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# Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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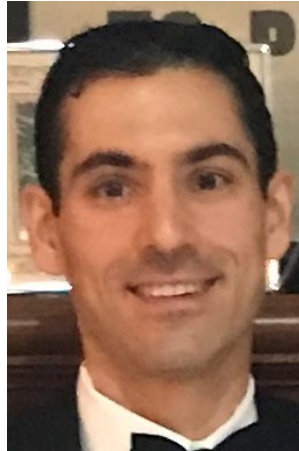
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**CSIMA** COLUMBIA STUDENT  
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## Alex Captain Cat Rock Capital



**Alex Captain**

Alex Captain is the Founder and Managing Partner at Cat Rock Capital Management LP, an investment firm based in Greenwich, Connecticut. Cat Rock makes concentrated, long-term investments in public and private companies across a range of industries, including software, internet, telecommunications, aerospace, business services, and infrastructure. Cat Rock seeks to establish long-term partnerships with high-quality, well-aligned management teams as a core element of its strategy.

Prior to founding Cat Rock in 2015, Alex had been a Partner at Tiger Global Management for six years, where he sourced and led investments in industrials, telecommunications, media, and technology globally. Before joining Tiger Global, Alex had worked in private

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## Mountaineer Partners



### Mark Lee, John Hallowell, and Greg Williams

Mark Lee is the Founder and Portfolio Manager for Mountaineer Partners Management, LLC, an opportunistic value and event hedge fund launched in 2012. Prior to founding Mountaineer, Mark worked at Contrarian Capital Management, a multi-billion dollar hedge fund firm, from 1999 to 2011. He joined Contrarian as a distressed debt analyst, and then in 2003 founded and was the sole Portfolio Manager for the Contrarian Long Short Fund for eight years until he departed to launch Mountaineer in January 2011. In late 2008, Mark also assumed management of the Contrarian Distressed Equity Fund, which he managed until his departure in January 2011. Both Contrarian Long Short and Contrarian Distressed Equity utilized a similar analytical framework to Mountaineer Partners. Prior to Contrarian, Mark worked as an Associate at Blavin & Co., a concentrated, long-biased value fund, and as an Associate at Centre Partners, a Lazard-affiliated private equity firm. Mark began his career in finance in 1992 as an investment banker at Credit Suisse First Boston. Mark received an MBA from Harvard Business School and an AB, Magna

## Welcome to Graham & Doddsville



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



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

We are pleased to bring you the 39th 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). Since our Winter 2020 issue, the Heilbrunn Center hosted the 23rd Annual CSIMA Conference and the Artisan International Value Stock Pitch Challenge.

We first interviewed **Alex Captain**, Founder and Managing partner of Cat Rock Capital. Mr. Captain discussed at length his private equity-like approach to public market investing, which evolved from the beginning of his career at Blackstone Group to time spent at Tiger Global before launching Cat Rock. Mr. Captain provided us with a view of how to think about high quality, durable businesses that can compound capital over long periods of time in a concentrated portfolio.

We also sat down with **Mark Lee, John Hallowell, and Greg Williams** of Mountaineer Partners Management. Mark, the

Founder, discussed his background in distressed investing at Contrarian Capital that led to his investment framework centered on downside protection across the capital structure. Mark, John, and Greg also shared two current ideas as well as how they traded and thought about picking stocks amid the pandemic turmoil.

We continue to bring you stock pitches from current CBS students. In this issue, we feature three of the finalist pitches from the 2020 Pershing Square Challenge: Kyle Campbell '21, Shaunak Misra '21 and Michael Weng '21 share their long idea on Sysco Corporation (NYSE: SYY), Ruth Chen '21, Yi Cheng '21 and Mark Hu '21 present their long thesis on Verisk Analytics (NASDAQ: VRSK), and Manas Bajaj '21, Akshay Chawla '21 and Amitabh Sahai '21 recommend buy on EPAM Systems (NYSE: EPAM).

Lastly, you can find more interviews on the *Value Investing with Legends* podcast, hosted by Professor Tano Santos. Professor Santos took advantage of the stay-at-home orders to conduct five exceptional inter-

views since March, with guests including C.T. Fitzpatrick, Michael Mauboussin, Dan Davidowitz & Jeff Mueller '13 from Polen Capital, Francisco Garcia Parames, and David Samra '93.

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

**G&Dsville Editors**



**Professor Tano Santos and Meredith Trivedi at the Artisan International Value Stock Pitch Challenge**



**Panelists judge student pitches at the Artisan International Value Stock Pitch Challenge**

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## 23rd Annual CSIMA Conference—February 2020



**Best Ideas Panel. From left: Clifford Sosin, Brian Gootzeit, Alex Captain, Angela Aldrich and Guy Adami**



**Robert Shafir '84 delivers morning keynote speech**



**Matthew McLennan provides expert insight**



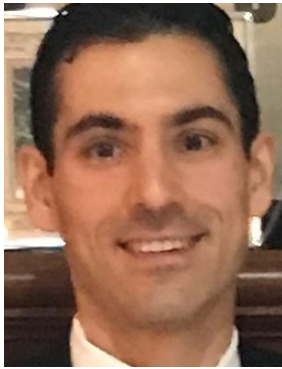
**William von Mueffling '95 (right) speaks with  
Eric Almeraz '02**



**Professor Michael Mauboussin (right) speaks with  
Anup Srivastava**



## Alex Captain, Cat Rock Capital



**Alex Captain**  
Cat Rock Capital

**equity at The Blackstone Group in the firm's New York office.**

**Alex graduated *summa cum laude* from Harvard College with an A.B. in Economics and from the Harvard Graduate School of Arts and Sciences with an A.M. in Statistics. He is a John Harvard scholar and a member of Phi Beta Kappa.**

**Editor's Note: This interview took place on March 24th, 2020.**

**Graham & Doddsville (G&D):** To get started, can you walk us through how you got interested in investing in the first place and decided to pursue it as a career?

**Alex Captain (AC):** I grew up in the San Francisco Bay Area, near Silicon Valley. My dad worked in the tech industry in R&D, and my mom stayed home and raised us. My dad got stock options through his job, my mom learned about them, and she got interested in investing herself. She would watch Nightly Business Report and CNBC through the day and would trade various stocks, so this was always something that was going on in our household ever since I can remember. When I was 10 years old, my mom gave me a copy of William O'Neil's *How to Make Money in Stocks*. I started using his CAN SLIM formula to pick stocks at around that age. I remember buying shares in American Woodmark, a cabinet maker, and Hot Topic, a gothic clothing retailer, which both screened well on the CAN SLIM criteria with a small part

of my parents' savings. Mom later got me copies of Peter Lynch's *One Up on Wall Street* and Robert Hagstrom's *The Warren Buffett Way*, which continued to kindle my interest in investing. I was fascinated by all the detail I could collect on companies by pulling their 10-Ks from Yahoo Finance – I could see where they had warehouses, how many employees they had, what raw materials they needed to buy, the structure of their contracts with customers, and all kinds of other details about their operations. It might have been dry material for most kids, but my parents would generally have us pulling weeds in the backyard if we weren't reading something productive, so reading 10-Ks sure beat the alternative!

I also started several minor businesses in high school, including a newspaper, a car-washing business, and a weed-control business. I pulled books from my local library to learn how to design good marketing material and read Karrass's books on negotiation. I loved the idea of starting a company and learning about how to manage all the details required to make it work.

When I was applying to colleges, I went to the websites of some of the biggest US corporations and looked at where the CEOs had gone to school and what they had studied. While Harvard Business School did well by that standard, there was no clear conclusion for undergrad, and so I figured that getting an Economics degree at Harvard would be a good way to start. I

spent every summer at school getting as much business experience as possible, working in the sales department of a medical equipment manufacturer, working in retail at the Boston Consulting Group, and ultimately interning with the Blackstone Group in Private Equity. I graduated in 2006 with a Bachelor's degree in Economics, and I had also gotten a Master's degree in Statistics during my four years at Harvard.

***"I was fascinated by all the detail I could collect on companies by pulling their 10-Ks...my parents would generally have us pulling weeds in the backyard if we weren't reading something productive, so reading 10-Ks sure beat the alternative!"***

I think statistical thinking is valuable for an investor because investing requires us to navigate uncertainty. As an investor, I look for companies whose earnings have fewer 'degrees of freedom' (variables that matter) and a lower 'standard deviation' of outcomes for those variables that drive earnings.

