



Columbia Business School
AT THE VERY CENTER OF BUSINESS™

Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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COLUMBIA STUDENT INVESTMENT
MANAGEMENT ASSOCIATION

Issue XXII

Fall 2014

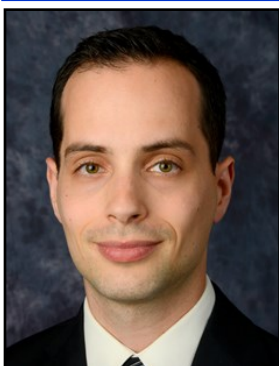


Wally Weitz

Wally Weitz — Power of Good Management

Wally Weitz is the Founder and President of Weitz Investment Management, an Omaha-based fund manager with over \$5 billion in AUM. Influenced by the value investing philosophy of Benjamin Graham and Warren Buffett, Mr. Weitz started his career as a securities analyst in New York after earning a BA in Economics from Carleton College in 1970. He then joined Chiles, Heider, & Co. in Omaha, working there for ten years before starting his own fund in

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Guy Gottfried

Guy Gottfried — The Value of Capital Allocation

Guy Gottfried is the Founder and Managing Partner of Rational Investment Group, LP, a Toronto-based investment firm following a concentrated, risk-averse value approach. Prior to founding Rational, Mr. Gottfried was an analyst at Fairholme Capital Management. He began his career at Veritas Investment Research, Canada's largest independent equity research firm. Mr. Gottfried graduated with a BBA with Honors from the Schulich School of Business at York University, where he was a President's Scholarship recipient.

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DCP Team

Development Capital Partners — The Changing Landscape in Africa

Development Capital Partners (DCP) is a New York-based investment manager focused exclusively on African markets. The fund was co-founded by Paul Tierney, Matt Tierney '02, Gordon McLaughlin '11, and Matt Magenheimer '11.

Graham & Doddsville (G&D): Could you start by explaining how you became interested in investing?

Paul Tierney (PT): I got started in the investment business with no background in investments. I graduated from college having studied philosophy, and then went into

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Welcome to Graham & Doddsville



Louisa Serene Schneider '06, The Heilbrunn Center Director. Louisa 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 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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INVESTING



It is our pleasure to bring you the 22nd 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).

To recap the happenings since our Spring 2014 issue, the Heilbrunn Center hosted the fifth annual "From Graham to Buffett and Beyond" Dinner in Omaha, held on the eve of the Berkshire Hathaway Shareholders' meeting and featuring a panel of renowned speakers. Photos of the event can be found on page 3.

We also proudly announce the formation of our inaugural student-run Value Investing Fund, made possible by a generous gift from Heilbrunn Center Advisory Board Member **Mr. Thomas Russo and his wife Georgina**. Please read more on page 4.

As our fellow students begin their Fall courses at CBS, we are reminded of a humorous quote from Charlie Munger: "In my whole life, I have known no wise people who didn't read all the time...my children laugh at me.

They think I'm a book with a couple of legs sticking out." Indeed, continuous reading and learning is critical to succeeding as an investor, and we thank you for counting *G&D* as part of your reading regimen.

For this issue we spoke with six investors from three firms, each with a distinct investment style and focus. We believe you will enjoy our interviewees' diverse set of perspectives.

Wally Weitz, Founder and President of Weitz Investment Management in Omaha, NE, was our first interview. We discuss how Mr. Weitz's investment philosophy has evolved over time, his views on valuation, and assessments of his past and current holdings.

Guy Gottfried, Founder and Managing Partner of Rational Investment Group, shares some of his key investing lessons with us, including the importance of partnering with strong management teams and maintaining a high level of investing discipline.

And as we look for investors with a global perspective, **Paul Tierney** and his partners at

Development Capital Partners shared with us the excitement and challenges of investing in companies across the African continent.

Lastly, we continue to bring you pitches from current students at CBS. CSIMA's Investment Ideas Club meets regularly throughout the year, including during the summer, and provides CBS students the opportunity to practice crafting and delivering investment pitches. In this issue, we feature two ideas from our classmates Kevin Lin '16 and Sisy Wang '16: long Countrywide PLC (LON: CWD) and short B&M European Value Retail (LON: BME).

We strongly believe in the value of diversity of thought and experience. These insights come from a variety of sources, and we look forward to bringing you these unique perspectives and fresh ideas during this academic year.

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



The Heilbrunn Center Team, Julia Kimyagarov, Louisa Serene Schneider '06, and Marci Zimmerman, at the May 2014 Omaha Dinner



Renowned Columbia Business School alumnus Mario Gabelli '67 shares his experiences as a panelist at the May 2014 Omaha Dinner

“From Graham to Buffett and Beyond” Omaha Dinner 2014



Dinner panelists included Bruce Greenwald, Wally Weitz, Bill Ackman, Tom Russo, and Mario Gabelli '67



Wally Weitz offers his thoughts alongside Bruce Greenwald and Bill Ackman



Tom Russo of Gardner, Russo & Gardner, LLC



Bill Ackman, Louisa Serene Schneider '06, Paul Hilal '92, and Alex Rodriguez converse during the reception



5x5x5 Student Value Investing Fund



Tano Santos, Tom Russo, and Bruce Greenwald at the Value Investing Program Welcome Reception. Mr. Russo donated a generous gift to create the first-ever student value investing fund: 5x5x5



Louisa Serene Schneider '06, Glenn Hubbard, Tom Russo, and Bruce Greenwald at the official inception of the 5x5x5 Student Value Investing Fund

Columbia Business School is delighted to announce the formation of its inaugural student-run Value Investing Fund. This innovative fund was made possible by a generous gift from Thomas Russo and his wife Georgina. Mr. Russo is a frequent guest lecturer at Columbia Business School, and a member of the Heilbrunn Center Advisory Board. Thanks to Mr. Russo's creativity and leadership, this unique entrepreneurial fund is both long-term and aligns with the fundamental principles of value investing, making it unlike any other student-run fund. The Russos' gift affords Columbia's value investing students the opportunity to connect value-oriented investment theories to real world practice as they apply their classroom learning in the management of this fund.

The 5x5x5 Student Value Investing Fund was introduced by Mr. Russo to the Heilbrunn community at the Value Investing Program Welcome Reception on September 12, 2014. In addition to Mr. Russo, the 5x5x5 Fund Board will consist of five students from the Value Investing Program along with Bruce Greenwald, Robert Heilbrunn Professor of Finance and Asset Management, and Louisa Serene Schneider '06, Senior Director of the Heilbrunn Center. During the Spring 2015 semester, students in the Value Investing course taught by Bruce Greenwald and Tano Santos will have the opportunity to submit their investment ideas to the 5x5x5 Board. The Board will then choose among these investment ideas and will articulate five reasons behind each investment. Five of the stocks will then be selected and invested in for a period of five years. At the end of five years, the original amount, accounting for inflation, will be invested back into the 5x5x5 Fund and the remainder of the gains will be used to support current-use scholarships for students interested in investment management. As alumni, program students will remain active managers of the 5x5x5 Fund, continuing their support of, and connection to, the Heilbrunn Center and Columbia Business School.



Tom Russo discussed the details of the newly created 5x5x5 Fund with value investing program students and alumni



Bruce Greenwald provided an overview of the structure of the 5x5x5 Fund to students and alumni from the Columbia Business School Value Investing Program



SAVE THE DATE

18th Annual Columbia Student Investment Management Association Conference

January 30, 2015

A full-day event featuring keynote addresses and panel discussions from some of the most well-known investors in the industry.

Presented by:

The Columbia Student Investment Management Association
and
The Heilbrunn Center for Graham & Dodd Investing

Visit our website for updates: <http://www.csima.org>

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Wally Weitz



Wally Weitz

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1983 with \$11 million in assets under management at the time.

Graham & Doddsville

(G&D): We would love to hear about your background. How did you originally become interested in investing?

Wally Weitz (WW): My mother was a single parent and a social worker so my grandparents gave her a small lump sum of money and introduced her to their stock broker to make sure she would not have trouble making ends meet. She and I went to lunch with him, and by the end of it, she was bored stiff while I was fascinated.

On the way back from the meeting, I started reading *How To Buy Stocks* by Louis Engel, which you can still find on Amazon. It explained the basics of what a stock is, what a bond is, and so on. I started investing two shares here and ten shares there. The ideas mainly came from the broker in New York.

That was when I was 12, and I became hooked. I went through a charting phase, and I was keeping 100 charts a day and trading on them using technical indicators. Tuition was cheap in retrospect, but losing \$50 in the '60s seemed tragic.

Anyway, I stumbled on Ben Graham when I was at Carleton College, and I read *Security Analysis*. Then, I took a correspondence investment course with the New York Institute of Finance, giving me the credibility (as to initiative, not knowledge) to get a summer job with a Wall Street

firm in 1970 when I graduated. I worked at G.A. Saxton, a small OTC trading firm. It was a terrific training ground. My boss, Artie Dunn, followed the five hundred stocks we actually made a market in and you can imagine how deeply we covered them. I'm not sure if he knew who Ben Graham was, but he was intuitively a value investor.

"I have paid attention to Warren over the years. A lot of what I try to do has its roots in what I've learned from him."

It was supposed to be a summer job, but I just didn't leave, and nobody really noticed. I stayed for almost three years before getting married and leaving New York for Omaha. I joined a regional brokerage firm and was asked to cover local companies. Fortunately, one of those local companies was Berkshire Hathaway.

One of my mentors in New York, Frank Monahan, told me about Warren Buffett, and my boss in Omaha was a good friend of Warren's. He took me to the Berkshire annual meeting when it was held in the National Indemnity lunchroom, and there were

only three outside shareholders. As you can guess, the meeting has changed over the years.

I have paid attention to Warren over the years. A lot of what I try to do has roots in what I've learned from him. I don't claim to do it as well or to be as disciplined, but I always feel like he's looking over my shoulder as I invest or as I write our investor letters.

That brings us to 1983 when I was thirty-four years old. I left the brokerage firm to start my own investment firm. A group of clients invested \$11 million into three partnerships. We kept it simple with a flat 1% management fee and no "carry." Over time, we converted the partnerships into mutual funds, and, thirty-one years later, we have 11 funds, primarily focused on equities.

The firm now has roughly \$6 billion in assets with an investment team of 11. We're a little unconventional in that we're willing to hold cash, we run concentrated portfolios, and we don't manage to any particular benchmarks. Everybody at Weitz has virtually all of their investable funds and all of their retirement assets invested in our funds. Eating the home cooking is true for us. We do our own thing, and I feel fortunate to get paid to do my hobby.

G&D: What was the inspiration to strike out on your own?

WW: When I was at Saxton, the head of the firm called me

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Wally Weitz

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in one day and said, “You’re doing fine, we’re not paying you much, so there’s no problem, but what do you want to do with your life?”

I said, “I’d like to manage money like Harold and Frank.”

He said, “Great, go get some.”

That was the cold slap in the face that helped me realize I needed to figure out where the capital would come from if I wanted to make investment decisions and manage money.

My wife and I preferred the Midwest to New York so we moved to Omaha where a regional brokerage firm agreed to let me do research and try to find accounts to manage. For the next ten years, I managed accounts as a broker, but I thought I could do a better job for clients if I could pool the accounts and charge a fee rather than transaction-based commissions. So, I started Weitz & Co. in 1983.

G&D: Could you talk about the specific style of investing at your fund and your philosophical approach?

WW: We try to think like business owners. We believe that the value of a business is the present value of the cash the business will generate in the future. Investors use varying definitions of “cash flow” or “free cash flow,” but we focus on “discretionary cash flow” – money that could be taken out of the business but which the owner might voluntarily reinvest in the business. In making estimates of future cash flows, we have to make judgments about the sustainability of the company’s

business model and its competitive “moat.” We try to have a general sense of the economic environment, but we do not want to depend on making correct macro-economic predictions. In short, if the price of the stock is well below what an intelligent owner would pay today for the whole business, the odds are strong that something good will happen with the stock. That’s the basic idea.

“We try to have a general sense of the economic environment, but we do not want to depend on making correct macroeconomic predictions.”

G&D: How much of a discount to intrinsic value or private market value is required to get you interested?

WW: We always used to say we wanted a 50% discount, and for years we found that kind of bargain. In recent years, we have found ourselves paying 60% or 70%. Valuations have risen, and it’s possible our valuation methods have been too conservative (We use a 12% discount rate when we do discounted cash flow models.) At any rate, we are wary of

“paying up” for stocks, because history has shown that when the weighted average price-to-value of our portfolios rises, the returns over the next six to twelve months tend to be lower than when we start from lower P/V levels. If this were not the case, we would have to find a new investment method.

G&D: Could you talk about how your investing philosophy has changed over time? For example, you became more comfortable paying higher multiples for higher quality businesses. Companies like Google and TransDigm may not have been in the portfolio 25 years ago.

WW: I’ve been paying very close attention to Warren for 40 years. I heard him say early on that Munger taught him that a great business is worth paying up for. In one of his annual reports, he talked about economic goodwill as distinguished from accounting goodwill. Economic goodwill measures the franchise value, or the ability to charge premium prices, because of your moat.

