, "Are we any better off?"

You want to look at who is acquiring effectively. That's the appeal of looking at those banks that are compounding book value. Maybe M&A is not a primary strategy but it can be something that a strong bank considers to accentuate the growth opportunities. For every management decision, I would ask, "If I really just boil it down to one share, is my one share more profitable after they do that? Are we compounding that per share value or not?" I would look at M&A within that prism as well.

**G&D:** How do you find these high quality banks when most banking services seem to be

commodities?

**RS:** For the banks, competition determines returns and profitability, and ultimately the winners and losers. We're trying to focus on those that have a track record of high performance. Since it's a competitive landscape, loans and deposits are really just commodities. We could get some capital, we could attract some deposits, and then make some loans. That by itself is not that hard. Those that have the ability to consistently generate double-digit ROEs—over 1% ROAs—there's usually something unique about the business, there's often a niche there. There's something about their business that makes the returns durable, that makes it so those returns aren't easily competed away by the thousands of other banks that are out there.

***"Management is critical in the banking industry because over time the industry hasn't had large barriers to entry. If you've got some capital, you can get some loans and deposits. That by itself isn't going to lead to good returns."***

Part of the process is trying to understand: do I have confidence that the factors that led to the returns over the past six to seven years are likely to persist for the next four to five years? Is there

something that inherently has changed about the business that might prevent this? Banks that have high returns and grow are usually not going to be the cheapest banks—but this can vary with size and liquidity of a bank stock as well.

Usually, an abnormal event makes a bank suddenly move up toward the top of our rankings sheet. Maybe a bank has a very good track record of performing and growing; but, for whatever reason, the market is focusing on a short-term issue and this is impacting the stock price. Then you have to determine if what the market is focused on is transitory. Is this something that is leading to a disappointing quarter but is not necessarily impacting the long-term model? Over the next year or two, is everything going to rectify itself and return the bank to high performance? Or is the issue an impairment of the business?

**G&D:** How do you consider and judge the quality of management? Specifically for banks, where does that skill manifest itself?

**RS:** Management is critical in the banking industry because over time the industry hasn't had large barriers to entry. If you've got some capital, you can get some loans and deposits. That by itself isn't going to lead to great returns.

The niches are really important and they can really vary. Part of it is based on the market on which you focus. There are some banks that focus on an ethnic market. It could also be a focus on a particular end-

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market. A large bank called Silicon Valley Bank has a niche catered towards the venture capital and private equity markets. If we were just putting together our bank and making loans and deposits, those are areas that are a little harder to penetrate. We couldn't just go out and get into those markets. That requires expertise.

Part of a niche can also be product-driven. For example, some banks focus on making commercial real estate loans and can do it better than other banks. So you've got this expertise that you develop that is very hard to replicate. Some banks are more responsive. Other deliver on execution. Some players provide deal certainty that others cannot.

There are different ways that a bank can establish a niche. You look at it over time and it proves itself out through the durability of the returns. At the end of the day, management is going to be critical in identifying, cultivating, maintaining, broadening, and protecting those niches.

**G&D:** What would you say is the biggest difference between utilities and banks, from an investor's point-of-view?

**RS:** Utilities are different in the sense that they are regulated businesses; they are monopolies. The returns are not determined by competition with other utilities – they are largely determined through a regulatory process. This is an essential service so regulators want to make sure that electric power stays on for the customers. It is a capital-

intensive business and the utility needs access to the capital markets to be able to fund ongoing capital expenditures needed to maintain the infrastructure to have a reliable power grid.

Over time that is going to result in certain valuations for utilities based on access to the capital markets. If a utility's trading around book value, they don't have very good access to the capital markets. If they're trading at 1.8-1.9x tangible book value, then they clearly do have good access to capital markets. That might cause some issues, such as a rate decision that might not be as favorable. That's a dynamic that's at play that's unique to a regulated monopoly.

***“Regulation is becoming more of a partnership as climate change is a common problem that regulators want solved.”***

**G&D:** How do you view the current fundamentals of each industry?

**RS:** The fundamentals for utilities are very strong. That's separate from the stock price valuations, but just the business fundamentals are very positive. They're state-regulated businesses and a lot of states are dealing with climate change. A lot of them are setting renewable standards, and that is having an impact on the business. Regulation is becoming more of a partnership as climate change is a common problem

that regulators want solved. Increasingly, regulators are viewing the utilities as a part of the solution, which is different than in prior eras in which the relationships were more adversarial in nature. Utilities have a lot of capex projects to address this issue and customers can really see the benefits, as opposed to prior capex projects, such as installing a scrubber on a coal plant, in which the project is large but at the same time it is harder for the customer to feel or see the benefit. The projects now tend to be smaller, more granular, so there is lower regulatory risk. Together you've got a backdrop of positive fundamentals. Obviously, prices are high for utility stocks at the moment which has been driven by low interest rates, but the fundamentals for the industry are good.