However, studying Economics and Statistics does not make you a good investor. Both

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## Alex Captain, Cat Rock Capital

fields attempt to simplify complex systems and quantify them. If you believe the predictions produced by these imperfect methods, you can get yourself into a lot of trouble in investing.

**G&D:** Were you actively trading in your PA throughout college? And would you say that, given your background, you lean more towards the quantitative mathematical approach to investing, or were you always able to marry the quantitative and qualitative elements?

**AC:** I didn't have much money in college, so no! My passion has always been running and owning businesses. Investing is fulfilling because it involves the ownership of businesses. In college, I started an e-commerce company called Ezaria that imported crafts from emerging markets like Honduras, Egypt, India, Kenya, and a variety of other countries. I hired other Harvard students to source these goods from their home-countries. It was one of the two big internet companies at that time at Harvard – the other was Facebook, which was started by a classmate in my year. I think we had about the same amount of funding, but alas the ROI turned out to be much better for Mark! Ezaria was one of the first advertisers on Facebook, and it had great demographic targeting for us because the user base was almost all at Harvard at that point.

You learn an enormous amount about business and investing by trying to start a business. At Ezaria, we hired about 10 people to work on

the project and paid them in equity. Managing the compensation and review process became such a burden that it interfered with running the business. That experience informed the way that I built Cat Rock, and it also informs the way I evaluate other businesses as an investor.

***“You learn an enormous amount about business and investing by trying to start a business... That experience informed the way that I built Cat Rock, and it also informs the way I evaluate other businesses as an investor.”***

**G&D:** It seems like you grasped this concept of being a partial owner in a business when you're investing very early on. How did you decide to go to Blackstone after college? And then why you did you decide to transition away from private equity and back into public market investing?

**AC:** Private equity was a great place to start my career because it gave me a chance to see how businesses really operate while also honing my skills as an investor. I joined Blackstone in mid-2006 and spent three years there. I saw a private equity boom in the first two years and the

economic bust in my last year there. I worked on so many deals – Travelport, Dollar General, First Data, Bobcat, the Alltel divestitures from Verizon, the ConAgra trade group, and a variety of energy deals. I had a great experience at Blackstone and worked with incredibly smart and talented people, many of whom continue to be good friends today.

After finishing my analyst program at Blackstone, I joined Tiger Global and started investing in public markets. Several Blackstone Private Equity analysts had previously joined Tiger Global, and I was attracted by the fact that the fund had a small, young, entrepreneurial team with a great track-record. I knew that I would learn a lot and be able to do some pretty interesting work early on, and that's exactly what happened.

**G&D:** Did you focus on a particular industry at Tiger Global?

**AC:** Everyone was technically a generalist, but I did spend more time in certain sectors like industrials, cable, telecom, and alternative energy. But I also worked on investments completely outside of those sectors, like Saudi dairy producer Almarai and Domino's Pizza.

**G&D:** Do you think the generalist approach is better than a specialist approach? How have you woven that into Cat Rock?

**AC:** There are clear benefits of the generalist approach. We can go after any one of 40,000 addressable equities, and we

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## Alex Captain, Cat Rock Capital

need to make sure that we've put the best 10 or 15 in our portfolio. There is no guarantee that the best 10 or 15 opportunities among those 40,000 are going to be concentrated in any given sector.

On the other hand, it is more difficult for a generalist to figure out where to focus his or her time, so a generalist needs to have a very clear set of criteria that helps focus time and research efforts on the most compelling opportunities. At Cat Rock, our investment criteria are very explicit: predictability, business, people and price.

By applying those four criteria, we can very quickly sift through potential investments and narrow the list of addressable opportunities to a manageable size. I think the combination of being a generalist and also having a very clear framework for what you're looking for allows you to focus your time and effort on the most attractive opportunities.

**G&D:** We definitely want to get into those four criteria a bit more in depth. But maybe first, can you walk us through your decision to launch Cat Rock?

**AC:** I have always been entrepreneurial, and I had always wanted to run my own firm. It's always been a dream, and it really was a question of when I was going to take action on it. I had learned a lot during the nine years I had spent collectively at Blackstone and Tiger Global, and I felt prepared to start Cat Rock at that point.

I also knew that the world did not need just another long-short equity fund. I wanted to do things differently and to do them better.

***“At Cat Rock, our investment criteria are very explicit: predictability, business, people and price.”***

First, a great firm will put itself in the shoes of the customer - I wanted to be totally aligned with my investors. I put more than 90% of my net worth in Cat Rock, and I continue to have more than 90% of my net worth in the fund five years later. I have no other investments.

Second, I wanted every decision at Cat Rock to be oriented around achieving the best returns with the lowest risk. This sounds easy, even tautological. But it's not. Raising money is difficult, and the process forces managers into making compromises that ultimately hobble investment performance. Managers are often trying to reduce the risks to their business by reducing their exposure in a drawdown, excessively diversifying their portfolios, crowding into investments owned by 'respected' investors, and investing in companies that are easy to justify to their limited partners. These tactics often make sense for the fund manager's business but can severely detract from performance. Cat Rock would

be more 'marketable' if it had a bigger team, more shorts, more liquid share classes, more impressive offices, and more marketing material. Every one of these choices would have consequences for our focus and ultimately for our investment performance. We always try to prioritize performance over presentation.

Third, I think a great firm would have a clear, measurable goal. At Cat Rock, we want to beat the stock market by the highest margin possible net of fees over a 3-5 year period while taking minimal risk of permanent capital loss. We won't change the goal if we miss it. We drive accountability and focus at Cat Rock because we have this clear and measurable goal. We won't talk to you about our Sharpe Ratio after the fact if it happens to look good. The goal is clear at Cat Rock. This Cat Rock strategy determines our tactics as we invest. The typical long-short fund could spend more than 50% of its time and research effort on shorts, and this activity will generate no return over a 3-5 year period even if the manager is 'outperforming' the market by a mid-high single digit margin. We therefore do little shorting of equities at Cat Rock. The typical long-short-fund could spend 20-30% of its time and research efforts collecting 'proprietary data' designed to give it an 'edge' in the market. We think that this type of very short-term data has little predictive value for stock prices in the short-term, and almost no predictive value for stock prices over the long-term. I don't think you need a Master's degree in Statistics to

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see that, but it certainly doesn't hurt! Buffett did not build his track-record because he had access to special satellite data or credit card data that his competitors lacked.

**G&D:** It sounds like there's a time arbitrage component to that as well, where a lot of the proprietary data is focused on just predicting the quarter and not necessarily focused on what's going to happen in three years.

**AC:** You can't figure out what can happen three years out by using proprietary data that's on a monthly basis. If you need monthly proprietary data to tell you what's going on three years from now, you've picked a system that's probably not predictable over a longer time horizon.

**G&D:** You mentioned the four key things you look for: predictability, business, people, price. Can you walk us through those briefly?

**AC:** Absolutely.

*Predictability* means that the earnings of the company do not depend significantly on factors that we know we cannot predict, like the state of the macroeconomy, interest rates, foreign exchange rates, most regulatory outcomes, most technology change.

*Business* basically means that we're looking for good businesses, and good businesses have two criteria. Number one, they provide a good or service that is going to be needed for as far as the eye can see. And number two, they

have some special advantage in providing that good or service.

Then we're looking for good people. These are good operators, good capital allocators, and people of integrity. Finally, we're looking for a good price. We use a 10-year cash flow model to figure out whether a company's price is attractive. We realize that predicting anything over 10 years is very difficult, so we try to be conservative and focus on companies that meet our other three criteria – predictable, high-quality businesses run by good people.

When assessing prices, we draw a clear line between investment and speculation, and we seek to avoid speculation. Investors buy assets for their future cash flows. Speculators buy assets in hopes of selling them for better prices to others in the future. Many public market managers have speculative valuation processes because their price targets depend significantly on their exit multiple, which represents the manager's assessment of what other investors will be willing to pay for an earnings stream in the future. We use a 10-year model where the exit multiple has much less of an impact on our expected returns than the interim cash flow and the trajectory of earnings. We therefore have a more stable view of intrinsic value that is based on fundamental factors we can try to predict, like earnings, instead of speculative factors we cannot predict, like the exit multiple.