At an intellectual level, I’ve been aware of that concept for 40 years. I’ve also been familiar with the idea of picking stocks as if you only had 20 “punches” on your investing ticket. Being able to act that way has only come gradually over time. Value investors can be drawn to the “statistically cheap,” like a moth to the flame, but eventually the pain of living with mediocre companies catches up with you. Learning where to draw the line between paying up for quality

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Wally Weitz



Mr. Weitz discussing his investment experiences with attendees at the 2014 Omaha Dinner.

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and accepting a flaw because of a cheap price is part of the fun of investing.

I would also say that management is a major consideration. Warren has said that it is good to buy a company that any idiot can run, because sooner or later, an idiot will be in charge. Fair enough. But if we're buying companies that generate excess cash, it's terrific if we can trust management to do something smart – accretive to per share business value – with that cash. Warren Buffett and John Malone have done wonders with discretionary cash over the years. Most others have not.

G&D: Can you take us through your investment process? Perhaps starting from idea generation through establishing a position.

WW: The ideas come from all over. We don't do much mechanical screening. We're aware of a number of companies as a result of assessing the businesses we own, their competitors, and the ecosystem. Also, everybody is reading interviews and thinking about companies all the time. We pay attention to a handful of other investors that we respect. I think the initial idea may come from any number of places.

When it's a company that's really new to our analysts and new to me, the analysts will read all the filings for the last few years as well as transcripts of conference calls and investor days. They will read about the industry and talk to others in the business. They

will try to understand the company's business model and the degree to which it has control over its own destiny. Then they'll start developing a model. We try to estimate the future cash flows that we can count on.

“Learning where to draw the line between paying up for quality and accepting a flaw because of a cheap price is part of the fun of investing.”

I think the most useful part of building the model is making sure we understand the relationships among the variables. We need to know what is important to the future success of the company and how realistic our assumptions are. Precise predictions are not required (or possible). We believe in the adage: “It's better to be approximately right than precisely wrong.”

Capital structure is also important. Is the balance sheet appropriately leveraged? How much option dilution will we face? Can we expect opportunistic buybacks? If we're dealing with a Malone company, I think it's okay to assume some stock buybacks over time. If you're dealing with many of today's tech

companies, maybe you would not build in much buyback. Judgment is required. We eventually get to a model that we discuss among ourselves. We argue and develop some level of confidence that we have an approximately correct appraisal number for the business.

That might take a month on a new company that no one knows much about, or it might take an afternoon if it's an area we're pretty familiar with and we know the people involved. If a stock has fallen out of bed for some reason that we believe is temporary, we can act pretty fast on it.

G&D: Is there any part of that process you would say distinguishes Weitz from other investors?

WW: Our process is probably similar to that of other value managers. What might distinguish us is temperament. We are not just knee-jerk contrarians, but we are willing to be early and out of step with the market at times. It's often a good sign when investors and analysts agree that “the stock is extremely cheap, but we shouldn't buy it yet because there might be another bad quarter coming.”

G&D: You spoke previously about how you try to poke holes in an investment thesis. Is there a way to systematically approach that?

WW: I know that others have a process where they assign a devil's advocate to look for trouble. We don't formalize that. With a group of eight to ten of us, each one coming

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Wally Weitz

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from a different place and background, we are pretty good at poking at the story. We have that debate and, at some point, if we decide we're comfortable with our appraisal, we buy the stock. But there often may be multiple rounds of research work that come out of the initial meeting.

G&D: Could you elaborate on how you view the cash portion of your portfolio? Is it optionality on future opportunities or just representative of a lack of current opportunities?

WW: Well, we would be quick to say it's not a market timing call. It's just a residual that comes from selling things when they get expensive and not finding cheap enough replacements. We try as hard as we can to be fully invested, and the cash represents failure to find opportunities that we really like.

G&D: What is the range of cash that you are willing to hold?

WW: We may hold as much as 30% cash. We have one fund that's allowed to borrow and sell short, and that fund is currently 63% net long. Most of the funds have around 20% to 25% held in cash at the moment.

G&D: Do you have a view on where you think we are in the economic cycle? Does that view impact your portfolio?

WW: I'm very skeptical of my own or anybody else's ability to predict the direction of the stock market. We try to have a sense of whether we face headwinds or tailwinds, but we

make no pretense about being able to predict the next six or twelve months. For what it's worth, the view that seems generally correct to us is that the economy is okay, and so companies have some control over their destinies.

Companies with competitive advantages will continue performing well and becoming more valuable, so I'm not bearish – I'm actually pretty optimistic.

However, it seems as if stock prices have moved faster than underlying intrinsic values. The Fall of 2011 was the last time any of us around here were really excited about price levels in general. Since then, almost all our companies have done just fine, but their share prices have gone up faster than

"It's often a good sign when investors and analysts agree that 'the stock is extremely cheap, but we shouldn't buy it yet because there might be another bad quarter coming.'"

their business values. We have gone from 60 cent dollars to 90 cent dollars. It seems very plausible to me that either stock prices drop back down

or they go sideways for a while so that business values can grow into their stock prices.

Being reasonably optimistic about the environment, if the stock market dropped 10% to 20% tomorrow, we might be willing to be 90% to 95% invested. It wouldn't take a move like the one we saw in 2008 and 2009 for us to get excited about some of the companies we follow.

G&D: How do you define and think about risk? Is it in terms of volatility, permanent loss of capital, or some other way?

WW: It's absolutely not volatility. Howard Marks has written about this extensively. He explains it so well that I like to point people towards his stuff. He has a new essay that focuses on various types of risk. It's all about the risk of permanent loss as opposed to volatility.

We love volatility. We try to appraise a company's business value and its likely growth path. The stock price should be loosely tethered to the business value over time, but volatility around that value gives us the chance to buy at a discount and sell at a premium.

In late '08 and early '09, what was then called Liberty Capital got down to around \$3.50. That was fabulous. The successor to that is now about \$150. Volatility is terrific. What we don't want is the permanent loss. In that recent Marks essay, he goes into all the different ways you can suffer permanent loss. He talks about having leverage risk, liquidity risk, credit risk,

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Wally Weitz



Professionals engage with each other during the Omaha meetings.

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interest rate risk, basis risk, and all those things. Those are all variations that can cause permanent damage.

You have people risk too. You have situations where managers push too hard on the underlings to perform. I think that's where you get the Enrons and the Worldcoms: the frauds.

There are all sorts of ways you can incur permanent loss, but that's what we're talking about, not volatility.

G&D: You've mentioned in the past that you view disproportionate overreactions to stock market selloffs as ideal opportunities. Given the reduction in quantitative easing, are you positioned to try to take advantage of a potential market reaction?

WW: We joke about that. At some point, rates have to go up. It's inevitable.

When that happens, some people will probably be surprised and unhappy. We are not positioning the portfolios for a particular market reaction to rising rates. We consider the likely effect on each company of future rate increases, but we are simply trying to hold companies that are cheap in relation to the future values of the businesses.

G&D: Do you have a view on current popular investment themes where people think the ideas are good, but they are actually just bad ideas in disguise and may be exposed at some point?

WW: Over the last several years of unusually low interest

rates, one popular notion that may have been carried too far is buying "high quality dividend-paying stocks." High quality

"I like Liberty Global because they build out cable systems using a lot of leverage, generate huge amounts of free cash flow, and then buy back lots of stock."

companies that are growing in value may be good investments if bought at reasonable prices, but the success of the strategy will not be based on their dividend yield. Cynical managements have raised a lot of cheap capital by using the MLP format to sell over-priced securities that look attractive to unsophisticated investors because of their high current yields. The most extreme case may be those royalty trusts which will become worthless in a few years yet sell at high prices, because of their current dividend payments.

G&D: Are there common characteristics in some of your most successful investments over time?

WW: We have done really well trading financials when the Fed was raising interest rates. We have done very well over the years with cable TV companies. Investors were skeptical in the early years as

cable companies borrowed huge sums to build out their systems before they had many subscribers. Interest costs and depreciation created large losses in the early years. However, cable is a subscription business with low "churn" rates, and cable companies developed new products (telephone, pay per view and broadband) that they could deliver over their existing plant. Cash flow eventually turned positive and the stocks went up several-fold. We had a similar experience with cellular telephone and benefitted when the industry consolidated.

G&D: Speaking of cable companies, we noticed that one of your larger positions is Liberty Global. Could you discuss your general thesis on that company?

WW: I like Liberty Global because they build out cable systems using a lot of leverage, generate huge amounts of free cash flow and then buy back lots of stock. Their balance sheet is highly levered, but they have a very tax efficient way to generate equity value per share.

That's great when you have Mike Fries who is really a good operator and John Malone who is making sure that they're managing that balance sheet. I might not be interested in the same company if it were run by some other people. Management makes a huge difference in all kinds of businesses and it is critical when you're dealing with leverage.

They've been very efficient on

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Wally Weitz

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the cost structure. They are cost conscious operators and, with Malone, you are also dealing with hypersensitivity to taxes. Their recent merger with Virgin Media provide major tax advantages. They have high debt on a per share basis, but the debt is compartmentalized in that each part is attached to a different system. They hedged currency and the interest rate risk. They have paid up in the last few years in order to lock in long term interest rates.

We value it in the mid-\$50s and the stock is around \$40.

G&D: Many of our readers know about Buffett and Malone, but are there any other underfollowed CEOs or management teams that you think highly of?

WW: In the banking world the Wells Fargo culture is impressive. They've had three or four CEOs since we got involved a couple of decades ago and each has been a strong leader. They have a culture that's very different from many other major U.S. banks and that's served them very well. When certain large banks got crushed in the 2008 and 2009 period, we were comfortable with Wells.

Nick Howley at TransDigm is a very disciplined buyer and strong operator with a private equity mindset, but he's collecting companies to keep instead of selling them a few years later like most private equity players. He's buying companies that are typically sole suppliers of aftermarket airplane parts. Then once he buys them, they just squeeze the costs out year after year.

They get terrific margins and their business is almost like a subscription business. If you are the sole supplier of seatbelts or some type of fastener that has to be bought, it can be a great business.

We like managements that are focused and demanding, but it can be dangerous if there is too much pressure to "make the numbers." Mae West said, "Too much of a good thing can be wonderful." Maybe so, but we try to be alert to the possibility that a corporate overachiever may be pushing too hard.

"We like to invest with managers we trust to treat us fairly – to treat us as partners rather than necessary evils."

G&D: What is your approach in dealing with management teams?

WW: We like to invest with managers we trust to treat us fairly – to treat us as partners rather than necessary evils. We want to know if they have a good, long-term business plan and have a sense as to whether they will execute it well. We want to trust them with capital allocation – investing in the business when there are good opportunities to compound value and to give capital back to shareholders

when that makes sense. We generally won't have a lot of advice about how to manage the business, but we will let them know how we feel about strategic direction and capital allocation.

Management is not going to call us for advice in times of crisis or of great opportunity, so we want to know them well enough that we will trust them to make the right decisions in those critical times.

G&D: You've talked about Valeant in the past. Could you share your view of the investment case with and without the Allergan deal? Would the failure to complete the deal change your opinion in any way?

WW: Well, it would be great if Valeant is able to acquire Allergan. Given the kinds of businesses they're in, Allergan has been a natural target for Valeant. I don't know what the odds of success are at this point. They are probably not a lot better than 50/50.

But if they don't buy Allergan, they will buy something else. I get a little queasy when a company announces an acquisition and both the buyer and the target go up. The implication is that there's some magic there. The "magic" with Valeant is that the earnings of the target company increase, because of Valeant's cutting of bloated cost structures. The bear case is that they cut too far and there's no real organic growth.

I do feel as if we're riding a tiger with Valeant. It's not the same as Berkshire Hathaway

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Wally Weitz



Tano Santos and value investing program students at the 2014 Value Investing Program Welcome Reception where the 5x5x5 Student Value Investing Fund was announced.

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or a Liberty company.

G&D: Has your team looked at Allergan on a standalone basis? Would that be a potentially interesting investment even if the Valeant deal doesn't close?

WW: Our analyst that specializes in healthcare has liked the business, but not the price. It seems as if the promises they're making now about how they're going to be more efficient, have better margins and grow faster are a little too late. It makes you wonder why they weren't doing that before.

G&D: What would you say is the most important factor for a great business?

WW: Well, monopolies are great. We also like subscription businesses. The cable model is a very good one. They had local monopolies on pay TV in the past and, although they face more competition today, they still have great business characteristics. You want the company that has the great asset that everybody has to have and where you have pricing power. But then those things tend to trade at pretty high prices. Although we like the comfort of having the great business at a fair price, which Munger talks about, we are really looking for mispriced assets. The best of the best rarely look cheap.

We've come close on some great businesses like Visa and MasterCard a couple of times when there were fears that they would be forced to cut prices or that they would be hurt by competition from

other kinds of payment systems, but we were just not willing to pay the price. Maybe someday we will. It's always a tug of war between the comfort of owning a great business and the temptation to buy the statistically cheap business. In the '70s, I bought a few things that were literally net-net Ben Graham stocks. They were cigar butts. Hopefully I've gotten over that.