For banks, the fundamentals have been challenged for several years since the financial crisis. The challenge that they face is persistently low interest rates and compressed margins. Since the financial crisis, Dodd-Frank was passed and that's led to more regulation, which has added a lot of additional costs to the industry. On top of that, the recovery, while it's been lengthy, has been rather slow. Banks can do well in a growing economy as the growth fuels more loan demand.

We'll see what happens in 2017, but the market seems to be anticipating change. Some of those headwinds may dissipate or you may see tailwinds. With the election, there's been a sharp rally in bank stocks with people expecting some

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Nicholas Turchetta '17, William Hinman '17, and Charles Wu '17 celebrate the end of the semester at the Value Investing Holiday Party

regulatory reform or that burdens will be reduced in some way. There's been talk of fiscal stimulus, so perhaps you would have a more robust economy. If that picks up, that would be something that could be a positive on the fundamentals for the banks as well. With interest rates, there was the increase by the Fed in December 2016 and we'll see if that leads to continued action. Some of the past challenges may disappear or be reduced going forward.

**G&D:** With both industries being driven by regulation, how do you try to assess industry prospects? How does heavy regulation influence your process?

**RS:** We're not making a bet on whether reform is going to happen. Partly because at this point, it's hard to really know. Taking the utility side first, you've got rate cases and it's a process, so you see how it plays out over time. Access to the capital markets is important as that's going to influence those rate cases going forward. It can create opportunity if a utility has a bad rate decision, leading to a decline in the stock price. All of a sudden, it may be trading at a value that one would question what type of access to the capital markets they have. That's a situation where you're going to see a good investment opportunity if it is managed properly.

You say to yourself, "Oh, they can't go out and raise equity to do the various projects and maybe they need to cut back on the capex." So what does that do? Maybe they're only going to do the minimum they

really need rather than new projects. That could lead to a better rate case as they file the next one, leading to better returns and an improvement in valuation from 1.0x book value to maybe 1.5x book value. In this type of a case, I don't think you're necessarily making an explicit forecast or prediction. It's more your reaction to opportunities that are coming about based on rate cases and how the market responds to them.

**CS:** As Roy noted, the regulation of the utility is primarily at the state level. You have a different set of forces and dynamics than you have with bank regulations at the federal level. In California, they have their own renewable program. As far as the change in federal rules, the movement away from coal burning is not driven by regulation, it's driven by the market. Gas is cheaper than coal to generate power. Bank regulation is a different animal and is dominated at the federal level.

**RS:** For the banks, we're not making any type of prediction on what type of reform is going to happen. You want to understand the industry on the macro level, but the drivers for stock selection are the forecasts for the all of the individual stocks in the universe. That's where you really focus on the micro rather than trying to make broader interest rate or reform calls. We break it down for each specific company and ask, what's the company-specific outlook? How does that outlook and valuation compare with the outlook for the other ones in the universe that we're looking

at?

**G&D:** Utility rates are driven by the government and they can ignore economic reality for periods of time before they have to come back to the underlying fundamentals. How do you handle this dynamic?

**CS:** We look mainly at regulation. When regulators make rate decisions that are very unfavorable, this sets off a chain of events: pressure on the utility and pressure on the stock price. We look at that and how far the regulations can go, which can be more telling than how far the company can go. At a certain point, the regulator's going to have to come to terms with economic reality. It's not the utilities coming to terms with that but more on the regulatory side.

**G&D:** Would you like to talk through a couple of recent investments you've made or ideas that you find compelling?

**RS:** We've been invested exclusively in banks since February 2016. The most attractive stocks between the two industries were clearly banks in our rankings. When they sold off in the beginning of 2016, the banks were just too cheap. That was the starting point. You have the headwinds we talked about and banks were not very popular. Now after the election, there's been a lot of anticipation or discussion of how some of these headwinds might go away.

I think people all of a sudden forgot how profitable the industry was before the financial crisis, before the

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regulation changed, and with higher interest rates. If you went back in time to 2003 to 2006, for a group of these midsize, high-quality banks, you're looking at ROEs of 15%. People have forgotten that was really achievable. Dodd-Frank came and people thought "We're not going to go back to that world."

I think the election may have caused some people to re-examine that assumption. ROEs don't necessarily have to get back to 15%, but if that 15% went to 9% from 2007-2011 that's a big drop. All of a sudden it goes during 2012-2015 up to 10.5%; that's a little better but you're not back to 15%. It frames the issue as far as where we were and where we are.

Back to the micro level, banks that we like are the high-quality ones that have a track record of growing. One I can think of off-hand is the largest Chinese-American bank, East West Bank (EWBC). The bank has a very good track record. A lot of these high-quality banks we view as "compounders." You look at tangible book value, they just have good compound growth year in and year out. They're putting up double-digit ROEs and the bank is growing.