**G&D:** A lot of those elements

are very standard in private equity models where you're looking at highly mature companies that are growing at a very defined range, maybe it's 3-7% a year. Do you find any challenges implementing this approach to businesses that are growing much faster, which seems to be where you focus more?

***"If you need monthly proprietary data to tell you what's going on three years from now, you've picked a system that's probably not predictable over a longer time horizon."***

**AC:** Estimating future earnings is difficult for both fast-growing and slow-growing companies. We focus on the customer value proposition, the market size, and the competitive environment of a business to judge whether it is predictable or not – both fast-growing and slow-growing businesses may score favorably on these criteria. In fact, fast-growing companies may be growing because they offer a compelling customer value proposition in a large, under-penetrated market with limited competition.

We know we're not going to be able to predict exactly what the numbers are going to be over long periods of time. We can create ranges, but ultimately what we're looking for is a huge margin of safety

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## Alex Captain, Cat Rock Capital

that is based upon both the size of the addressable market as well as the gap between the value that the company is providing to its customers and the price that it is assessing for the good or the service.

**G&D:** How do you approach idea generation and sourcing given that you have a relatively lean team, and how do you ensure you're only allocating your time to the names that really have a chance to make it into the portfolio?

**AC:** Everyone at Cat Rock spends about 50% of their time sourcing. That's really for two reasons. Number one is we have to do the work of making sure that the 10 or 15 companies that we've invested in are the 10 or 15 best possible opportunities that are out there. And secondly, we think that it helps drive intellectual honesty. If we're constantly looking at opportunities, we can actually have more conviction in our own portfolio because we understand how that portfolio stacks up to the rest of the universe. We think that if you're running a concentrated portfolio like we do, 10 or 15 positions, it's possible to develop tunnel vision.

We source from scratch. What that means is that we have designed a Cat Rock one-pager that has a business description, the capitalization, the valuation, the management ownership, the 10-year total shareholder returns, the 10-year income statement, cashflow statement, balance sheet, how the company has allocated capital. This one-pager can be produced on any ticker. We'll go out and come

up with screens. We might look at every company that's growing revenue over 20% a year. We might look at every company that is trading at less than 10 times cashflow with no debt or every company that has more than 10% management ownership. Or,

*“... by the time an idea's being pitched by someone or it shows up on the 13F and so forth, often the opportunity is much less attractive than it had been when it was originally there, waiting to be discovered.”*

we might look at every company that has a 20%, 10-year total shareholder return.

These screens will give us hundreds, or thousands, of company one-pagers from all over the world. We'll go through those and we'll narrow it down to 50 where we want to read the annual report, read the transcripts, go through the analyst presentations on the company and figure out whether that company meets our four criteria. From those 50, we will narrow it down to 15 where we go out and talk with the management team and dig even deeper. From those 15, there might be seven that go into a deep private equity due diligence process that takes weeks or months to complete.

And then, of those seven, two might make it into the portfolio.

The beauty of this method is it doesn't rely on looking at the portfolios of other investors. It doesn't rely on pitches or Value Investors Club. It really doesn't rely on all these standard sourcing techniques that others in the industry are using that we think are inherently flawed. Because by the time an idea's being pitched by someone or it shows up on the 13F and so forth, often the opportunity is much less attractive than it had been when it was originally there, waiting to be discovered. We think that there's a lot of value to be added by sourcing from scratch. If you go back and read about Warren Buffett when he was running his Partnership, he would go through the Moody's manual that had 10,000 stocks and flip through it, page by page. This company one-page process that we have is our own Moody's manual of stocks that is customized to the factors that we find to be most relevant to determining whether we want to spend time on opportunity.

**G&D:** How do you approach holding periods and selling?

**AC:** Our 10-year model gives us an Internal Rate of Return, or IRR, and we will invest in a company that meets our criteria and yields an IRR of 15% or better. When a stock goes up, the IRR in our model goes down, all else equal. We will sell a position when the IRR becomes unacceptably low or our research suggests we made a mistake in assessing predictability, business, people, or price. We do not sell a

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## Alex Captain, Cat Rock Capital

stock just because its price rises, since its intrinsic value may have grown also, and the stock may have a cheaper valuation despite having a higher nominal price.

**G&D:** What is your view on the current market environment, given the massive dislocation in the markets over the past few weeks with coronavirus? *[Editor's note: this interview took place on March 24<sup>th</sup>.]*

**AC:** I think there are many things that are uncertain right now with respect to coronavirus and its effects. However, I think a few propositions are reasonably clear at this point. First, coronavirus has created panic in both financial markets and across society more broadly. Second, coronavirus and the associated behavioral changes will have a massive negative impact on the economy in the coming quarters. Finally, it is quite clear to us that two to three years from now, coronavirus is very unlikely to radically change the intrinsic value of the world's equities. If those three propositions are true, there can be some very exciting opportunities that are created by the coronavirus and the associated behavior changes that you're seeing right now. That is particularly the case for companies whose earnings are not as sensitive to the types of behavior changes that coronavirus will cause and not as sensitive to changes in the macroeconomy that will result from the coronavirus response. We think this is a very interesting and attractive environment for value investors looking for deals that look good on a 10-year

cashflow basis.

**G&D:** You mention that opportunities are perhaps better in companies not as susceptible to coronavirus impacts. One name that you've previously had in the portfolio is TransDigm, which you mentioned earlier and have seen its stock price get hit hard recently. What are your thoughts on them currently?

**"We think this is a very interesting and attractive environment for value investors looking for deals that look good on a 10-year cashflow basis."**

**AC:** We continue to own TransDigm and we've actually added significantly to our position here. TransDigm fits our criteria quite well. The company sells aerospace parts to aircraft manufacturers ('OEMs') for new production and to airlines and the military for the maintenance of their aircraft ('aftermarket'). TransDigm derives over 75% of its EBITDA from the aftermarket, which has traditionally been stable and correlated to air traffic. In addition, over 75% of the company's revenue is derived from parts for which it is the sole-source producer, which helps drive sustainably attractive economics as long as the company delivers high-quality parts on time.

TransDigm was founded over 25 years ago and has never had a full-year decline in EBITDA during that time, even through September 11<sup>th</sup> and the Global Financial Crisis. The company has significant pricing power, a highly variable cost structure, and one-third of its revenue in the acyclical defense business. Its management team, led by Chairman Nick Howley and CEO Kevin Stein, is world-class and incredibly experienced. TransDigm's parts are mission-critical and a very small part of its customers' cost structures, so the company earns revenue whenever planes are flying. Coronavirus has caused air traffic to decline precipitously this year, possibly as much as 80% in the near-term. TransDigm's stock has accordingly been punished severely, falling by more than 50% at points this year. Investors are no doubt spooked by leverage of six times trailing EBITDA, even though the company has no maintenance covenants and very strong liquidity. Our view is simple – the current air traffic numbers are abnormal and temporary, TransDigm has the capital structure to survive this environment, and the company is trading at a very attractive price on its earnings in a more normal air traffic environment.

Specifically, TransDigm has over \$3.4 billion of cash on its balance sheet, or almost 20% of its market capitalization, and a \$760 million revolver, with no maintenance covenants and no covenants at all on a third of their revolver. TransDigm also has strong cash conversion, with almost 50% of EBITDA flowing through to

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## Alex Captain, Cat Rock Capital

cash flow even after taxes. Capex is low and working capital is minimal. With no debt maturities until 2024, the company has a really good capitalization to go through a temporary economic shock or a shock to air travel. Over time, we think people will return to flying and air travel. If that is the case, then TransDigm is incredibly attractively priced right now, trading at just 11x our normalized free cash flow estimate over the next twelve months. We think TransDigm grows intrinsic value 20-30% per year through volumes, pricing, margin expansion, and capital allocation.

***“Panic, fear, and market psychology all play an important role in driving stocks during periods like this one. Markets become less efficient because investors are not behaving like rational calculators of long-term intrinsic value.”***

Insiders on the board have bought about \$230 million of stock at about \$450 per share. That happened a couple of weeks ago, and the stock is currently trading at about \$330 per share. Notwithstanding that, the IRRs are more attractive now than they ever have been if you assume coronavirus is not going to be

a permanent inhibitor to air travel, which we don't think it will be.