G&D: Can you give an overview of an investment that didn't go as anticipated, what lessons you learned from that, and how it improved your investment process?

"It's always a tug of war between the comfort of owning a great businesses and the temptation to buy the statistically cheap business."

WW: Over the years, we have had a series of successful trades – buying banks and thrifts after the Fed raised interest rates and those stocks fell. Six to nine months later, the Fed always lowered rates again and the financial stocks rallied. I now consider those trades "bad ideas we got away with." They were bad ideas

because we took more risk than we realized in buying those stocks. Those banks were often over-levered and poor loan underwriters, but they (and we) got away with it because home prices always rose. Foreclosed properties could be sold at minor losses (or sometimes gains) and the risks didn't catch up with the banks. Until they did... in 2007-2009. We foresaw trouble in the mortgage business, but we owned some financials that we thought were strong enough to survive and take advantage of the problems of their weaker competitors. When losses came in 10-20x as bad as ever before, our "strong" companies were swamped by their losses and we suffered some permanent loss of capital.

From that experience, we learned to be much more imaginative about what can go wrong with a business.

G&D: Munger has this concept of lifelong learning that he has talked about. What do you do or read to make sure you keep getting better all the time? Is there some area where you think you've really improved over the years?

WW: We read all the time. We travel around and see companies, and we read. I've tilted a little more toward business history or biographies lately. A book like *The Outsiders* is a good example of what I like to read. It uses eight case studies to illustrate how unconventional managers can make a huge difference in creating per share value for shareholders.

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Wally Weitz

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Hopefully by reading about the successes and failures of others, and examining our own mistakes, our investment team has learned to be more discerning and realistic about the companies we research.

G&D: Is there a more recent addition to the portfolio that you'd be willing to discuss?

WW: A spin-off of the Liberty complex, Liberty Ventures, is complicated but potentially interesting. Through a series of acquisitions, Liberty had accumulated stock positions in companies they didn't really want to keep. In order to extract the value of these assets in cash without incurring capital gains taxes, they sold exchangeable securities that are convertible into those shares. The bonds had 25 to 30 year maturities and very low coupons. But, because of the optionality involved, Liberty imputed a 9% interest cost that they deducted from their earnings. So they have more tax savings than they have coupon costs. They got all the value out in cash by selling these bonds, but they have a negative cost-of-carry. In a sense, they receive additional zero interest loans each year from the government. In 20 plus years, Ventures will have to pay off the principal of the bonds and the deferred taxes, but in the meantime they can invest the cash any way they wish.

Very few people will want to bother to figure this one out, but I think it's an interesting investment that is really a blank canvas for Malone and Maffei. There has been some speculative interest in Ventures, but when we have

been able to buy it at a discount to the present value of its assets, we have. We don't know what the Ventures portfolio will own in future years, but we trust management, in this case, to make good investments on our behalf.

G&D: This has been great. Thank you for taking the time with us, Mr. Weitz.

Guy Gottfried



Guy Gottfried

(Continued from page 1)

Graham & Doddsville

(G&D): Can you tell us about your background and how you became interested in a career in investing?

Guy Gottfried (GG): It was during the junior year of my undergraduate studies in Toronto when I realized I had to get a good summer internship in order to land a desirable job after graduating. Everyone at my school was flocking to accounting, marketing, or investment banking, none of which appealed to me. One of my professors that year, Anthony Scilipoti, was (and still is) a partner at Canada's largest independent investment research firm, Veritas Investment Research. I worked hard to excel in his class and, through that connection, was able to summer at Veritas. I ended up parlaying that into a full-time position.

I enjoyed the work right away and toward the start of my summer position, I decided that, if I was going to potentially pursue investing, I should learn as much as I could about the discipline. I asked the president of the firm if there were any books he could recommend, and he suggested Graham's *Security Analysis*. I read that and followed it up with every Berkshire Hathaway letter to shareholders, and by that point I was hooked on value investing. I simply couldn't fathom how any other approach could even be considered investing; as Charlie Munger once said, "All intelligent investing is value investing – acquiring more than you are paying for."

From there, I gobbled up

anything I could get my hands on: Greenblatt, Klarman, Fisher, *OID*, articles and interviews. At Veritas, we had access to an article database called Factiva. Any time I'd come across a value investor or manager that seemed interesting, I'd search for every article that had ever been written about them and every interview they'd ever done and just devour them.

"I read Security Analysis, followed that up with every Berkshire Hathaway letter to shareholders, and by that point I was hooked on value investing. I simply couldn't fathom how any other approach could even be considered investing."

I also went to the very first Value Investing Congress in 2005. I paid for the tickets myself and flew from Toronto so I could learn first-hand from the likes of Klarman, Einhorn, and Ackman. The cost to attend the conference was a lot of money for me back then. Like a true value investor, I stayed in Midtown Manhattan at a two-star hotel, which was really a quasi-hostel with shared bathrooms. I certainly

wouldn't have guessed back then that I'd one day be a regular speaker at that very conference.

In any case, within a few months of joining Veritas full-time in 2004, I was promoted to sector analyst covering Canadian income trusts. It was a solid position for a twenty-four year old, but the more I delved into investing, the more motivated I became to excel at it, and by 2006 I resolved to work for a prominent value investment firm to further hone my skills. Fortunately, I managed to join Fairholme as an analyst. Despite having a multi-billion dollar asset base, there were only five of us on the investment team. Everyone else was roughly twice my age and I learned some valuable lessons there.

G&D: How did you get introduced to Bruce Berkowitz and the Fairholme Team?

GG: I knew that I was competing with Harvard, Columbia, and Wharton MBAs with serious work experience, and here I was with an undergraduate degree from a Canadian school that many Americans had likely never heard of. I recognized that I needed to distinguish myself somehow. With that in mind, in 2006 I wrote a comprehensive research report on a stock in order to illustrate what I could contribute and sent it to 12 or so firms that I thought would be great to work for, one of which was Fairholme.

G&D: Can you share some key lessons you learned while at Fairholme?

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Guy Gottfried

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GG: As I mentioned earlier, I had long been a voracious reader of books, articles, and interviews by and about countless great investors, going back decades. I picked up their unique insights and perspectives on investing and applied them to my own portfolio. My time at Fairholme reinforced many of those ideas and gave me the opportunity to be immersed in value investing every day.

For instance, Fairholme reinforced my appreciation for the value of cash. The first reason is obvious: it's better to earn nothing in cash than to potentially lose money by making a risky investment that isn't up to your standards. Second, and perhaps less intuitively, cash is a weapon. When a general market dislocation erupts or a compelling individual opportunity arises, it is only those who have cash – precisely when everyone else lacks it or is afraid to use it – who are able to capitalize. This was an important concept at Fairholme, and it's a lesson that has served me well.

Also, one of the attributes that originally attracted me to Fairholme's approach when I researched the firm was its disproportionate emphasis on management. At Fairholme, we wanted to understand exactly with whom we were partnering and to whom we were entrusting our capital, just like any sensible businessperson or private investor would want to do. Of course, none of this came at the expense of studying the business, industry, accounting, valuation, and so on. But I'd say that Fairholme prioritized,

more than the average fund, the need to understand the insiders' backgrounds, operating style and capital allocation throughout their careers and in different business environments.

G&D: You launched Rational Investment Group in 2009. What factors led you to launch your own firm?

GG: I'd always had the desire to start my own fund and hopefully one day become a respected value investor in my own right. I distinctly remember one day in the summer of 2005 when I was thinking about the last few market crashes and the

“When a general market dislocation erupts... it is only those who have cash... who are able to capitalize.”

tremendous investment opportunities that they created. I recall reflecting on how rarely these events occurred and thinking that the next time something like that happened, I'd do my best to pounce on it.

After Lehman collapsed in late 2008, the markets' reaction was so severe, and the fear and irrationality so rampant,

that it was like nothing I'd ever experienced. There was one week in particular – the week of October 6 – when every stock I was following fell 10% a day. I decided that the valuations I was seeing were too good to pass up.

I launched Rational in early 2009 with \$500,000 in outside capital from one investor. I knew this would be a difficult climate in which to raise capital, but I figured that either the whole world was coming to an end, which was highly unlikely and in which case you'd be screwed no matter what you were doing in life, or this represented an extraordinary chance to exploit some unbelievable bargains and to start building a strong record.

Since inception, we've generated net returns of 21% a year. That compares to 13% for the TSX Composite Index in Canada, where the vast majority of our portfolio has been invested over the years. We've beaten the index by about 8% annually while averaging 24% cash.

G&D: How would you characterize your investment approach and philosophy?

GG: One of my favorite investing quotes comes from Benjamin Graham, who wrote in *The Intelligent Investor*, "Investing is most intelligent when it is most businesslike." Suppose you were a businessperson considering taking a stake in a private company. What are the questions that you'd ask yourself? Chances are you'd ask, do I understand this business? Is the balance sheet

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Guy Gottfried



Bruce Greenwald discusses competitive strategy with a second-year MBA student at the 2014 Value Investing Program Welcome Reception.

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sound? Am I partnering with the right people – is management capable and does it allocate capital shrewdly? And, of course, am I getting a bargain?

And chances are that as a private businessperson, you'd probably insist on all of these criteria being met to your satisfaction; it would be too risky to do otherwise when tying up your hard-earned capital for multiple years. If you think about it, as a long-term value investor in the public markets, that's exactly what you're doing. Yet in the public markets, people often compromise on one or more of these criteria. For example, they'll say, "This isn't as undervalued as I'd normally like, but I really like the business," or they'll invest in a highly leveraged or mismanaged company because it's statistically cheap. That happens all the time and it's arguably due to the illusion of liquidity. Knowing that you can always change your mind and sell out of a position creates a subtle, subconscious temptation to loosen your standards, especially when the market is strong, and that's often where people go wrong. I've found that it's rarely worth making exceptions and that if you're going to commit your capital to an investment, you should insist on the complete package.

G&D: What is your process for identifying opportunities?

GG: First, you can't do the same thing as everybody else and expect different results; it is going to be difficult to find truly compelling investments that way. Many investors might

start by screening for stocks with low multiples to their earnings or free cash flow. But the most attractive opportunities often involve businesses that are under-earning or even losing money and that therefore won't be found in a screen. For example, when Warren Buffett first invested in GEICO for Berkshire Hathaway in the

“Knowing that you can always change your mind and sell out of a position creates a subtle, subconscious temptation to loosen your standards, especially when the market is strong, and that's often where people go wrong.”

1970s, it was mired in red ink and was facing financial difficulties. It is very doubtful that GEICO would have shown up on a computerized screen, but it was arguably the greatest investment that Berkshire ever made.

Because the best investments don't necessarily stand out by conventional means, I try to look for special situations that are relatively unrecognized and underexploited. For instance, as I mentioned earlier, I formerly was a sector analyst covering Canadian income

trusts. Income trusts resembled REITs and MLPs in that their structure allowed companies to avoid taxation. However, in a Canadian twist that was subsequently barred by the federal government, any business in any industry could become a trust.

Since income trusts tended to trade at premium valuations, many companies adopted the trust structure, including some that had no business paying out all of their earnings. However, if a trust ever reduced or, God forbid, eliminated its dividend, its shares would be cut in half like clockwork. When I was still at Veritas, I noticed that there were almost no professional investors who systematically sought out trusts that stopped paying dividends or cut them substantially. This unique special situation became a source of a plethora of bargains over the years, including several in Rational's early days.

Another example involves dilutive debt recapitalizations. Suppose that a company has an upcoming debt maturity that it cannot pay off or refinance and is therefore forced to settle that debt with shares. As an equity holder, few things are likelier to make you cringe than your investment being massively diluted. However, a debt recap is like a built-in catalyst because the event itself can eliminate the very problems that precipitated it. It will often leave companies with a clean balance sheet and be accompanied by the arrival of intelligent lead shareholders and the replacement of incumbent management that

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Guy Gottfried

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got the company in trouble in the first place. Further, since firms that need to be recapitalized tend to already trade at depressed valuations and the announcement of the recap will cause their shares to plunge further, they can still be quite cheap despite the dilution. So here's another case of a situation that causes indiscriminate selling and can therefore be an attractive source of undervalued investments.

Another example arises when you identify great owner-operators or controlling shareholders. Brilliant managers and capital allocators are rare, and when you find one, it can pay to ask, "What else is this person involved with?" On occasion, you'll find that this individual may be present at other undervalued companies. For example, in 2009, we invested in a Canadian energy company called Paramount Resources. Paramount was founded and remains controlled by a phenomenal owner-operator in the Canadian energy space named Clay Riddell. What initially drew my attention to the stock is that it appeared to have a single asset that was worth more than the market value of the company, giving you the rest of the business for free.

As I dug into the company, I was increasingly impressed with Riddell's capital allocation. Most notably, Paramount had leased a significant amount of acreage in the Canadian oil sands in 2001, before people were even talking about the oil sands. Then, in 2007, when the oil sands were all the rage, it sold a portion of its acreage

for \$1 billion, for a gain of \$800 million. Consequently, I looked further into Riddell and found out that in the prior half a year, he had bought 15% of the outstanding shares of another Canadian public company called Newalta on the open market. Riddell, who had been a Newalta director for 20 years, had spent some \$65 million on these purchases at double or triple the price at which it was trading at the time.