For EWBC, their niche is their expertise in facilitating business between Chinese and American businesses. EWBC brands itself as a "bridge" between the two markets and they can help facilitate relationships in either direction. There are other Chinese-American banks out there – but it is the largest. EWBC has expertise in that

market and this differentiates it from other banks. The bank can provide a level of service competitors cannot or do not provide. It does not only help them get business directly related to China or Chinese companies entering the U.S., it also helps them get non-related business because some might want the option to access this expertise at some point, even if it is not needed immediately. I think that's something that can help them elsewhere outside of that targeted Chinese-U.S. business.

In addition, while EWBC has a strong record of financial performance, the mix of its loans and deposits has changed over the past ten years to make the bank more attractive. Specifically, EWBC used to be a bank focused on commercial real estate loans that were funded by high-cost CDs—both of which are transactional in nature rather than based on a relationship. This mix has shifted as EWBC has diversified its loan portfolio to also include more home mortgages and commercial business loans while significantly reducing its percentage of deposits comprised of CDs and increasing its core deposits. So, these have made the bank more of a "relationship" bank rather than a "transactional" bank which, all else equal, makes the bank more valuable. In addition, EWBC is a very asset-sensitive bank with lots of variable rate loans which position the bank well for higher interest rates.

Why is it attractive? EWBC became very attractive towards the end of 2015 and it remains so. EWBC faced two

issues. One, there was concern on the Chinese economy and how that was going to grow. Two, EWBC had a regulatory issue with Bank Secrecy Act (BSA) compliance. Regulators examined the bank and said, "We don't think your procedures to monitor Bank Secrecy Act compliance are sufficient enough and we're going to require you to beef that up."

This was the first time they'd gotten any type of regulatory order in their history. The CEO has been at the helm for over twenty years and it's been the same management for some time. Those two issues made the stock sell off and become quite attractive. Our analysis was: first, was the stock attractively valued? Since the valuation was attractive, we moved on to a second step: are the issues causing this high-quality bank to become attractively valued transitory? Is there an impairment of the business going forward?

On the BSA issue, we got confidence that this was isolated. This isn't a bank that's perpetually in and out of regulatory problems, and they had a clear plan to deal with it. They laid out the parameters and the course of action. Throughout 2016, one could track and see how that was going. We got comfortable that this was not an impairment of the business. There are implications if you have an order like that. It does have some restrictions on management and capital allocation, but those are primarily related to M&A and opening new branches. It can take a bank a year or eighteen months to get out of this type

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of order. That didn't seem overly onerous to us and wouldn't change the thesis or the quality of the opportunity. We got comfortable that these were transitory issues. In addition, EWBC has spent significantly on non-recurring consulting costs to improve its BSA systems and these costs should reduce significantly (around \$15 million) in 2017 which can provide an additional benefit to earnings.

**G&D:** Don't the remaining concerns regarding the health of the Chinese economy represent a substantial and possibly unknowable risk for this investment?

**RS:** We're not experts on the Chinese economy and can't provide any unique insight on it, but we're not looking to trade for a particular quarter. We're trying to take a longer term view and make an investment that is going to work out over the longer term. We think that the interconnectedness of the world's two largest economies will continue to increase over time and that there will be a growing need for expertise for facilitating business between these economies. The increase may not be linear but the direction is up.

If you looked at Chinese investment in the U.S. over the last several years, it's been steadily increasing. In fact, the Chinese direct investment in the U.S. surged in 2016 to about \$50B up from a few billion five years ago. China is a very large market, and we think the expertise of EWBC is hard to replicate. EWBC has ten offices in China. They're not making many loans in

mainland China, but they have the presence there and that's solidifying the expertise they have.

Those are things that gave us the comfort that the shorter term issues aren't impairments of the business model. This bank has a long track record of high returns and good quality assets and one can reasonably expect that to continue over the next few years. When we look at our five year forecast and the valuation screens we run on that, even now it still looks very attractive to us.

**G&D:** Does the company get an advantage in attracting and retaining low-cost deposits with its focus on China and Chinese-Americans?

**RS:** They're not unique in the sense that they're a Chinese-American bank. There are numerous others as well. I don't want to create the impression that they're unique in that sense. Where their uniqueness comes from is higher up the food chain. It is in the expertise and the sophistication that they can provide. On the sophistication level, these other Chinese-American banks can provide access to or knowledge of the Chinese market, but they're small and do not have the expertise or product offerings of EWBC. In addition, they don't have the balance sheet to access certain parts of the market. For those larger banks, Chase is going to have a desk to deal with China or Korea. They're going to have those people that are dedicated towards that market, but they don't provide the service.