**G&D:** When you see such a high-quality business like TransDigm selling off over 50% in a few weeks, what do you attribute that to?

**AC:** Panic, fear, and market psychology all play an important role in driving stocks during periods like this one. Markets become less efficient because investors are not behaving like rational calculators of long-term intrinsic value. Managers panic and ‘de-gross’ to avoid larger losses. They sell entire sectors (like aerospace) or factors (like leverage). They make assumptions about how other managers will react to the news and try to react more quickly than their peers. A large stock price decline itself can scare investors into exaggerating the severity of a company's problems. It may be perfectly rational for investors to sell stocks whose earnings prospects have deteriorated significantly because of a macroeconomic shock like coronavirus. We need to remain rational and intellectually honest to decide whether to buy, hold, or sell after a stock price decline.

We certainly will sell a stock at a loss if we discover that we have made a mistake. In 2015, we bought a meaningful position in the global cable operator Altice at €27 per share, discovered that there were issues in both our modeling and our research, and sold it a few months later at around €17 per share. The stock ultimately fell to €6 per share over the next two years,

underscoring the importance of maintaining our intellectual honesty and ignoring price history.

On the other hand, we significantly increased our position in TransDigm in early 2017 when short sellers attacked the company and claimed that it was the ‘Valeant Pharmaceuticals of Aerospace’ because of its alleged price-gouging on parts sales to the government. We suspected the short sellers were wrong because TransDigm's defense business had been roughly flat over the preceding few years, consistent with the rest of the industry – these results were not consistent with triple-digit price increases. Nevertheless, we hired an aerospace consulting firm to analyze all the roughly 200,000 contracts TransDigm had signed with the government over the past seventeen years to figure out how much prices were actually rising each year. The results showed that TransDigm's mid-high single digit price increases were consistent with those of peers. We increased our position further and shared the results of this research with the short-sellers, the company, its top shareholders, the Defense Logistics Agency, the Office of Inspector General, and several members of Congress. Ultimately, the short interest fell significantly and TransDigm's stock made a strong recovery.

**G&D:** That's a great example of your differentiated research process and investment philosophy coming to fruition. Could you walk us through a current high-conviction idea you have in the portfolio?

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## Alex Captain, Cat Rock Capital

**AC:** Sure – let’s walk through JustEatTakeaway.com (or “JET”), which is our largest position. JET is an online platform that consumers can use to order food for delivery from restaurants. The food can either be delivered by the restaurant or by JET. JET earns revenue by charging restaurants a commission ranging from 10-30% and a delivery fee to the consumer when JET delivers an order. JET owns online food delivery businesses in 23 countries around the world with an addressable population of 450 million people. JET is the clear market leader in countries representing over 90% of its revenue, including the UK, Germany, Netherlands, Canada, Spain, Italy, Ireland, Poland, Israel, and Brazil. At about €63 per share, JET has an enterprise value of about €9.5 billion, and we expect the company to generate about €2 billion of revenue in 2020. Our thesis is simple – JET is a high-quality business with massive growth potential and excellent management trading at an attractive valuation.

Let’s start with growth. Global online food delivery penetration is low-single digits, which provides tremendous headroom for growth. JET grew revenue about 40% organically in 2018 and about 30% organically in 2019. We think that the company will continue to grow for a long time. Revenue is calculated by multiplying population by penetration by order frequency by average order value by average commissions. Penetration, order frequency, and average commissions can increase substantially over

time. Penetration is about 13% across JET’s markets, when the Netherlands, UK, and China are at 25-30% already. Order frequency is about once per month, compared to 30 dinners and 90 total meals. Order frequency has already reached 2-5x per month in markets around the world, including China, Kuwait, Korea, and New York. Commissions are currently at 17% but can go as high as 30%, with restaurants earning more than 40% gross margins on the food they sell through these platforms. JET revenue would increase 8-fold if penetration reaches 25%, order frequency increases to 2.5x per month, and commissions rise to 25%. All these metrics have already been achieved in other markets around the world, and they continue to increase. We think JET is a high-quality business with strong network effects, highly recurring revenue, pricing power, strong unit economics, and proven profitability. JET is the clear market leader in markets representing over 90% of its

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revenue, generally with market share that is 3-20x the size of its next largest competitor. JET benefits from network effects in these markets, where consumers want to join the platform with the greatest selection of restaurants, and restaurants want to join the platform that offers the greatest amount of order volume. High relative market share also drives marketing efficiencies that are difficult to overcome by smaller players. Eating is a recurring activity, and customers stick to the platform because they are familiar with the offering, it has stored their old orders, and it has stored their payment information. JET also has pricing power because of the significant value they deliver for restaurants – restaurants earn over 40% gross margins on orders, while paying an average commission of 17%. There has been little or no historical sensitivity to commission changes. Finally, JET has great unit economics. About two-thirds of revenue comes from the marketplace business where restaurants do their own delivery, and gross margins in this business are 90%. R&D and sales and marketing costs are minimal if you are not investing in growth. The online food delivery business has already proven its profitability in markets around the world, with the UK, Netherlands, Sweden, Finland, and Turkey all achieving EBITDA margins of over 50% in the last few years.

Management is excellent and highly aligned with shareholders. CEO Jitse Groen started the company in his basement about 20 years ago and continues to own 11% of

(Continued on page 12)

## Alex Captain, Cat Rock Capital

the company. The rest of the management team is very capable and highly experienced, in many cases having started online food delivery businesses of their own. The company has proven itself to be one of the best online food delivery operators in the world over the past two decades, and Jitse's clever capital allocation has allowed him to build a billion-dollar fortune already. Jitse is in his early-40s – we think he is just getting started.

Finally, we think JET has a highly attractive valuation. JET trades at only 16x our estimate of maintenance free cash flow over the next twelve months with a revenue growth rate of 25-30% and significant additional runway for growth. We think our 35% maintenance operating margin assumption is conservative – recall that several important markets already have meaningfully higher margins despite their growth investments. In addition, JET owns a one-third stake in Brazil's largest online food delivery operator that is not captured in its financials. This stake could be worth over 10% of JET's market cap and has a clear buyer in Prosus, which is the majority owner of the Brazilian business.

**G&D:** Many investors in the US are probably wary of this space given the competitive struggles and issues that companies like GrubHub have faced. What distinguishes the competitive dynamics in European markets from what we've seen here in the US?

**AC:** The US online food delivery market has been a

competitive bloodbath, but we think JET's markets in Europe are structurally different. We think the situation is comparable to that of Orbitz and Booking.com – both companies were online travel agencies, but they had very different business mix and market structures, which translated to radically different outcomes for shareholders. There are three critical differences between JET's markets and the US online food delivery market.

First, the US online food delivery market has three relatively equal players: DoorDash, Uber, and GrubHub. None of these players benefit from the network effects associated

***“When JET spends on sales and marketing, they're not spending it to re-acquire a customer. They're spending it to add new customers and thereby grow the business efficiently.”***

with this business. By contrast, JET is 3-50x the size of its next largest competitor in markets representing about 90% of total revenue, so the network and scale effects are significant.

Second, the US market has a disproportionate number of restaurant chains and QSRs, which have much more

negotiating power with the online platforms and drive less attractive economics.

Finally, the US market has a lower share of restaurants that provide their own delivery, which means that the platforms must compete to win consumers on the delivery fees instead of selection. The unit economics of hiring drivers and delivering food are tough, and European markets are more attractive because a much higher share of restaurants provide their own delivery.

JET competes primarily against UberEats and Deliveroo in its core European markets. JET offers greater selection and lower average delivery fees than its competitors in these markets, and yet it earns a profit while its competitors endure significant losses. JET is able to accomplish this feat because it has much greater relative market share and because so many restaurants in its markets offer their own delivery, driving attractive unit economics for JET. This situation is clearly very different than GrubHub's predicament in the US.

**G&D:** Given the fact that a lot of restaurants have their own delivery network and that JET has such high relative market share, they don't have to keep spending to re-acquire repeat customers. The incremental margins must be extraordinarily high here.