***"Brilliant managers
and capital
allocators are rare...
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with?'"***

I delved into Newalta and found that it, too, was dirt-cheap, trading at just 3x to 4x free cash flow despite having a near duopoly in its core business of outsourced oilfield waste management. Rational ultimately invested in both companies and made approximately 170% on Paramount in nine months, and 175% on Newalta in a year-and-a-half.

In exceptional cases, you'll find one security that exhibits multiple special situation characteristics. For example, among investments that I've

discussed publicly, The Brick and Holloway Lodging suspended their dividends, underwent dilutive recapitalizations and had excellent lead shareholders come aboard in conjunction with their respective recaps.

G&D: These are great examples, specifically with how you identified Newalta. It reminds us of a recent comment from Seth Klarman about how "pulling threads" on an existing investment leads to additional investment opportunities.

GG: That's right, and by the way, there's no shame in using the same method multiple times. It's so difficult to find truly compelling ideas that you have to take them any way you can get them. When I find some way of simplifying the process of locating bargains, I'm unapologetic about reusing it for as long as it works.

G&D: Can you share with us a current idea in your portfolio?

GG: Holloway Lodging is one of the ideas that I presented at the recent Value Investing Congress. Holloway is a Canadian hotel company that had historically been mismanaged. The company ran into severe problems last decade after the financial crisis and had to eliminate its dividend (Holloway used to be a REIT). That obviously hurt. The situation became even worse in late 2011 when Holloway announced that it would have to pay off a maturing debenture entirely with shares, diluting existing shareholders by some 90%. The stock traded at \$5 at the

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Guy Gottfried



Students in the 2014-2015 Value Investing Program discuss potential investment ideas.

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time of my presentation compared to the \$150 range, split-adjusted, before the crisis. Our average cost is around \$4. Along with the recap, an activist investor took control of Holloway in 2012, replaced management, and significantly improved the operations. The company's legacy portfolio is performing very well today. Where it gets really interesting, though, is that Holloway just completed a transformative takeover whose potential I don't think the market has caught on to. Specifically, it just closed the acquisition of another hotel company called Royal Host. Although Royal Host doubled Holloway's size, it generated less than 20% of its free cash flow due to extreme mismanagement. The deal creates tremendous value, which I'll demonstrate shortly.

At the time of the presentation, the stock traded at 7.7x free cash flow based only on Holloway's and Royal Host's combined trailing results, without any further adjustments. That compared to 11.7x for Holloway's publicly-traded peers. If you normalized the results for actions that are already being taken to improve Royal Host, the stock would trade at just 5x estimated free cash flow.

Further, if you ignored Royal Host altogether and pretended the acquisition never happened, Holloway was still valued at 8.4x, equivalent to a 12% free cash flow yield and a 28% discount to its peers. In other words, the market was giving you Holloway at an attractive price and throwing in Royal Host for free.

What makes Royal Host such a tremendous opportunity for Holloway? The company was very poorly managed for close to a decade. From 2006 to 2013, it had three presidents or CEOs whose average tenure was just 13 months, and the rest of the time it was run by committee with no effective leader prior to the current chairman. Without adequate management, Royal Host didn't pay attention to costs, underinvested in its assets and generally failed to do the basic blocking and tackling of operating a hotel business.

“It's so difficult to find truly compelling ideas that you have to take them any way you can get them. When I find some way of simplifying the process of locating bargains, I'm unapologetic about reusing it for as long as it works.”

I'll give you a couple of examples that illustrate the mismanagement. Both Royal Host and Holloway have hotels in Yellowknife, Northwest Territories. Royal Host's hotel has 129 rooms; Holloway's has 66. Royal Host's is a full-service hotel with a restaurant

and banquet hall, while Holloway's has no food and beverage offerings. Yet Royal Host's hotel only generates around 30% more net operating income despite being double the size and having the food and beverage business. Second, Royal Host had a hotel it recently sold in Chatham, Ontario, where it was paying nearly double the property taxes of another hotel in Chatham owned by a rival company. Same city, same type of hotel, similar size, and Royal Host was paying approximately \$100,000 more a year in property taxes. Amazingly, the company just never bothered to check competitors' property tax records and appeal its own taxes. Royal Host has since made these appeals and was able to receive prior-year refunds for a majority of its hotels and generate ongoing savings of several hundred thousand dollars annually.

The magnitude of the cost-cutting opportunity at Royal Host is enormous. Some of these initiatives have already been achieved but have yet to flow through Royal Host's trailing financials, let alone Holloway's, as the acquisition only closed on July 1. Others are being worked on as we speak. Holloway is addressing virtually every major cost item at Royal Host such as property management, food, insurance, wages, etc. Overall, Holloway can generate millions of dollars in annual cost savings, a significant amount for a business with \$12 million in trailing free cash flow. And none of these measures are herculean – this is just the result of running the business

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Guy Gottfried

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the way it should be run. I should also add that these are after-tax improvements, as Holloway will not be cash taxable for the foreseeable future.

As another case study, for years Royal Host under-invested in its most valuable asset, the Hilton in London, Ontario, which is now Holloway's most valuable asset as well. Management estimates that by spending \$5.5 to \$6 million renovating the hotel, it can boost net operating income by \$1.5 million per annum. At a 9% cap rate, you'd get a \$17 million increase in property value on a \$6 million investment.

Royal Host also has numerous hidden assets: it has a hotel near Toronto's Pearson Airport which only earns cash flow (net operating income less capex) of \$300,000 to \$400,000 a year, but could probably be sold for \$15 million due to its real estate value. If Holloway can divest this property and redeploy the proceeds into hotel acquisitions at a 10% cap rate with a 55% LTV mortgage at 6%, it would add \$2 million to its free cash flow. And again, we're talking about a company with \$12 million in trailing free cash flow, so each of the actions I've discussed will provide a sizeable boost. There are likely \$20 to \$25 million in disposition opportunities in Royal Host's portfolio.

So you have this huge growth opportunity due to the Royal Host acquisition that won't take anything heroic to realize; it's just cutting costs and capitalizing on under-earning

assets. Factor this in and you wind up with an estimated valuation of 5x free cash flow. Then, beyond Royal Host, Holloway's management is very capable and allocates capital intelligently, as the Royal Host acquisition attests. You have a multi-year horizon over which management can continue executing accretive deals. If Holloway can grow its portfolio from 33 (including assumed near-term dispositions) to 50 over four

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or five years, think about what free cash flow will be then. Ultimately, this stock will trade at a low single digit multiple, which is hard to find in any business nowadays, let alone a real estate heavy company that's very well run and has years of growth ahead of it. What'll the stock be worth at that point? Should it trade at 8x, 10x, or 12x? It's hard to say, but it doesn't really matter; the point is that your margin of safety is huge and that it's hard to find a scenario where the shares don't skyrocket. And insiders seem to agree: six of them have

bought 9.5% of the company on the open market since May.

G&D: How have you evolved as a professional investor, and what are some lessons you have learned at Rational?

GG: I launched Rational during a very anomalous time when I was only twenty-seven years old, so I was bound to learn a thing or two. I'd say that one of my greatest regrets has been not reaping the appropriate rewards on some of my highest-conviction ideas, and that relates to the issue of portfolio concentration.

It's fashionable to say you're a concentrated investor, but in practice it's very challenging. Rejecting an investment that clearly has a poor margin of safety is easy. The hard part is finding an idea that actually is attractive and still turning it down because it isn't up to your high standards and you can do better, be it by adding to your current best holdings or by waiting for future opportunities whose timing you can't know, but which invariably come around from time to time. That takes great discipline.

G&D: What is the size of Rational's team now?

GG: It's just me and our CFO. It's unconventional, but I'm a control freak when it comes to the research process and being entrusted with other people's capital. I'm very cognizant of the fact that just one unnoticed or misinterpreted detail can result in making the wrong investment or passing up the right one. Don't get me wrong, our due diligence is

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Guy Gottfried



Bill Ackman converses with guests at the 2014 Omaha Dinner.

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heavily dependent on the knowledge and insights of an extensive network of people, including management teams, industry specialists, fellow investors, and others who may be familiar with a given business. You can't attain and sustain the necessary conviction level in an investment entirely on your own. People are a critical part of the process; it's just that for us, it's been more external than internal in the form of having a team of analysts. That said, I certainly wouldn't rule out adding an analyst or two over time under the right circumstances.

G&D: Other than your presentations at the Value Investing Congress, you tend to keep a low profile. What is your view on publicity as an investor?

GG: Actually, even the Congress opportunity came about by happenstance, after I was introduced in 2011 to the organizer, John Schwartz, by a mutual friend. But you're quite right, I do tend to keep a low profile. Rational doesn't have a website and it isn't unusual for me to be contacted by prospective investors apologizing for calling or emailing me directly because they couldn't find any other contact information and asking me to forward them to our IR person (which, of course, we don't have).

I've worked hard to structure my life and work in a way where I can focus on being efficient, eliminating waste and clutter and being in total control of how I spend my time. Of all of Buffett's great attributes, one of the most

unheralded is the tremendous focus and productivity he achieves on a daily basis by structuring his life so that he can virtually always do what he enjoys and actually wants to do. I think I still have a long way to go before I perfect this, but that's how I try to arrange things here as well.

"It's fashionable to say you're a concentrated investor, but in practice it's very challenging... The hard part is finding an idea that actually is attractive and still turning it down because it isn't up to your standards... That takes great discipline."

One of the advantages of not doing much marketing is that the people who do tend to locate you are more likely to be like-minded investors. I'm really thrilled with Rational's capital base – we have unbelievable partners. It's very easy to take such things for granted, but it's important to stress that regardless of your ability as an investor, you won't be able to execute your strategy successfully over the long haul without a stable capital base.

Imagine that a market dislocation arrives and instead of being able to take advantage, you're forced to use your cash to meet redemption requests from panicky investors while the opportunity passes you by. Not only is it counter-productive, but also psychologically, the anguish and helplessness of being handcuffed can leave you vulnerable to becoming irrational and making bad decisions. It is much easier to cope with temporary losses when you feel that at least you're capitalizing on the environment.

G&D: We noticed you are one of the key speakers at Canada's Capitalize for Kids Investor Conference this October. How do you view this philanthropic endeavor?

GG: There are countless prominent investing conferences in the US, so this may be hard to believe, but Capitalize for Kids is probably the first large-scale investment conference in Canada, let alone one that is devoted entirely to a philanthropic cause. What attracted me to Capitalize for Kids when I was first contacted about it by Kyle MacDonald, one of the co-founders, was that it targeted specific areas within The Hospital for Sick Children in Toronto that it identified as being underfunded or in need of special attention. The folks at Capitalize for Kids put a great deal of thought not only into organizing the conference itself, but also into how to best allocate the proceeds. I was impressed by that.

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Guy Gottfried

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G&D: Can you share any advice with our readers?

GG: In one of his old partnership letters, Buffett makes the important point that in investing, there's a difference between being conventional and being conservative. Since convention is dictated by the crowd, following it will frequently lead you in the wrong direction. This is in keeping with his philosophy of having an internal scorecard – of doing what makes sense to you and judging yourself by your own standards rather than the standards of others. This has been a guiding principle for me in building Rational. I've often done things that didn't exactly help our marketability because they were right for me and enabled me to create an environment that was suited to my investing philosophy and personality. For instance, Rational has never engaged in short selling. Some allocators consider this blasphemous, and there's no lack of managers who short mainly to justify their fees. Personally, I consider it virtually impossible to find any short that can come close to matching a well-researched long; not only is the upside capped and downside unlimited, but even those who do find great shorts tend to size them so small that they'd arguably be better off avoiding them. Sure, shorting can reduce volatility, but over time it's nearly destined to underperform. There are many ways to get to heaven in the industry, but that's what makes sense to me.

Similarly, I don't have a team of analysts for the reasons I articulated earlier, which I'm

sure turns some people off. I could go on, but you get the idea. You'll go farther in the long run – and have a great deal more fun – if you do what resonates with you instead of worrying about convention and how you look in the eyes of others.

G&D: That is a valuable piece of advice and a great way to conclude our interview. Thank you for your time, Mr. Gottfried.



Sisy Wang '16

Sisy Wang is a first-year MBA student at Columbia Business School. Prior to CBS, Sisy was an Analyst at Delaware Investment's Emerging Markets Fund and a pre-MBA Summer Analyst at Plymouth Lane Capital.

B&M European Value Retail SA (LON: BME) - Short

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Thesis

B&M is an over-hyped IPO story stock ("Dollar General of the UK, with Tesco management as chairman"). At 25x FY14 and 20x FY15 EV/EBITDA, the stock price is discounting very bullish assumptions around TAM and market share relative to a small and saturated UK market. Meanwhile, saturation of the concept will intensify competition and drive down margins (at peak today). There is also a stock lock-up that expires Dec 2014.