**G&D:** How about a past or

current idea in the utilities space?

**RS:** Since we do not own any utilities at the moment, a past utility investment may be worth discussing. Ameren (AEE) exemplified some of the issues that we've talked about and is a great case study. They're a utility in Missouri and Illinois. They have a history of good returns. They're primarily a regulated utility but they also had some merchant power plants in Illinois, which were deregulated. AEE operated them very well and had good performance. Then power prices went down and the returns in the merchant business went down.

When the financial crisis hit, they decided to cut their dividend. When a utility cuts its dividend, it can have a very out-sized negative impact on the stock because that's why a lot of people own the stock. Maybe management thought other utilities were going to cut their dividends as well. But only one other utility did so during the crisis, so AEE stood out even more. The stock sold off sharply. It began trading a little bit below tangible book value. There was a change in management and a bad rate case decision as well. The issue was "How are we going to deal with this? What is the plan to bring the returns up?"

**RS:** The new management's plan after they got the bad rate decision was that it would only undertake absolutely essential capex. That would result in fewer jobs, so the unions all of a sudden joined the side of the utility because they don't want to see the job cuts. That sent a clear message to the regulator

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to get a better rate decision because clearly the company doesn't have access to the capital markets at that low valuation.

**CS:** New management was actually a promotion from within, so it was not a new executive from outside.

**RS:** It showed a lot of discipline. If they'd just kept going with the plans as if nothing had happened and were still going to spend money on capex, then that's on the shareholder. The shareholder's subsidizing everything and they're the ones taking the hit. In that case, the customers and regulators aren't taking a hit for the poor rate decision. It was important to see how the utility management was going to handle the situation.

***"I would recommend initially getting as much exposure as you can in many industries. I think that can help you even if you focus on another one later on."***

The other thing in the background was the merchant power business, which was a small part of the business, but it started to dominate the story. The merchant power business was only 10% to 15% of earnings, but people really focused on it all of a sudden. This shouldn't have been a big negative. You could back out the value of the rest of the business and the merchant business had a negative implied

value. The cloud hanging over this company represented only 10% to 15% of the earnings and it should not have been part of the story.

Eventually AEE sold the merchant business, which made it a much cleaner story. They became a pure regulated utility focused on the right issues, notably the rate cases. Over time, it's worked out very well, beginning around 2010. From 2010-2014, Ameren produced a very good annual return of approximately 14% with low risk.

**G&D:** Did they have any problems servicing their debt during the crisis?

**RS:** They cut the dividend but they didn't need to cut it. We thought they were being overly cautious by cutting. In our view, they were doing something that they didn't need to do. Obviously it created a significant opportunity as a result.

**CS:** They absolutely didn't need to cut the dividend. It was important in that it led to the management change. There were some other things happening at that time that showed a lack of leadership in management and that got changed.

**RS:** The merchant business had some debt as well, but they had that ring-fenced.

**G&D:** Do you have any advice for current students?

**RS:** I would recommend initially getting as much exposure as you can in many industries. I think that can help you even if you focus on

another one later on. It can help you get a feel for how different each industry can be and what the drivers are. I just think about banks and utilities. A lot of people wouldn't initially think that they would go together. The person who's covering the banks is generally not covering utilities. I don't think they are paired together at all in that sense. Initially they seem very different but as you see, over time, the drivers of one industry can drive another industry, and reactions can be very different. That can create unique opportunities in unexpected areas.

Five years ago, I wouldn't have thought that these two industries together would have this great fit. Being open-minded about those things and looking at relationships that aren't presented by Wall Street is valuable. Remain open-minded about investing.

**CS:** Being open-minded is not a matter of finding glamorous industries. Utilities are usually thought of as a rather dull industry, but I think you can see from what we've done that you can make very good returns in an industry like this. The important thing is not to start excluding anything. As Roy said, be very open.

**RS:** Sometimes investors have preconceived notions on what is possible from certain industries. Sometimes you'll want to look at the facts and the numbers, and not necessarily listen to people's preconceived notions. That can lead to more opportunities.

**G&D:** On that point, do you have any particular view

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regarding specialization versus remaining a generalist?

**RS:** I've narrowed over time on what I've focused on. It's worthwhile to have the broader experience to provide more context than maybe focus on particular industries. At a Graham & Dodd Breakfast, Bruce Greenwald was talking about specialization and how he was a proponent of it, suggesting that this was one feature that could lead to high performance. We would probably agree with part of that. The problem is, to us it's not just knowing the stock – it's knowing the industry. It's knowing what drives economics for that industry. It's harder to gain that expertise in a short period of time and be actionable on a stock. Not that it can't be done, but from our point of view, it seems a little more challenging. That's how I would think about specialization, but there's not a wrong way.

**G&D:** Thank you again for the time.

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