**AC:** That's exactly right. One of the things that we've thought about online food delivery is as the consumer downloads the app, they start making orders and they stick

(Continued on page 13)



## Alex Captain, Cat Rock Capital

to the platform that they've been using because their payment information is there, their historical orders are there for repeat orders. They know how to navigate the platform. They know that the platform is going to have the food that they're looking for. Therefore, the cohort retention rates in online food delivery in Europe are very high and attractive, with 80-90% cohort retention rates on an annual basis.

That means that when you spend sales and marketing, you're not spending it to re-acquire a customer. You're spending it to add new customers and thereby grow the business efficiently.

**G&D:** You mentioned that delivery today globally has low-single digit penetration. Do you have a view on what that could get to over time? And are there other cultural factors in Europe that are different from places like New York – is there a cultural cap to how much people will order food delivery as opposed to going out to restaurants and socializing?

**AC:** We think online food delivery is e-commerce for restaurants. The low-single digit current penetration can grow by many multiples as more people use the service and those who are using it do so more often. Consumers are increasingly getting acclimated to ordering goods online and having them delivered, and online food delivery from restaurants is clearly benefitting from this trend.

The coronavirus-induced shutdowns occurring globally

right now should increase awareness and usage for online food delivery, just as these shutdowns are benefitting other forms of e-commerce. Different countries have different 'food cultures' and levels of penetration of online food delivery, but the trajectory in all markets is the same and positive.

**G&D:** Are there any other new additions to the portfolio that you'd like to walk us through?

**AC:** Sure – we invested in a Swedish company called Evolution Gaming late last year and have continued to build our position this year. Evolution is the leading global provider of live gaming services to online gaming operators. The games include roulette, blackjack, baccarat, and a variety of other casino-style games. The company runs production studios with live dealers, hosts, and croupiers who can deliver a gaming experience that feels like a physical casino. Consumers like this format because it is more trustworthy, interactive, and familiar than playing an online game based on a computerized random number generator. Consumers do not pay more for this superior experience, so naturally live gaming has been rapidly taking share from computerized online gaming. Gaming operators pay Evolution a 10-15% share of their gaming revenues to offer Evolution's games. At about 310 Swedish Kronor per share, Evolution has an enterprise value of just over €5 billion with about €490 million of expected 2020 revenue and €250 million of expected 2020 EBITDA.

Evolution trades at about 27x 2020 expected consensus earnings with a net cash position, with revenue and EBITDA growth in 2019 of 49% and 70%, respectively.

Evolution derives 70% of its business from Europe and 30% of its business from other regions, which include North America, Latin America, and Asia. The European online gaming market was €107 billion last year, of which 25% was online. Casino games in Europe represent a €9 billion market, of which 24% is now live gaming. Live online gaming, which is Evolution's market, is therefore about €2 billion in the €107 billion European

***“When JET spends on sales and marketing, they're not spending it to re-acquire a customer. They're spending it to add new customers and thereby grow the business efficiently.”***

gaming market. Online gaming is taking share from offline gaming, live online gaming is taking share from computerized online gaming, and Evolution is gaining share within live online gaming. The markets in North America, Latin America, and Asia are less penetrated by Evolution and are growing even faster than the European markets.

(Continued on page 14)

## Alex Captain, Cat Rock Capital

Live gaming is difficult to execute. Evolution must deliver high-definition streams with low-latency and high reliability. It must hire thousands of employees and train them to provide an effective streamed casino experience in the studio format. Evolution has mastered the details of this process since it was founded in 2006, which has allowed it to consistently gain market share. Today, Evolution has over 50% market share in its core European market and continues to gain share. Competitors like NetEnt and Playtech have built their businesses on simple, computerized games and face an innovator's dilemma in shifting their customers over to live gaming. Moreover, live gaming economics depend significantly on scale, so entrants face a big barrier to success in the market. Evolution's Chairman Jens von Bahr is a co-founder and owns 15% of the company together with the other co-founder. CEO Martin Carlesund, and CFO Jacob Kaplan have served since 2016 and executed admirably during that time. We

***"Competitors like NetEnt and Playtech have built their businesses on simple, computerized games and face an innovator's dilemma in shifting their customers over to live gaming."***

think management is excellent and well-aligned. The track-record speaks for itself — Evolution has compounded equity value at 86% per year since its IPO in 2015, with earnings growing by a factor of seven.

We think the upside in the stock is clear and substantial. Evolution has been growing earnings between 30% - 80% per year over the past five years, and we think it can continue to grow earnings at a high rate given 2% penetration in the European gaming market and even lower penetration in Asia and the US. In the US specifically, online gaming is only currently offered in New Jersey and Pennsylvania. Evolution is operating in both states, but the market could grow by an order of magnitude in a short period of time if other states follow in their footsteps and legalize online casino games. Evolution trades at less than 30x earnings and has a net cash position, so we think the stock is trading at a very low multiple of its likely earnings a few years in the future.

**G&D:** Do you view the online gaming population and the people who go to the physical casino as the same – is there a lot of overlap between those two cohorts?

**AC:** There is definitely some overlap but it's actually pretty hard for us to tell for sure what portion of the Evolution user base is going to land-based casinos as well. In many cases throughout Europe, the people who are playing the online games don't have access to a land-based casino in their local area.

Online gaming is much more convenient than traveling to a casino, and the current coronavirus-lockdown is only accelerating the consumer tendency towards online gaming. Evolution is a clear beneficiary of this trend.

**G&D:** Shifting gears - what advice would you give students at Columbia Business School interested in pursuing a career in the investment management industry?

**AC:** Great question – I do have two pieces of advice that I think can be helpful.

First, approach your job as if you are an entrepreneur running a business, with your boss as your customer. Your business will grow if you can find ways to add more value to your customer than you demand as a price. Invest early in developing a reputation for quality and integrity, which is like building your brand as a business. When your customer complains, handle it like Costco would, and your business will grow.

Second, embrace the details of the craft. Details often make the difference between success and failure in investing. When someone says that a stock is cheap, are they using a levered or unlevered metric? What portion of capex are they assuming is growth-related? Are they using a normalized tax rate or a realized one? How are they treating finance leases in their free cash flow calculation? Are the company's supposedly non-recurring add-backs actually non-recurring? How are we treating the

(Continued on page 15)

## Alex Captain, Cat Rock Capital

convertible debt in the share count? These are some of the questions we need to answer just to figure out whether a valuation is attractive today based on reported numbers. The conclusion may be simple – the stock is cheap – but the process of arriving at a reliable answer to that simple question may require a lot of detailed work. Many investors will seek to avoid that detailed work, which creates opportunity.

I am an analyst first and foremost, and I love the analytical work of investing. Warren Buffett built his record by being a great analyst. Do not begrudge the detailed work of an analyst – to be truly successful, I think you need to genuinely enjoy reading the 10-Ks, poring through the financial statements in detail, and conducting the 50<sup>th</sup> customer call to learn more about a business.

***“Approach your job as if you are an entrepreneur running a business... Invest early in developing a reputation for quality and integrity, which is like building your brand.”***

**G&D:** Finally, how do you spend your time outside of work?

**AC:** I have five kids, all under

10, and I have a great time with them. I bring the older ones to the office with me on Saturdays and they do their homework or play online chess while I read up on stocks – we all have a blast! I'm also on the board of Greenwich Academy, which is a girls' school here in Greenwich. I try to work out every day and play squash whenever I can – I love the sport, the workout, and the competition.

**G&D:** Thank you so much Alex – really appreciate you taking the time to speak with us today.

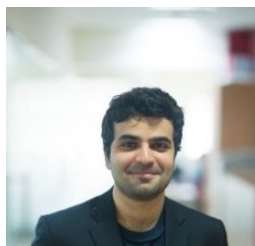
**AC:** Thank you – I have been a reader of your publication for a long time and have learned from it – keep up the good work!

## EPAM Systems (NYSE: EPAM) - Long 2020 Pershing Square Challenge - 1st Place

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**Manas Bajaj '21**

Manas is a 1st year MBA student at CBS. He started his career with Credit Suisse in their investment banking team covering consumer and TMT in Asia Pacific. He then worked at Samara Capital, a buyout and growth equity firm investing in consumer & retail, healthcare, IT & business services in India.