Background

- B&M is the #2 UK general merchandise discounter (pound store) by sales, with a similar operating model as dollar stores in the US.
- Pound stores' value proposition is price + convenience. They have a small number of SKUs (3000-5000 vs. 30K for a discount store), which allows them to sell only the most profitable SKUs (highest turn consumables, highest margin general goods).
- B&M was acquired by two brothers in 2005, and the store base has grown 18x since (21 to 373).
- IPO'ed in June 2014. CD&R bought half of the company in 2013 from management and installed Tesco's ex-CEO Sir Terry Leahy as Chairman.

Competitive Landscape – why B&M is not the next Dollar General

- DG benefited from white space in the US – small, rural populations that were not profitable enough for big box. Given the country's large size, DG and FDO could grow profitably within their own geographies without much direct competition. Dollar stores mainly gained share from grocery stores, a fragmented and less-efficiently run group.
- The UK retail landscape is much smaller and more concentrated. 50% of the UK population shops for non-food items in just 90 locations. Unlike in the US, the grocer space is concentrated (Big 4 has ~75% share)
- Pound stores also face 2 sets of unique competitors that US dollar stores didn't have: grocery discounters (Aldi, Lidl – a category that largely doesn't exist in the US) and the "express" versions of Tescos (Wal-Mart and Target are later to small format convenience stores vs. UK big box retailers).
- Within pound stores, competition is also fiercer. The sector as a whole doubled store count since 2008 (+1,100 stores total), and the main players are planning to double store count again (implying UK pound store penetration at 3x that of the US on a % of retail sales basis).
- Converging geographical expansion: B&M stores are mostly in Northern UK / Midlands, but they are now expanding into Southern UK. As they expand, they will face more competition from Poundland (national player) and 99P (Southern UK focus), who are in turn starting to enter B&M's geographies.
- Recession retail bankruptcies created a one-time land boon for pound stores (around 1/3 of B&M's leases today). However, bankruptcies peaked in 2012 both in number and size. Going forward, B&M will face a lot more pressure on finding cheap leases (rent at 4% of sales is much lower than older competitors).

Operating Metric Comparisons				
	B&M	PLND	DG	FDO
Store count	373	458	11,215	7,916
Sq ft / store	14,145	5,143	7,400	7,200
Sales / store	£3,410	£1,922	\$1,561	\$1,313
Gross margin	34.0%	36.7%	31.1%	34.2%
EBITDA margin	10.2%	4.9%	11.8%	8.8%
Turns (on Tang IC)	7.4x	19.5x	5.6x	4.5x
PP&E as % sales	5.1%	4.3%	11.9%	16.7%
NWC as % sales	8.3%	0.8%	6.0%	5.5%
CROTIC (EBITDA / Tang IC)	76.0%	95.7%	66.2%	39.6%
Net Debt / EBITDA	2.9x	(0.3x)	1.4x	0.4x

Management & PE Cashing Out

- IPO was 93% secondary with both management and PE halving their stakes.
- Although CD&R has a track record of creating value, they held this investment for only 1 year (doubling their money). The extent of their value-add seems to include a small German acquisition (to sell a longer-term international story) and installing ex-Tesco CEO, Leahy, as Chairman.

Leahy (ex-Tesco) holds no shares in B&M. He is a CD&R advisor and owns shares in the 2009 fund. He sits on the board of 4 other companies (2 of which he actually is a significant direct investor).

US margins from the low-20s to the mid-/high-20s is just now getting started in

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B&M European Value Retail SA. (Continued from previous page)

Valuation

- Even putting aside issues on competition, the current valuation barely justifies the most bullish long-term growth assumptions
 - Valuation methodology: I focus on the time it takes for the stock to re-rate to a reasonable multiple (I use DG's 10x EV/EBITDA from before the M&A talk) and where CROTIC (cash ROIC) will go. I assume 50 stores per year (management's goal is ~40).
- ⇒ High Case: To stretch the bull case, 8 years for the multiple to erode to a normalized level and CROTIC to expand to 100% (beyond PNLD's 96%). This is a scenario where B&M outcompetes its competitors to become one of the dominant players in the UK, thus retaining profitability as it grows.
- ⇒ Low case: 3 years for the multiple to erode and CROTIC to mean revert to 60% due to market saturation, increasing competition, and less profitable geographies (still a good return vs. DG's 66%, FDO's 40%).

Low Case (3 years)				High Case (8 years)			
	FY14	FY17	CAGR		FY14	FY22	CAGR
# Stores	373	523	11.9%	# Stores	373	773	9.5%
Sales per store (M)	3.4	3.3	(0.9%)	Sales per store (M)	3.4	4.4	3.3%
Revenue	1,272	1,737	10.9%	Revenue	1,272	3,414	13.1%
GM	34.0%	33.0%		GM	34.0%	34.0%	
Opex % of sales	23.7%	24.0%		Opex % of sales	23.7%	22.0%	
Adj EBITDA	130	156	6.2%	Adj EBITDA	130	410	15.4%
% Margin	10.3%	9.0%		% Margin	10.3%	12.0%	
CROTIC	76.2%	60.0%		CROTIC	76.2%	100.0%	
EV/EBITDA (TTM)	23.8x	10.0x	(25.1%)	EV/EBITDA (TTM)	23.8x	10.0x	(10.3%)
EV	3,100	1,563	(20.4%)	EV	3,100	4,097	3.5%
Net debt	380	380		Net debt	380	380	
Market cap	2,720	1,183	(24.2%)	Market cap	2,720	3,717	4.0%
Dividends (assume 100% FCF)		109		Dividends (assume 100% FCF)		1,158	
IRR			(22.5%)	IRR			8.4%

IRR Sensitivity										
		Time frame (years)								
		2	3	4	5	6	7	8	9	10
CROTIC / EBITDA / Tangible Inv Capital	20%	(89.7%)	(68.0%)	(51.7%)	(40.2%)	(31.9%)	(25.8%)	(21.2%)	(17.6%)	(14.7%)
	30%	(67.9%)	(48.2%)	(35.3%)	(26.5%)	(20.3%)	(15.9%)	(12.5%)	(9.8%)	(7.8%)
	40%	(55.7%)	(37.3%)	(26.0%)	(18.6%)	(13.6%)	(9.9%)	(7.2%)	(5.1%)	(3.5%)
	50%	(46.2%)	(29.1%)	(19.2%)	(12.9%)	(8.6%)	(5.6%)	(3.4%)	(1.7%)	(0.3%)
	60%	(38.1%)	(22.5%)	(13.7%)	(8.3%)	(4.7%)	(2.1%)	(0.3%)	1.1%	2.2%
	70%	(30.9%)	(16.7%)	(9.1%)	(4.4%)	(1.3%)	0.8%	2.3%	3.5%	4.4%
	80%	(24.3%)	(11.7%)	(5.0%)	(1.0%)	1.6%	3.3%	4.6%	5.5%	6.2%
	90%	(18.3%)	(7.1%)	(1.4%)	2.0%	4.1%	5.6%	6.6%	7.3%	7.9%
	100%	(12.6%)	(2.9%)	1.9%	4.7%	6.5%	7.6%	8.4%	8.9%	9.3%
	110%	(7.3%)	0.9%	5.0%	7.2%	8.6%	9.4%	10.0%	10.4%	10.7%
	120%	(2.3%)	4.6%	7.8%	9.5%	10.5%	11.1%	11.5%	11.8%	11.9%
	130%	2.5%	8.0%	10.4%	11.6%	12.3%	12.7%	12.9%	13.0%	13.1%
	140%	7.1%	11.2%	12.8%	13.6%	14.0%	14.2%	14.2%	14.2%	14.2%
	150%	11.6%	14.2%	15.2%	15.5%	15.6%	15.6%	15.5%	15.3%	15.2%

Catalysts

- CD&R's 180 day lock-up expires Dec 2014
- Growth slows due to less available space (fewer bankruptcies)
- High margins mean-revert due to competition and industry saturation

Risks

- Continued strong growth in short-term from new store opening.
- Strong return profile / cash flow generation – management has set dividend payout at 30-40% ratio
- Technical risk: B&M may get added to FTSE 100 index if market cap reaches £3 billion



Kevin Lin '16

Kevin Lin is a first-year MBA student at Columbia Business School. Prior to CBS, Kevin was an associate at Sansome Partners, a long only family fund.

Countrywide, Plc. (LON: CWD) - Long

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Recommendation

Buy Countrywide (LSE:CWD) equity with a 12/31/18 base case price target of £8.35. This represents ~90% upside from the current share price, including dividends. The investment thesis has five main points:

- 1) Countrywide should benefit from a recovery in housing transaction volumes in the U.K., which currently sits ~15%-20% below historical levels
- 2) The cost structure has changed post recession, with ~40%+ incremental margins and long term margin targets well in excess of prior 2006 peak
- 3) The business will generate high FCF (~£400m over next 5 years), and the Company has directed 35%-45% (but up to 70%, barring any acquisitions) of net income to be returned to shareholders
- 4) Countrywide continues to find opportunities to "roll up" rental businesses at 20-25% return on acquisitions (within 2 years) and believes there is room to double its market share over time
- 5) Management incentives are aligned with shareholders, with options based off EPS and TSR targets

Business Description

Countrywide is the largest real estate agency in the United Kingdom, operating ~1,370 branches and 47 brands. The Company has 6% market share of UK housing transactions, followed by LSL Property Services (3%) and Connells (estimated ~3%). The Company was acquired by Apollo in 2007 (Oaktree and Alchemy took stakes in 2009), and IPO'd on the London Stock Exchange in March 2013. LTM 6/30/2014, Countrywide generated £661 million of revenue and £105 million of EBITDA.

Countrywide is the dominant player in a cyclical industry that is operating below historical norms. Following the recession, the Company restructured, reduced fixed costs, and improved employee productivity. In addition, the Company has diversified by growing its lettings (rental) business, which is countercyclical to transaction volumes and now accounts for ~1/4 of EBITDA.

I believe Countrywide has significant operating leverage and will be able to generate strong earnings growth as the market recovers. The Company enjoys economies of scope (provides surveying, conveyance, and financing services in conjunction with real estate brokerage) as well as economies of scale (national back office infrastructure). Combined with low capex requirements, good reinvestment opportunities, and strong shareholder alignment, I believe Countrywide can compound at double digits over the next 4-5 years.

Investment Thesis

1) Rebound in Housing Transactions

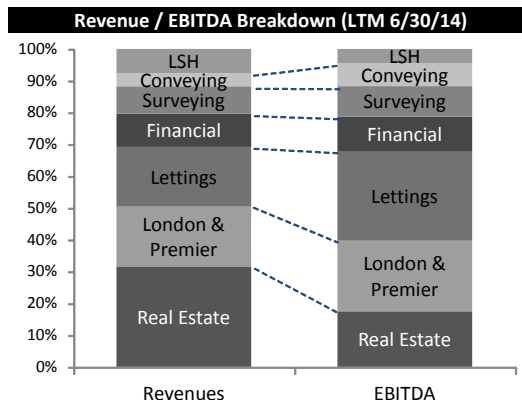
Transaction volumes in the UK were ~1 million in 2013, and are estimated to be ~1.2 million this year. This compares to long term averages of ~1.4 million (after factoring out the number of transactions associated with increasing home penetration levels). Residential investments sit at 4.0% of GDP, compared to 4.5%-5.0% pre-recession (7% at peak), and UK household turnover has fallen to 4.1%, versus an estimated 6.9% average since 1971. The current rate implies households will now move every ~25 years versus every ~14 years pre-recession. As UK's economy recovers over the long run, I believe credit will loosen and the volume of transactions will move closer to the norm. In addition, the government has signaled its support for first time home buyers through its Help To Buy programs, and UK's own Office for Budget Responsibility forecasts >1.5 million property transactions by 2018. The Royal Town Planning Institute also suggests that there may be a ~375,000 shortfall in UK households.

2) High Incremental Margins

Coming out of the recession, Countrywide has reduced its fixed cost base by closing unprofitable branches, consolidating its IT infrastructure, and outsourcing back office functions. Incremental margins over the past 3 years

Market Overview	
Stock Price (10/8/14)	£4.73
Shares Out (Diluted)	226
Equity Value	£1,067
Less: Cash	(44)
Plus: Debt	118
Enterprise Value	£1,141

Current Valuation (Consensus)	
EV / 2014E EBITDA	9.0x
Price / 2014E EPS	11.8x
Dividend Yield	2.4%



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Countrywide, Plc. (Continued from previous page)

are in the neighborhood of ~40% (the Company guides to 40%-60%, exclusive of investments in personnel that are currently ramping up). Incremental margins are high since the current infrastructure can support higher transaction volumes, and only ~half of staff costs (56% of revenues) are variable (though it will begin to fall if volumes come back in such a way that additional headcount is needed).

3) Free Cash Flow and Shareholder Returns

Countrywide has historically been a very capex light business, but will be ramping capital expenses for the next 2 years to implement its IT transition (~£20m a year). Post this, capex is expected to tail off. I believe the Company will be able to convert ~90% of its net income to FCF as provisions wear down over time (2014E FCF yield of ~6%).

On the first half 2014 call, Countrywide stated it would return 35-45% of net income back to shareholders, and up to ~70% barring any major acquisitions. In July, the Company declared a special dividend from the liquidation of a portion of its Zoopla stake (recently IPO'd real estate portal CWD owns ~4% of). The Company also commenced a £20m share repurchase program on October 1st.