**Akshay Chawla '21**

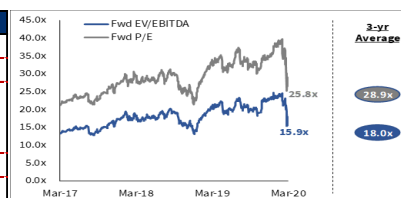
Akshay is a 1st year MBA student at CBS. He started his career with Deutsche Bank in their investment banking team covering Diversified Industrials sector. He then worked at Madison India Capital, a growth stage equity fund investing in technology, consumer and business services.



**Amitaabh Sahai '21**

Amitaabh is a 1st year MBA student at CBS. Prior to CBS, he worked at Baring Private Equity Asia covering buyouts in the global technology and business services sectors. Prior to Baring, he worked in investment banking at Greenhill & Co. in their M&A team in New York and London.

Capitalization Summary		Valuation Summary	
Share Price (\$)	192.3	Price / FY19A EPS	35.5x
Shares Outstanding	55.2	Price / FY20E EPS	38.3x
Market Cap (\$ Mn)	10,612.0	Price / COVID-19 Adj. FY20E EPS	29.8x
(+) Debt	25.1	EV / FY19A EBITDA	22.8x
(-) Cash & Equivalents	(936.6)	EV / FY20E EBITDA	25.4x
Enterprise Value	9,700.5	EV / COVID-19 Adj. FY20E EBITDA	19.2x



### Investment Thesis:

Recommendation to long EPAM Systems ("EPAM" or the "Company") with a 3-yr target price of \$430 (~24% IRR), led by (a) strong growth potential based on robust industry tailwinds and best-in-class service standards, (b) asset-light operating profile, and (c) attractive valuation versus historical levels and intrinsic value.

### Business Description:

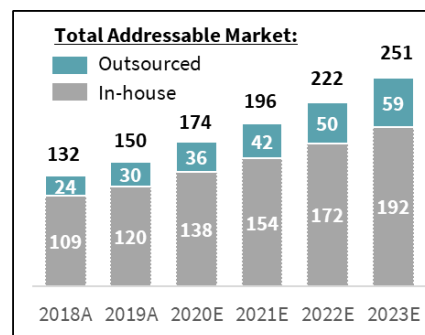
EPAM is a best-in-class digital software engineering company that works with clients in building their software capabilities and transforming their UI/UX (*user interface / experience*). Clients are primarily based in the US and Western Europe (90% of revenue), while employees are primarily based in offshore locations in Eastern Europe (>75% of all employees and India). Underpinned by strong demand for digital software engineering and 90%+ client retention, EPAM has seen rapid organic growth of ~25% CAGR from 2014 – 2019 and 36 consecutive quarters of 20%+ YoY growth, all while maintaining EBITDA margins between 17-19% and FCF/EBITDA conversion between 50-60%.

\$ Mn, FYE Dec 31	2014	2015	2016	2017	2018	2019	Sy CAGR
Revenue	730.0	914.1	1,160.1	1,450.4	1,842.9	2,293.8	25.7%
% YoY Growth	31.5%	25.2%	26.9%	25.0%	27.1%	24.5%	
Gross Profit	282.1	360.9	439.6	550.0	683.2	843.2	24.5%
% Margin	38.6%	39.5%	37.9%	37.9%	37.1%	36.8%	
Adjusted EBITDA	135.3	170.7	207.0	255.7	343.6	424.6	25.7%
% Margin	18.5%	18.7%	17.8%	17.6%	18.6%	18.5%	
(-) Stock Compensation	(24.6)	(45.8)	(49.2)	(52.4)	(59.2)	(72.0)	
(-) One-Time Expenses	(7.0)	(1.5)	(0.7)	(1.7)	(2.1)	(4.4)	
(-) D&A Expenses	(17.5)	(17.4)	(23.4)	(28.6)	(36.6)	(45.3)	
Reported EBIT	86.2	106.0	133.7	172.9	245.8	302.9	28.6%
% Margin	11.8%	11.6%	11.5%	11.9%	13.3%	13.2%	
Reported EPS - Diluted	1.40	1.62	1.87	1.32	4.24	4.53	26.5%
Adjusted EPS - Diluted	2.01	2.47	2.90	3.46	4.38	5.42	21.9%
% YoY Growth	33.7%	22.9%	17.4%	19.3%	26.6%	23.7%	

### Key Investment Factors:

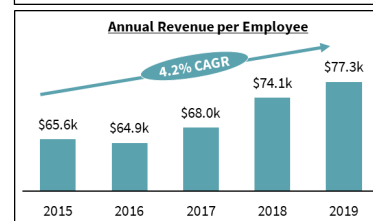
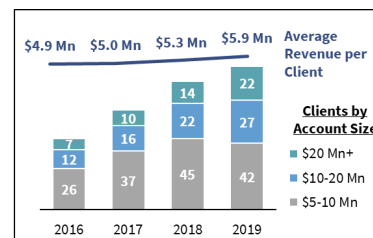
**Core addressable market sized at \$150 Bn and growing at 13% annually led by strong structural tailwinds**

- EPAM operates exclusively in the digital IT services industry, which includes new-age technologies such as mobile app development, software enablement, internet-of-things, UI/UX transformation, and digital IT modernization
- Global spend on digital product and platform engineering is sized at \$150 Bn and expected to grow at a 13% CAGR over the next 5 years, led by increased demand for digitization, software-enablement, and UI/UX transformation
- Outsourced component is sized at ~\$30 Bn and expected to grow faster at 18% CAGR as digital technologies gain greater adoption and outsourcing penetration increases
- As a focused and pure-play digital vendor, EPAM has consistently taken share from competitors and is well positioned to benefit from the rapid wave of digitization



**EPAM is a market leader with demonstrated abilities to scale and blue-chip client base**

- EPAM is the largest pure-play digital IT company globally (3x as large as no. 2 player) with a demonstrated ability to scale
- Market position is validated by blue-chip client base consisting of 120 Fortune 2000 companies and strong client retention (top 5 clients average life of 12 years and top 10 clients life of 10 years)
- Best-in-class service capabilities is validated by industry analysts (Gartner, Everest, IDC and Zinnov) and client testimonials
- Strong service capabilities also illustrated by growing account sizes and increasing average revenue per client (demonstrating increasing demand for EPAM's services from existing clients)

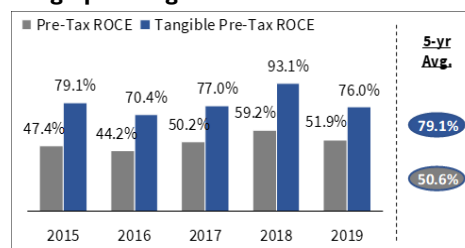




## EPAM (NYSE: EPAM) - Long

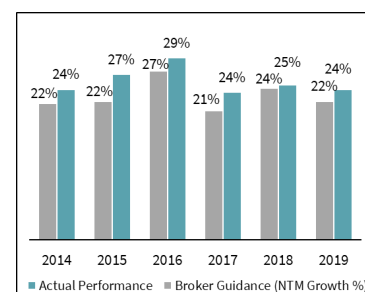
### Revenue growth is supported by asset-light operating profile, high ROCE and strong operating metrics

- Strong 5-yr revenue growth from 2014 – 2019 of 25.7% CAGR (total) and 25.0% organic CAGR
- Revenue growth supplemented by annual pricing increases of 4.2% due to EPAM's market-leading service delivery capabilities; pricing power has enabled stable gross margins of 37% and EBITDA margins of 18-19%
- Asset-light operating profile: (a) minimal capex at 2.3% of revenue (5-yr average), (b) high cash conversion from EBITDA at 58.2% (5-yr average), and (c) high pre-tax ROCE of 51.9% in 2019 (50.6% 5-yr average) and 76.0% tangible pre-tax ROCE
- Asset-light operating profile and strong cash generation has resulted in minimal debt requirement (\$25 million outstanding) and large cash balance of \$936.6 million as of December 2019
- Large cash balance of ~\$1 billion provides insulation from COVID-led dislocation in the near term and inorganic growth potential in the medium to long-term