4) Investment Opportunities

Post IPO last year, Countrywide's debt has fallen to less than 1x net leverage. The Company is using FCF and a new term loan to buy up lettings agencies (in conjunction with its own organic growth in existing real estate branches). The Company made 28 lettings acquisitions in 2013 and 16 in the first half of 2014. Management believes the opportunity to roll up small lettings businesses will persist for years.

Countrywide targets a 20% to 25% return on acquisitions in the second full year of ownership (and which management confirms they are in line to achieve). The Company is able to acquire at such low multiples since 1) it changes the cost profile of the acquired business by stripping out and outsourcing the costs (sometimes the entire business is lifted into an existing branch), and 2) it has tons of visibility into the lettings market, and acquires businesses that are currently under-priced and have room to increase rental fees over time.

5) Management Incentives

2/3 of long term share incentive awards (up to 300% of salary) are subject to absolute EPS targets. "25% of this part of an award will vest for EPS of 57.6 pence increasing pro rata to 100% vesting for EPS of 70.4 pence for the year ending December 31, 2016." The remaining 1/3 is based on relative TSR versus the FTSE 250, with 25% vesting if performance is the median of the group.

Key Risks

The UK could very well be in a new normal where housing transactions are permanently below historical averages. However, the shares don't appear to be too expensive even at 2014's estimated 1.2 million homes, and both commissions and lettings should serve somewhat as a natural hedge in a lower-level environment. Discount brokers could potentially take share, but I believe people will inherently want an agent to be involved in the sale of a home (~90% of sellers are fairly/very satisfied with their agents). The UK has already has one of the lowest commission rates (1.5%, vs. the U.S. at 5%-6%) in the world, so online brokers like Redfin seem to be less economically viable.

In the UK, property portals Zoopla and Rightmove control the market and charge real estate brokers monthly fees to list homes on their sites. The companies have been increasing ARPA rates at double digit percentages due to their dominant positions. I believe a 10%-15% increase in rates would increase Countrywide's advertising costs by ~£1 million. To combat this, six real estate agents (including Savills) have gotten together to launch an alternative (non-profit) 100% agent owned portal. The portal plans to launch in January with ~5,000 participating branches, and should alleviate the existing duopoly pricing pressure.

Valuation

My £8.35 price target is based on roughly 14x 2018E diluted EPS £0.58. I assume transaction volumes return to 1.4 million by 2018, commission fees fall from ~1.75% to 1.5%, while average prices post 2014 increase at 2% (this compares to OBR and Savills projections at 3.5%-4% pricing growth). For London and Premier, I am predicting 2% pricing and transaction growth and flat commission rates. I model incremental margins at 35%, falling to 30% over time, and assume the Company keeps leverage at 1x net, using FCF to buy back shares and make tuck in acquisitions.

Barring another global meltdown, I believe a downside case could involve a new "normal" of ~1.1-1.2 million transactions, no growth in price or transaction volumes, and a higher stabilized commission fees. At a 12x 2018 exit multiple, I believe investors could still achieve a high single digit IRR.

			Restated		Projected				
	2010	2011	2012	2013	2014E	2015E	2016E	2017E	2018E
Revenues	£477.9	£509.1	£524.7	£584.8	£705.3	£730.8	£755.8	£780.1	£803.9
% Growth		6.5%	3.1%	11.4%	20.6%	3.6%	3.4%	3.2%	3.0%
Total EBITDA	£63.6	£56.4	£63.0	£86.6	£120.2	£133.3	£146.8	£159.6	£172.9
% margin	13.3%	11.1%	12.0%	14.8%	17.0%	18.2%	19.4%	20.5%	21.5%
Diluted EPS	-£0.05	-£0.02	-£0.02	£0.17	£0.34	£0.40	£0.45	£0.51	£0.58
% growth					104.8%	16.4%	14.6%	12.6%	12.4%
Free Cash Flow	-£91.6	£0.3	-£16.0	-£38.3	£39.6	£45.0	£54.2	£59.6	£67.5

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Development Capital Partners



Development Capital Partners Team
(from left to right):
Jason Yang '14,
Gordon McLaughlin '11,
Paul Tierney,
Matt Magenheimer '11,
Matthew Tierney '02

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the Peace Corps for two years. In the Peace Corps, I had intended to pursue a career in economic development. While there I observed that there were an awful lot of smart, well-intentioned people in the field of economic development, but collectively there were very few practical skills in the community. It was full of PhDs in Economics and Political Science but had very few people with training or experience, the sorts of things that make privatizations work, or that enabled cooperatives of small, poor farmers to make a living.

After leaving the Peace Corps, I won a Ford Foundation fellowship to go to graduate school. There were about ten other winners and all of the others went into programs in Political Science and Economics. I chose to go to Harvard Business School, which was a very suspect decision to the fellowship. Consequently, I had to take extra courses and find a mentor at the Kennedy School.

Through the program, I became very interested in entrepreneurship and investing. I started a PhD Program at Harvard, but never finished it because I started working at an investment firm in New York. That's about the time when I got more interested in investing.

Since I can remember, I have been interested in creative things: the creation of value, the creation of new entities, the creation of new businesses. At that time I made an important decision - instead of being an entrepreneur and building or starting a business, I would be a financial entrepreneur.

I wanted to financially back and invest in lots of different businesses, participating in a whole portfolio of creative activities, rather than just taking a concentrated shot at one thing.

That interest continued to grow in the next few stages of my career. I went from doing that with the New York entity, to helping start a merchant bank in London, which in turn financed lots of entrepreneurial activities worldwide. Then, after spending one year in the federal government on a quix-

"I made an important decision, that instead of being an entrepreneur and building or starting a business, I would be a financial entrepreneur. I wanted to financially back and invest in lots of different businesses."

otic venture, I joined White Weld, an investment banking firm in New York. I was a junior partner of that firm until we were acquired by Merrill Lynch, at which point I left to start my own firm with two other partners.

That firm was the originator of a whole variety of investment partnerships, which all tended to have something to do with corporate reorganizations, activist investing, mergers and acquisitions, risk arbitrage or event-driven marketable security purchases. There was a little bit of private investing, but for the most part it was a private investing approach to marketable securities.

It was pretty successful. In the late 90s, we decided to shut down the partnerships that we had with outside limited partners and I began a private office to invest my own capital together with friends and partners that I had known. I formulated an emerging market specialty investing my own and some friends' capital outside of the United States — usually in conjunction with local partners or money managers in those countries. We spread from China to Russia, then Latin America. Then about five years ago, I started focusing on Africa.

Part of my reason for being interested in Africa was the fact that I had been Chairman of TechnoServe for a long time. TechnoServe is a not-for-profit organization that does economic development work in Africa, Latin America, and India. It started in Ghana and is now in 33 different countries, most of which are in Africa. I've had a long-standing involvement in Africa and an on-the-ground experience with it.

Due to my long involvement in the region and what I observed there, I thought Africa was the place that had the greatest opportunity and where I had

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Development Capital Partners

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the greatest personal interest. And so three years ago, the four of us began Development Capital Partners.

Gordon McLaughlin '11 (GM): When I was in high school I worked part time installing software systems in the homes of Radiologists so that they could view images from home at night as opposed to having to work "on call" at the hospital. I became so interested in the software and hardware I was installing that I opened a brokerage account and invested a few hundred dollars in two of the companies that owned the technology. Eventually my consulting gigs dried up, but I ended up making more money on the companies I'd invested in. That experience really planted the seed of my interest in investing.

My first real professional role after college was working for an economic consulting firm providing valuation analysis on patents, trademarks and early stage technologies. But I always knew that ultimately I wanted to get into the investment industry and make decisions as a principal as opposed to as a service provider.

After a couple of years of consulting, I joined an investment manager in Chicago called Security Capital, which is part of JP Morgan. At Security Capital I was able to get formal training in the areas of investment research and security analysis. I also spent a couple of years in London leading an effort for Security Capital researching real estate companies across Europe and Asia. The international work allowed me to witness a lot of the things that

were happening in emerging and frontier markets. Ultimately, I decided to go back to school to try to find an area in emerging and frontier markets to apply the security analysis skills that I had been developing. That's how I ended up at Columbia Business School and in Paul's class on investing and entrepreneurship in Africa. In Paul's class, I was exposed

"We quickly became more and more interested in Africa after we saw a lot of the macroeconomic changes taking place, which eventually led to the formation of DCP."

to CEOs running highly profitable companies across Africa. I was also able to study the investment management industry in Africa and observed that the relative intensity of competition of investment management in Africa seemed less than in other geographies.

All of these observations about Africa were very appealing to me. By the time I hit my last semester at Columbia, I was quite keen on the opportunity. I started spending three days a week working with Paul and Matt Tierney identifying investments in Africa, and that led to my involvement in helping to form DCP.

Matt Tierney '02 (MT): DCP was created to employ a similar investment strategy to what Paul, Gordon and I had been doing, but was organized as a new entity to bring in outside capital and be a standalone business. I knew I liked Gordon when I first met him and I found out he had run a personal stock portfolio since high school.

You'd asked how we got interested in investing. I grew up in a household where investing was talked about a lot. My brother, sister, and I would sit around the table on Sunday night at dinner, and Paul would be talking about a deal that was being done.

There are two things that got me to where I am with DCP. One, I have been interested in entrepreneurship and investing since a young age. Two, I have a passion for international affairs and emerging markets. I went to Georgetown, where I studied international relations with a concentration and focus on Latin America. After undergrad, I wanted to gain experience in emerging markets, so I worked for TechnoServe in Peru for a year. I ended up working with small businesses, primarily in the agricultural space, that TechnoServe was consulting with, both in Peru and across Central America.

During my second year at TechnoServe, I focused on Africa and conducted cost-benefit analysis of TechnoServe's programs across the continent. I had been to Africa before, but that was the first time I spent a lot of time there professionally. I realized rather quickly that there's only so

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Bruce Greenwald, Wally Weitz, and Tom Russo at the 2014 Omaha Dinner.

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much you can learn from an analysis standpoint at a non-profit, so I joined an analyst program at Credit Suisse in New York. I worked in the global corporate finance group for a few years, before going to Columbia Business School. I graduated in 2002 and joined Paul and a couple of other folks to help start a health care venture capital initiative called Aperture Venture Partners. I enjoyed doing venture capital deals, but after several years, I realized that health care was not something that I wanted to spend the rest of my life on, and I missed the emerging markets aspect of what I'd previously done.

Thus in 2008, Paul and I started talking more about what we could do in emerging markets, and began investing our own capital through various means, by taking direct or indirect positions across EM, in both public or private opportunities. Then we quickly became more and more interested in Africa after we saw a lot of the macroeconomic changes taking place, which eventually led to the formation of DCP.

Matt Magenheimer '11 (MM):

My passion for emerging market investing was developed early in my career. Six months into my first job, I was sent to Madagascar to work with the Malagasy government on an undersea cable project. Afterwards, I spent 15 months in Mongolia setting up two businesses for a MENA (Middle East-North Africa)-based investment group. I was hooked by the massive opportunities and challenges that these markets provide. It was difficult to land in a foreign environment with limited contacts and im-

perfect information, but it was stimulating, rewarding work. And during my time there, I quickly recognized that these markets would offer some of the most attractive financial returns.

My career path was somewhat backwards in that my financial analysis skills were mostly developed after Mongolia, during my time at Morgan Stanley and

“While sophisticated financial analysis is an important part of what we do, the ability to get data and information to inform your assumptions and view of the business and management is a more important differentiator.”

Columbia Business School. However, I believe my earlier jobs overseas provided much more valuable learning experiences. These jobs trained me to build contacts and find data and information in developing countries, a task which is much less straightforward there than it is in the US. For example, when I needed to find staff for our halal abattoir in Mongolia, I had to visit a funeral in a town with a large Kazakh population in order to speak with the local imam. He referred me to someone, who then referred me to someone else ... and so

on and so forth. Here it would have been an easier task.

While sophisticated financial analysis is an important part of what we do, the ability to get data and information to inform your assumptions and view of the business and management is a more important differentiator. Of course, you never want to take a framework or lens from one country or market and apply it blindly to another, but I believe there are skills beneficial for investing or doing business in imperfect, inefficient markets that can be transferred across geographies.

After Columbia Business School, I knew I wanted to focus on emerging markets investing. Given the nearly four years I had spent living and working in Central and South-east Asia, I was leaning towards Asia. However, as part of Paul's class, I traveled to Ghana to work on a project with a mortgage company based in Accra. I added two weeks in East Africa to my trip and spent the time both on safari and meeting numerous medium and large companies in Tanzania and Kenya. I was impressed by the managers I met - from a banana beer entrepreneur to the CEO of a major East African bank - and the opportunities for growth they saw. I came home and immediately began to focus my job search on Africa-focused investment firms.

Following graduation, I joined Allan Gray, a Cape Town based asset manager that was attractive for the quality of the investment team and the firm's value-oriented strategy. I worked there until I got a call

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from Paul about what the team was planning in DCP. The chance to work with these guys was too good an opportunity to pass up, and I was soon on a plane back to New York.