### The Street is underestimating EPAM's current pipeline and growth potential by ~300bps

- Demand for EPAM's services is currently outpacing supply (i.e. EPAM's ability to hire and staff new employees) by ~300bps
- Excess demand is highly related to existing projects at EPAM and provides a pipeline of future revenue, which results in strong growth potential in future years and the ability to maintain recurring 20%+ growth
- The street has consistently failed to give credit to this pipeline, and as a result EPAM has consistently outperformed street estimates over the last 5 years
- We believe that the street continues to under-estimate EPAM's pipeline and demand, and the Company will therefore continue to outperform estimates going forward



### Base Case and Exit Valuation:

- Base Financial Case:** FY2024 EPS of \$13.00 (EPS CAGR of 19.1% from 2019 – 2024)
- Exit Assumptions:** Exit in December 2023 at 33.0x NTM P/E (based on an intrinsic DCF valuation)
- Projected Returns:** Exit price of \$430 / IRR of 24% / MOIC of 2.2x (unlevered)
- Other cases:** IRR range of 17.9% - 30.2% assuming entry share price between \$175—\$210 and exit NTM P/E multiples between 30.0x—36.0x. Returns expected to hold across cases with 6.1% in bear case and 38.2% in bull case

	Bear	Base	Bull
#1: Revenue Growth	6.8% 5-yr CAGR	17.9% 5-yr CAGR	25.1% 5-yr CAGR
#2: EPS Growth	7.2% 5-yr CAGR	19.1% 5-yr CAGR	27.8% 5-yr CAGR
FY2024 EPS	\$7.67	\$13.00	\$18.45
Stock Price	\$240.0	\$430.0	\$650.0
Exit multiple	31.0x	33.0x	35.0x
IRR	6.1%	23.8%	38.2%

### Risks and Mitigants:

#### EPAM provides highly differentiated services and inability to maintain a strong talent pipeline would be detrimental to the business

- EPAM's typical cost/FTE is \$52k, which is higher than the average but helps them maintain their competitive advantage
- The company has had low attrition rates of 12% compared to an industry average of 18-20% over the last 5 years

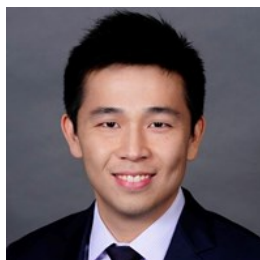
#### Large IT players such as Accenture, Cognizant and TCS can deepen their capabilities in the digital space and take EPAM's market share

- Unlike large IT majors, digital product development drives 95%+ of EPAM's revenue
- Large Indian IT majors such as TCS and Cognizant do not have the DNA and culture to drive excellence in software engineering
- Companies such as Accenture are highly acquisitive and could look to acquire EPAM to deepen their capabilities

#### Services-led business could limit ability to drive margin expansion (current GM of 37%)

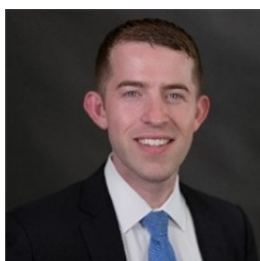
- Focus on digital IT enables pricing power (4.2% 5-yr CAGR in rev/FTE)
- EPAM can raise utilizations from 78% to ~80%, which is in line with peers, but it is reinvesting in the business to keep a deep bench, maintain digital expertise and drive high-quality organic growth
- 60%+ of SG&A expenses are fixed G&A expenses, which should benefit from operating leverage

## Sysco Corporation (NYSE: SYY) - Long 2020 Pershing Square Challenge - 2nd Place



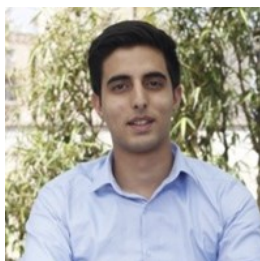
Michael Weng '21

Michael is a 1st year MBA student at CBS. Prior to CBS, he worked in accounting and credit risk consulting for 10 years. Pre-MBA and during his first semester, he interned at a fund led by a former MD from Blue Ridge Capital. He will join T. Rowe Price as an intern for summer 2020.



Kyle Campbell '21

Kyle is a 1st year MBA student at CBS. Prior to CBS, he served 13 years in the US Air Force. Alongside his military service, he managed his family office, making decisions in equities, bonds, and real estate. He interned at StackLine Partners during his first semester and accepted a return offer for summer 2020.



Shaunak Misra '21

Shaunak is a 1st year MBA student at CBS and has 5 years experience in public markets and investment banking. Prior to CBS, he worked at a value-focused \$4B AUM fund looking at investments across the consumer, financial services, and technology industries. He holds a CFA charter and interned at 3G Capital's Dumont Fund during the semester. He will join T. Rowe Price's London office as an intern for summer 2020.

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SYY										
Price	\$53.08	Mkt Cap	\$26,992		2015	2016	2017	2018	2019	2020
52 Wk Hi-Lo	\$86 / \$26	Debt	\$9,557	Revenue	\$48,681	\$50,367	\$55,371	\$58,695	\$60,303	\$54,827
Cash/shr	\$1.03	Pref.	\$0	YoY	5%	3%	10%	6%	3%	(9%)
Bk Val/shr	\$4.97	Cash	\$525	EBITDA	\$2,345	\$2,630	\$2,844	\$3,261	\$3,499	\$3,054
Tang Bk Val/shr	\$4.62	Short-term Inv.	\$15	Margin %	5%	5%	5%	6%	6%	6%
Dil. Shrs. OS	518.5	Ent. Val.	\$36,009	EPS	\$2	\$2	\$2	\$3	\$4	\$3
Float Shrs.	507.4			YoY	5%	10%	22%	22%	16%	(11%)
Daily \$ Vol (mm)	\$384.6	EBIT Cov	7.8x	<b>Valuation</b>						
SI (% float)	2%	Debt/EBITDA	2.8x	TEV/Fwd Sales	0.7x		Fwd. P/E	17.1x		
Div. yield	3.4%			TEV/Fwd EBITDA	11.8x		P/FCF	17.3x		

### Recommendation

We are recommending a long in Sysco with a 3-year price target of \$92, representing 73% upside or 20% IRR.

### Business Description

Sysco is the global leader in distributing food products, equipment, and supplies for the food service and hospitality industries. The company services over 650,000 customer locations, including restaurants, healthcare, and educational facilities, lodging establishments and other foodservice customers. Sysco commands approximately 16% market share of the U.S. foodservice distribution industry, operating as a business partner for restaurant, leisure, and other client locations through its network of 330 distribution centers in 13 countries and 13,000+ fleet of delivery vehicles.

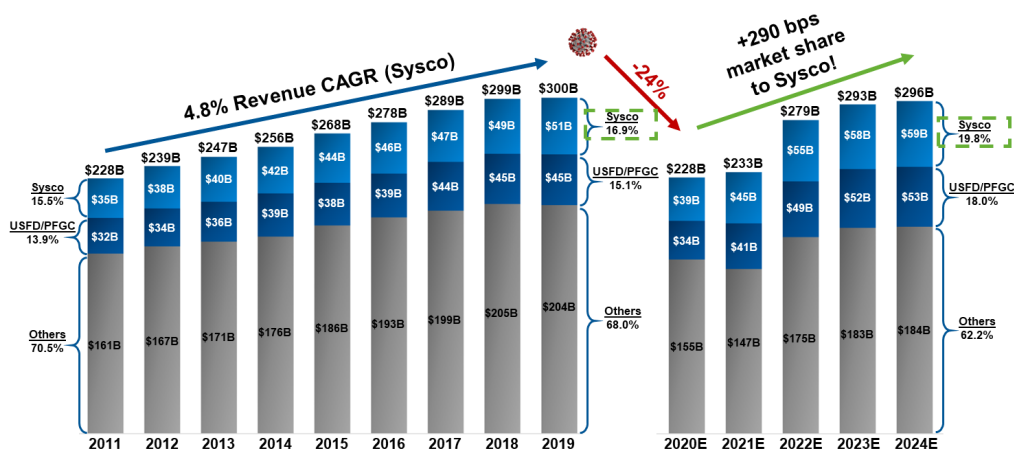
### Our Variant View

- SYY's strong balance sheet ensures survival while under-capitalized competitors buckle under pressure
- Once-in-a-lifetime industry consolidation opportunity will enable SYY to capture significant market share.