G&D: Your investment philosophy is probably a little different than some of the traditional value managers that we have featured over the years. Could you give us an overview?

PT: Well, we are similar to other value investors, but perhaps different than other investors in Africa, in that our primary focus is on a concentrated portfolio of publicly traded long positions. We normally have 20 to 25 positions.

Because we deal in markets with a lot of volatility, we have an initial two year lockup on the capital. It was my feeling that the fund structure would make it more difficult to raise capital, because people want to believe that there is daily liquidity even if it doesn't always exist. We are allowed to have up to 20% of our partnership capital invested in non-quoted securities. We didn't want to pass up special investment opportunities that we wouldn't be able to cover, nor did we want to do them on the side with some carve-out where the general partner could do some things in the partnership and some things out. All four of us have extensive relationships all over Africa. If one of them happened to be a great chief executive officer running a company where all we could do is invest privately, I didn't want to let that go by the board.

Our partnership was certainly

not set up to allow the easiest raising of capital, but we didn't want to compromise the structure of the fund in order to make it easier to market. We wanted to be able to make good, long-term investments with high rates of return and not have structural impediments get in the way.

GM: At the heart of it, we really formed the partnership to invest in the best companies and the best management teams at the best price that we

“At the heart of it, we really formed the partnership to invest in the best companies and the best management teams at the best price that we could find.”

could find. The philosophy is not terribly different from what you would find in the value investment community. When we decided to form the partnership, we said we just wanted the 10 to 20 best long-term investment ideas we could find in Africa.

G&D: Tell us a little about your investment process and the diligence you perform.

MT: There is certainly a lot of travel involved. There are similarities to the analytical process, which we do here in

New York. The access to information is getting better. There are publicly available documents that you can pull from Bloomberg. You can get them off websites, but that information is often limited. There are several companies which only give half year or annual results. Those are the types of companies where you have to actually go and gather more information. Aside from the analytics and the numbers, it's really important to go and decide if management is good or not. That's where our network comes into play, which is really helpful. It's not just meeting the CEO; we look to understand mid-level management, the board's corporate governance policies and other factors in finding strong, fortress-like companies.

GM: I would add that another element of the diligence process that's somewhat unique is accessing publicly available information. Information is theoretically available to all, but it sometimes takes extra work to access in Africa. Even for simple things like finding long histories of annual reports, sometimes you have to go knock on the broker's door in order to find an actual hard copy from six years ago. Sometimes you can call someone sitting in Lagos and have it scanned to you in a 100 megabyte documents. These things can be frustrating at times, but we think they enhance the potential of a strategy like ours.

PT: You can't have it both ways. You can't have the benefits of being in an inefficient market with maybe a little lower level of competition and

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Paul Hilal '92 at the 2014 Omaha Dinner.

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also have access to easily accessible information. This is probably a generational thing, but I'm amazed at how much information is available even if it's somewhat difficult to obtain. Ten or fifteen years ago, you couldn't do what we're doing now.

MT: Even five years ago. There's been a really big change in the level of interest in Africa, especially in the US. I think Europe definitely had more interest in Africa from an investment standpoint. About five years ago, I remember going to a conference and there were maybe twenty people in the room. It was a general conference about Sub-Saharan Africa. Two years ago, there was a conference across the street with two hundred people just on Kenya alone. There's definitely a lot more interest, a lot more information available, but nowhere near what you get in developed countries.

GM: One other important component of our work is accessing people. Getting the first interaction with a management team can be a significant challenge. We often work through existing relationships to facilitate introductions to certain management in order to get a first meeting. Once we have the first meeting, it's very easy for us to establish a rapport and the trust level required to develop an ongoing relationship. As the years go on and accessibility increases, it's advantageous to have developed relationships earlier on than later.

G&D: Given the interest in Africa over the last few years, have you seen any changes in

market efficiency or decreases in potential opportunities? Do you think that there's still a long runway to finding mis-priced securities?

PT: I think there's still a long runway, but there's also been more capital and more attention being paid to the region. The whole region from the Middle East down to South Africa is dynamic and the opportunity set changes on an ongoing basis. Periods of fear and optimism tend to get exag-

“You can’t have the benefits of being in an inefficient market with maybe a little lower level of competition and also have access to easily accessible information.”

gerated. Egypt is one of the three largest capital markets, and Egypt has been very volatile over the last several years. This year, Egypt is the first or second best performing publicly-traded index on the continent. We shifted our attention to Egypt pretty early and have some great holdings there.

When the Arab Spring went through North Africa, one of the most misunderstood areas was Tunisia, which has proven to be a place where there's been a lot of opportunity and not too much competition. As

public offerings have taken place and markets have risen, there's more competition there. It's similar to elsewhere in the world when good companies start to show what they can do and capital markets are broadened, more and more money flows into them. The dynamism of the region creates a continuous stream of opportunities.

MT: Obviously there are 54 countries and they're all quite different. There's not too much correlation when you look across regions in Africa. Dislocation in one country from a macroeconomic standpoint oftentimes creates a lot of opportunity from a pricing standpoint. There's typically something wrong somewhere in our universe. Asset prices may be rising in one area where you'll also see IPOs, which we've seen taking place over the last year. At the same time, you can see pricing of great companies drop in another area that is experiencing a more volatile period. Falling prices often draw our attention.

GM: Some of the scariest markets to us exist when everything is perceived to be calm politically and the prices of assets get too high.

G&D: Outside of South Africa, what are the market cap sizes of these countries? What are the investable opportunities in places like Ghana, Kenya, Tanzania, Tunisia, et cetera?

MT: Our investable universe, including some opportunities that we see that aren't listed in Africa, has a total market cap of about \$1.4 trillion.

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GM: If you break it up, though, it's really about \$130 billion of market cap in North Africa and then approximately another \$150 billion in Sub-Sahara excluding South Africa. There is near \$1 trillion in South Africa. The liquidity is also a more challenging element than overall market cap. For example, if you exclude South Africa from the other exchanges in Africa, the approximate liquidity for all the markets is approximately equal to that of a single US stock like Home Depot.

PT: Another part of our strategy is to know a lot about Africa and then find ways of taking advantage of that knowledge – knowing about an opportunity despite the fact that the company might not be traded on an African exchange. It might be traded in London or Mumbai, but have growth potential and strategic focus in Africa; that's part of our universe and that enlarges the pool a lot.

G&D: We imagine you must travel a lot. How much of your time is actually spent on the ground there and how do you approach it?

GM: In general terms, one or more of us is in Africa every month and each of us probably spend 25% or 33% of our time on the ground in Africa. Each trip is, on average, two to four countries, a lot of times in a region, because it's easier to cover ground that way.

PT: We've never had a day in which we've sat down and said, you know, we have spent three weeks and nobody has gone to Africa.

MM: Though the flights can be painful sometimes, the face-to-

face interactions are critical, especially when building new relationships. All investors typically meet with the same four or five individuals on their first visit to a new country. The key is getting beyond this first wave. It is great to have a network of key contacts that we can call from New York for quick feedback, but we are

“Some of the scariest markets to us exist when everything is perceived to be calm politically and the prices of assets get too high.”

always looking for new perspectives. Meeting with suppliers, customers, former employees and mid-level management is invaluable to understanding a company, and these conversations can frequently only be done in person.

G&D: Are you at the point where you have some level of institutional knowledge of every country in the continent? Are there some areas where you're still developing expertise in the companies that are available in those markets?

MT: North of South Africa, there are about 16 exchanges that we would consider, so we're primarily focused on the

countries where there's a local exchange. Then there's often-times surrounding countries where a company is working in and so we'll take a trip there. Ethiopia, in particular, is very interesting and we've spent a lot of time there. I wouldn't say we're experts in every country, but the ones where the companies are located we definitely have an institutional knowledge base, which is helpful.

PT: There are changes occurring and some government regulations and restrictions, which make countries more attractive at one point in time than another. The changes in Egypt are pretty obvious. Ethiopia, which Matt mentioned, is another big country and big opportunity, but it's currently closed. It's a tough place to do business and a tough place to acquire assets. The country still has a government-controlled telecommunication system. That can't continue into the future.

Tanzania had limits on foreign ownership, but they recently dropped the 60% maximum foreign ownership position. So you had situations where non-Tanzanian investors were negotiating with each other to buy stock that was available because both of them didn't qualify as Tanzanians, and there are similar kinds of changes in Saudi Arabia now, so this makes certain countries and certain exchanges more interesting. Angola has no exchange, but has plans to set one up.

G&D: Some investors look into countries that have recently had poor economic per-

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Ken Shubin Stein and Bruce Greenwald at the 2014 Omaha Dinner.

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formance. Do you have a similar framework for identifying new opportunities – is it more systematic? Or more organic as opportunities arises?

PT: We meet regularly. We have scheduled meetings and then we have a million unscheduled meetings. I would say we all have a nose or an interest in countries where the market has been smashed and things are very cheap, and skepticism about things that have gone up too quickly. Our choice of investments is all bottom up, but our instinct, or smell, increases when we see situations that are either too good or too bad and we look into them.

We also follow themes of investments that we like, so if we've observed a certain type of consumer products company or telecom or financial institution be successful in one country, we will look for more opportunities with similar profiles in neighboring countries.

G&D: Given that you invest in Africa, you have a limited investment universe. Natural resource and other commodity type companies have a large presence. Can you elaborate on the types of opportunities where you have been successful? What do you like and what do you look for in the companies that you typically invest in?

PT: We like transparent companies that have good corporate governance, audited statements and good and deep management teams, but in terms of industries, when we started, one of our priorities was looking at fast-growing consumer products companies. Guess what? It was a priority

for everybody. As new, uninformed money entered the region, certain companies with a good franchise and all the other qualifications – we always mention Nestle Nigeria as an example – became the fashion of the day. It might be a good company, but is it a good enough company to purchase at 40 times earnings?

While we're still interested in consumer products companies, it doesn't constitute as big of a percentage of our portfolios as it used to. We're also not gen-

“We like transparent companies that have good corporate governance, audited statements and good and deep management teams.”

erally commodities players. We try to buy into companies that provide a product or service that generates good cash flow.

GM: None of us have a deep background with commodity-based businesses. We see large opportunities in healthcare, retail, financial services, even industries that support infrastructural development like cement.

MT: As has been mentioned, we're bottom-up, but from looking at natural resource

companies, it's pretty interesting to see any potential change that's taking place that will affect the larger economy. There have been a lot of exploration and gas discoveries in East Africa over the last five years. We've looked at those companies and then tried to figure out what related indirect investments might do well as a result of that. As the economy grows, how is it going to affect the consumer? What industries are going to grow as a result? Many of them are the ones that Gordon mentioned.

GM: There are many industries where we believe latent demand exists, but where products and services aren't reaching the population. For example, with retail, which is an industry that we like a lot, an estimated 90% of trade outside of South Africa in Africa occurs in informal settings. Purchases of basic food, for example, don't generally occur in an organized grocery store. Oftentimes these situations have evolved in other parts of the world and by studying historical trends, we inform our view of what might occur in Africa in the future.

G&D: How do you think about investing from a top down perspective? Are there countries that hold a greater appeal for you now that you may want to consider investing in? And, conversely, are there other countries that you want to avoid given macro factors and geopolitical stability?

PT: We unanimously agree on what companies we sell and what companies we buy, but I don't know if we'd all unanimously agree on a macroeco-

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nomic profile of each country. One of the biggest risks in our portfolio is currency risk, and we often debate and make decisions on the currencies in Africa. For example, Ghana has been the worst performing market in Africa this year from a US dollar perspective, mainly due to currency depreciation.

We followed Ghana closely and have a lot of friends there. We have a lot of first-hand information, not inside information, but information on how the Ghanaian government makes decisions. We had a large concern regarding the currency and were lucky and smart enough to exit our investments in Ghana before the cedi started to unravel. On the other hand, we started to build positions in Tunisia and Egypt quite soon. Personally, I'm very worried about South Africa's political and macro environment. However, there's a big enough investment universe that I don't think that a top down approach in South Africa is worth very much for us.

G&D: Can you speak to the process of managing currency risk? Do you take a view based on a macro assessment, or do you take a different approach?

PT: It's very hard to hedge our currency risk. We try to have diversification in the portfolio with different currencies represented and manage our level of cash, but we don't do any currency hedges.

GM: Generally speaking, when we are looking to make an investment, we consider the expected return on an investment in its local currency. Then we'll also have a view of

what we think the long-term drag from that currency will be. Ultimately, our consideration of currency risk manifests itself in the rate of return that we are requiring on investments that derive their income in a given currency or currencies. For example, we might make an investment in Botswana where we are expecting an 18% Botswana pula return

“Finding ways to use management’s time efficiently, asking the right questions and winning their confidence is part of what we have to do.”

over seven years, but we might require a 27% return for investments in companies that earn Ghanaian credits. As Paul mentioned, we also limit our overall exposure to various fiscal and political regimes depending on our views.

G&D: You alluded to the fact that you have close relationships with the management teams of many of the companies you invest in. When analyzing a business, how close do you typically need to get with the management team and understanding their strategy before you actually invest?

PT: Well, we try to meet and know every management team,

but as far as the ones that we're close enough to that we'd have regular dialogue with and would have come make presentations in the US, say at Columbia Business School, that would probably be around half of them.

GM: It's a requirement that we understand their motivations, incentives and general ethos, but it's not necessarily a requirement that we have an extremely special relationship with them.

PT: A couple of things that are different about publically traded marketable securities investing in Africa is access to people, because they must feel somewhat like purchasing agents that are besieged with neophytes who are coming in who want to talk to the company. Somebody sends in a junior guy to see whether they ought to have a fund in Africa and he calls the CEO and thinks he's going to be treated like royalty. Well, these are very sophisticated people running key organizations in their countries, so they don't have time to meet with everybody else. Finding ways to use their time efficiently, asking the right questions and winning their confidence is part of what we have to do.

The other thing is that sourcing stock is not so easy, because there's not much liquidity in many of the markets. It's nothing like calling a broker and placing an order with a limit. It's often necessary to get some help. Some of these companies have chief executive officers who have had a meaningful personal family stake in their businesses for a long

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Mario Gabelli '67 at the 2014 Omaha Dinner.

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time. They might know that one of the family members who's ill or wants to sell his stock, or some institution that backed him five years ago, who now has made 10 times his money, might want to sell. They can help you source stock, or brokers can because they want to work with you, or know that you're for real if you indicate an interest.

G&D: How have you thought about potentially having an office in Africa? There are obviously pros and cons. Could you explain how you decided to be in New York?

PT: We've thought about it a million times. Currently we rely heavily on a network of relationships in each of the important countries, in places where if we want to use a friend's office we can, and reciprocally when they come here, we'll help them. With the relationships these guys have with all of the business and investment community there, I think we might even be at an advantage. It's the sort of thing that Warren Buffett talks about by being in Omaha and having a better perspective than being in New York. We're not as much in the rumor mill perhaps.

MM: After spending nearly five years as an expatriate in Asia and Africa, I appreciate the extremities of the highs and lows when living in the developing world. When battling the daily logistical and infrastructure challenges, it is sometimes difficult to keep perspective and detect the incremental improvement. New York also attracts more private and public sector leaders than most African capitals, especially dur-

ing the UN General Assembly.

GM: We don't think it would be an advantage to have an office in Kenya and be investing in Nigeria. It would be very

"It was a tactical choice for us to have all key decision makers sitting next to each other. What we face is a constant stream of complex decisions that need to be made with limited emotion."

difficult to fund and manage a local presence in all of the different countries we're investing in right now. It was a tactical choice for us to have all key decision makers sitting next to each other. What we face is a constant stream of complex decisions that need to be made with limited emotion. There are always complicated situations that we need to get our heads around, so it's really important that we sit next to each other and debate solutions and decisions.

G&D: Management is clearly important to you for investing. How often do you meet with management over time? Is this a process that will take you six

months or more to get comfortable with a particular team, no matter how good the business fundamentals are?

PT: It can be. I would say that different types of companies require attention to different areas of management. Some companies require attention to mid-level and front line management. For example we were interested in a company in Kenya, Equity Bank, which is run by a guy named James Mwangi. We have known James for a long time. The question is not whether James is a smart guy. Helios Investment Partners owns 25% of the company. In this instance, the relevant question is also not whether the Helios team is a great team or that the directors that they have on the bank are great. Equity Bank has grown into an extremely large and fast growing company. The relevant question for us with regard to management is how deep the team is, and how deep the bench is where some of the riskier day to day parts of the business are being run. That can take a while to analyze and then the question is valuation, right?

Then there are some other companies for which it takes us a while to get to know key individuals. For example, there is a retail company in Botswana that is more of an up-and-coming, more entrepreneurial company. We have all visited the company several times. The head of the company has visited us here in New York. He is coming back again soon. We also want to know our other partners that are invested in the business including in this case the private equity

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firm that is invested in the company. That can take quite a long time.

Then there are some businesses, not many, that aren't as management-sensitive. They are relatively easy to understand and might be a listed affiliate of a foreign company, such as Nestle Nigeria. You are pretty sure that the financials are clean, the management is at least competent and they might have licenses from the parent company.

MT: In fact, for subsidiaries of multinationals it is quite common for there to be a rotational program. You will get to know a CEO, but he or she may leave in a year or two. You can check the backgrounds on them, but they are usually at a certain level, which you could feel more comfortable with maybe faster.

GM: Management talent is scarce in Africa and exceptional management teams can do extraordinary things and create a lot of value. Investing the time to get to know them yields large dividends.

G&D: What is the valuation criteria that you focus on? What would be an interesting investment from a valuation standpoint? Is there a minimum hurdle that you view as appropriate for the fund structure that you have?

MT: Gordon touched upon the expected returns from a local currency perspective, which of course vary depending on where we are. But the fund is in USD. From a US dollar perspective, we're looking for high rates of return given the riskiness of different

markets that we're in.

GM: We try to use as many tools as possible when considering valuation. We look at the fair value of a company based on forecasted models. We also look at historical ratios, peer analysis and the multiples that the company is trading on. Generally, when we invest, a five-to-seven year expected IRR is a critical point of discussion.

“Exceptional management teams in Africa can do extraordinary things and create a lot of value. Investing the time to get to know them yields large dividends.”

If you look back and say, "What's been the average expected rate of return in your base case for all the investments that you've made?" The answer would be between 20% to 30% in local currencies. Selling tends to be much more difficult. We don't simply sell if the expected IRR goes below mid-20s for example.

Generally, the heated discussions around selling a position from a valuation standpoint have occurred when expected

IRRs drop below 10% in local currencies. Of course whenever we find something that we really love, we start kicking out the lower return ideas – it's a constant competition of ideas.

Aside from simply valuation, one of the things that we really look for are businesses that are efficient with their capital. We are interested in determining, at the unit economic level, what kind of return on its capital a company can earn. We are probably more interested in this than things like multiples, in many cases.

A big difference between companies in Africa and those in most other parts of the world is that debt costs are still extremely high for most of these companies. They really can't finance growth projects with debt. For example, health care companies in Nigeria are paying around 20% interest on their debt. That's an enormous burden on any company and it's a death sentence for capital intensive or inefficient companies.

G&D: Can you speak about a recent success and take us through your process?

GM: Sure. There's a listed company in Nigeria called Stanbic IBTC. It's a listed affiliate of Standard Bank, which is a South African company. It's really a financial services company with three lines of business. It makes loans to individuals and small enterprises and provides financial related services to those groups of customers, it has an investment bank which serves large companies, and it has the dominant asset management franchise in

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Louisa Serene Schneider '06 and Tracy Britt Cool at the 2014 Omaha Dinner.

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Nigeria, which is the real reason we love the company.

In 2004, there was a major pension industry reform. Since that time, pension assets in Nigeria have grown at about 30% a year, every year, and we don't see asset growth ending for a long period of time.

When compared to other banks in Nigeria, Stanbic looks relatively expensive on a price to book multiple, but the asset management business generates more than a 50% ROE. It's not appropriate to apply bank book multiples to an asset management business.

Additionally Stanbic's been investing heavily in people to grow its two banking divisions. We view these investments as a form of capex in people and infrastructure as the bank grows. But the expenditures flow through the company's income statement and have dragged the profitability of those divisions as they are growing.

The historical result has been that analysts see a sub-20% ROE bank and a relatively high book multiple. We looked at it and saw a dominant, fast-growing, pension management business, with huge opportunities in other wealth management business lines. We also saw quite clearly that the company's ROE was subdued by investments it was making in future growth.

It's been a very good success for us as the fruits of the company's investments started to materialize and investors and analysts perceptions of the business have changed. It's one that we still like a lot. We still

think that people are underestimating the overall potential of the asset management industry in Nigeria. Even after 10 years of 30% AUM growth, pension assets only represent around 5% of GDP. By contrast, Kenya's are 18% of GDP, South Africa's are 67%, and in the United States pension as-

"We still think that people are underestimating the overall potential of the asset management industry in Nigeria. Even after 10 years of 30% AUM growth, pension assets only represent around 5% of GDP."

sets are over 100%. There's a lot of room to grow in the Nigerian asset management industry. It could easily be a \$150 to \$250 billion industry in terms of assets and today it's \$30 billion.

G&D: What are some other investment ideas that you could share with us?

MT: One investment, which we've alluded to in the conversation, is Choppies. It's a food retailer which is based in Botswana. It was started more than 20 years ago by an entre-

preneur. The current CEO moved from India to Botswana about 20 years ago, and one of his first assignments upon arriving was to audit this particular business.

At that time, Choppies only had one or two stores and was nearly insolvent. Despite this, the CEO saw a big opportunity in retail and decided to join the business. He has since grown the company into the leading supermarket chain in Botswana. The CEO is essentially a founder and he owns a large piece of the company.

We started tracking Choppies about three years ago when it IPO'd on the local Botswana exchange. It was raising capital to expand into the northern section of South Africa, which it has done successfully. It's interesting because there's obviously a very mature market in South Africa compared to other parts of Sub-Saharan Africa. The CEO thought he could compete in the rural markets of South Africa against the larger format stores of, say, ShopRite or Massmart, which he's successfully doing. Choppies typically has a smaller footprint store.

GM: The payback on a new Choppies store is typically one to three years with an ROIC of around 25% to 40% at the store level.

MT: So it's pretty attractive. He should be breaking even in South Africa soon. Botswana's quite profitable and he's also expanded into Zimbabwe. Those countries are all in the same region and an important part of any food retailer is the distribution network, which he

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spent 15 to 20 years building up. A lot of goods come in from southern South Africa and feed right into his depots in northern South Africa that service the entire region, so he can still expand further into Zimbabwe as well as other surrounding areas of southern Africa.

GM: It also has a relatively small base of stores, so it should be easier to grow from a 100 stores to 1,000 stores than it would if you had 1,000 stores growing to 10,000. One of the reasons that the ROIC at the store level is so high is that he does not really have a credit card infrastructure, so his customers pay cash and he gets supplier terms. The stores are actually working capital positive to him. The growth essentially finances itself after a time. We really like that.

G&D: Are there other competitors that have come close to Choppies in Botswana?

GM: There is definitely competition in Botswana. There's another local company called Sefalana, and South African retailers are also active in Botswana and other parts of southern Africa. South African retailers are much larger than Choppies and have tended to focus on putting up big box stores.

MT: One challenge for these bigger retailers in South Africa to expand to the rest of Africa is basically finding enough retail space, because there's not that much commercially developed real estate.

GM: Development of new space is not trivial either. Some malls in Nigeria have

taken more than seven years to build.

MT: We like the smaller footprint model that can go up almost anywhere, and he has various price points that serve different customers. We think that it's the right model to

“At that time, Choppies only had one or two stores and was nearly insolvent. Despite this, the CEO saw a big opportunity in retail and decided to join the business. He has since grown the company into the leading supermarket chain in Botswana.”

expand across Africa, certainly southern Africa and potentially beyond.

G&D: What's helped penetrate this food supermarket or retailing, generally speaking? You mentioned that lots of markets are very informal. What is the penetration of organized food retailers in the total market?

GM: Across the continent, it's close to 10%. In Botswana and

South Africa, it's significantly higher because there's been more development of formal retail. South Africa is closer to 60% formal.

MM: This story is also not unique to retail. With increased urbanization and growth in the middle income segment, we are seeing similar trajectories in ICT adoption, banking penetration, and consumption of many consumer goods. Since 2000, African mobile phone penetration has gone from less than 2% to more than 80%. The growth rates in other areas have not been as profound as that found in the telecommunications sector, but we know where the trends are heading. We just need to find the brands, distribution networks and most importantly management teams that are best positioned to leverage these opportunities.

G&D: For our readers that might be interested in becoming investors in frontier markets, what sort of advice would you give them?

MT: Well, investing in Africa is difficult. It's amazing we got to where we are in creating this fund. We looked at every possible entry point and there's a limited sphere of public equity funds, which are hard to access as an individual, and then there's really only a handful of ETFs.

GM: If you are looking to start a career investing in Africa, there are probably more funds from South Africa that are looking for investment talent. Generally Africa and frontier funds are unlikely to come to

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Wally Weitz at the 2014 Omaha Dinner.

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campus, but that's where I'd be writing letters and making calls.

MM: Do your homework and be proactive. I was a bit naïve when I started my search for Africa funds. I remember being initially amazed that there were South African firms like Allan Gray with \$40 billion of AUM. As capital markets and pension systems mature across Africa, you will find more large, indigenous funds in Nigeria, Egypt, Kenya and other markets. Have a local stock pick, preferably a write-up. It can set you apart from other applicants.

MT: There is definitely a lack of high quality talent across the continent from corporates to investment firms, so certainly people who are willing to go live there or travel extensively there could be successful.

GM: It's a strange dynamic because it's a small universe so there are a relatively limited number of spots that come up, but I guess there's also fewer people looking. On the other hand, there's also an extremely limited set of very experienced people, so I think it's a path worth pursuing, though I'm obviously biased. I guess we have to hustle a little bit, but it's worth it.

G&D: Thank you very much to all of you for taking the time.

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Graham & Doddsville Editors 2014-2015



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