### Thesis

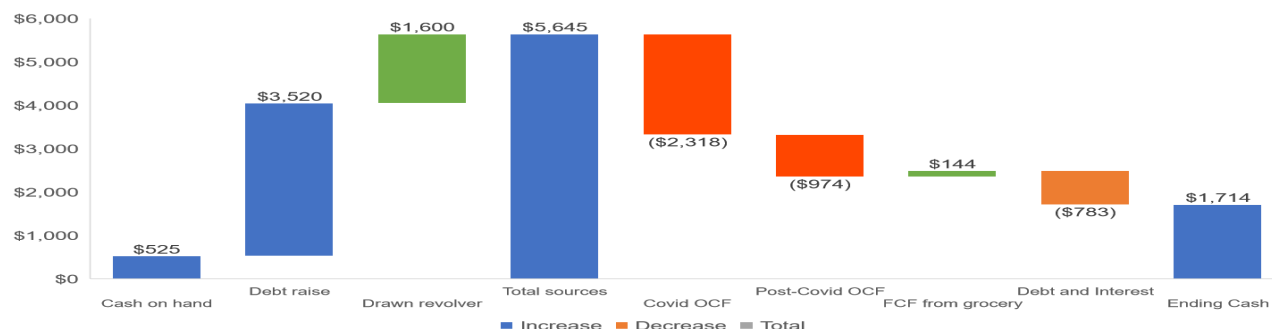
#### 1) Massive catalyst for industry capacity consolidation

- Sysco has the highest capacity to suffer:** With its scale, geographic diversification, and strong balance sheet, Sysco has the highest capacity to suffer and ultimately come out ahead of its competition. Our analysis of small to medium sized distributors' business economics uncovered that many of these companies cannot withstand more than 12 weeks of industry independent case volume declines of 40% or greater. In comparison, we estimate that Sysco can withstand up to a 77% decline for 30 months, a reflection of prudent leverage and superior economics.
- COVID-19 impacts force weaker distributors to exit:** Under-capitalization is common amongst small to medium sized distributors, many of which have cash balances covering 23 days or less of operating costs. Restaurant closures are making it hard for suppliers to cover fixed costs, with one contact telling us, "This is an extinction level event for these smaller distributors." With limited cash balances and shrinking access to liquidity, even a small increase in doubtful receivables would cripple these companies.



- Accelerated market share capture:** Sysco stands to be a major beneficiary of capacity consolidation, capturing additional wallet share from current customers and new market share from washed out competitors. The market punished Sysco as a result of COVID-19, but we believe this is a once-in-a-lifetime opportunity to accelerate share capture and estimate 290 bps of incremental share over the next 5 years.

## Sysco Corporation (SYN US) - Long | 2020 Pershing Square Challenge



### 2) Sysco will survive and thrive, emerging from the crisis stronger

- **SYN has a strong balance sheet capable of surviving a prolonged downturn:** Assuming zero revenues, full operating costs and no working capital benefit for the next 3 months and only ~70% of FY19 volumes for the remainder of FY20, SYN still has enough cash to survive (as shown in the chart above). If COVID-19 impacts persist for an extended period of time, SYN should have no issue further accessing credit markets, given its current debt is unsecured and there are substantial physical assets on the balance sheet.
- **National contracts help cover fixed costs:** With smaller independent restaurants feeling the most pain, we forecast slower local case volume recovery than the overall industry. We estimate a peak to trough decline of 93%, recovering to a net ~7% decline at the end of our forecast period (Jun '24). In such a scenario, SYN's scale becomes key, leveraging its scale and reach to serve the large chain restaurants that are likely to see a more rapid rebound.
- **No heroic assumptions needed for Sysco to be a winner:** Despite modelling industry volume declines of ~25% in FY20 and assuming SYN merely maintains its current market share within the top 3 distributors—we still see returns in excess of ~20% annually, owing to the large market share gain opportunity that will naturally present itself in this industry shake-out.
- **Free option on international expansion opportunities:** We have not modelled in any benefit from international expansion or future acquisitions. International margins are currently ~1.1% vs ~7.7% margins for the US foodservice operations, implying sufficient headroom to grow once integration efforts are complete. This free option is worth ~\$7 in additional value per share if management is successful in expanding margins to just half that of the U.S. operations.

### Valuation

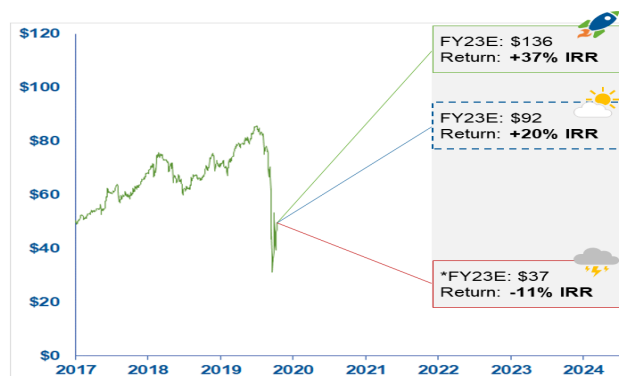
- Assuming a forward EV/EBITDA multiple of 11x, we derive a 3-year target price of \$92 under the base case. We estimate a higher-than-consensus growth in revenues, attributable to market share gain and resultant operating margin expansion from increased private label penetration and operating leverage. This implies a 73% 3-year investment return, or 20% IRR.
- Under a Bear Case scenario, we model ~1% market share capture vs 3% in base case, compressing overall revenues and margins, leading to a 3-year investment return of -30%.

### Key Risks

- Prolonged impact of COVID-19 could change consumer behavior, reversing a secular shift from in-home eating to food away from home. While certainly negative for the industry overall, we believe SYN's scale and value proposition provide a competitive advantage that will enable the company to weather the storm.
- Amazon Foodservice could disrupt SYN's traditional distribution model, resulting in lower sales and operating margins. Based on our primary research, we believe the Amazon threat is overstated, with the greatest impact being felt by warehouse club stores.
- Regulatory scrutiny over acquisitions could limit SYN's ability to expand market share moving forward. While certainly a factor to keep in mind, the shakeout from COVID-19 will allow SYN to accelerate market share organically.

Assumptions	Downside	Base	Upside
<b>Drivers</b>			
Industry Case Vol CAGR	-4.5%	-0.4%	0.4%
US Market Share	17.9%	19.9%	21.9%
5-Yr Revenue CAGR	-2.5%	3.0%	4.6%
Gross Margin	19.4%	19.9%	20.5%
EBITDA Margin	5.9%	7.1%	7.8%
NTM EV/EBITDA Multiple	9x	11.3x	13x
3-Yr Upside / (Downside)	-30%	73%	157%

Forecast period through FY24E



## Verisk Analytics (NasdaqGS: VRSK) - Long 2020 Pershing Square Challenge Finalist



**Ruth Chen '21**

Ruth is a 1st year MBA student at CBS. Prior to CBS, she worked in consulting for biotech & pharmaceutical companies. She will be interning with Artisan Partner's Global Equity Team this summer.

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Mark Hu, CFA  
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### Financial Statistics

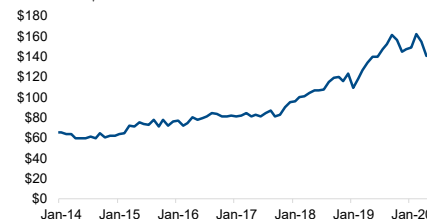
*in \$ millions, unless otherwise noted*

Current Price (Apr 13, 20)	\$144.16
Shares O/S (M)	162
<b>Market Cap</b>	<b>\$23,419</b>
(+) Debt	3,400
(-) Cash	(185)
(-) Net unfunded pension	(45)
<b>Enterprise Value</b>	<b>\$26,589</b>
Daily Volume	866,930
52 Wk High	\$171.73
52 Wk Low	\$116.61

### Trading Statistics

LTM Revenue	\$2,607
16-19 Revenue Growth	9.3%
LTM Adj. EBITDA	1,144
Adj. EBITDA Margin	43.9%
Adj. ROIC	10.7%
NTM EV/EBITDA	20.1x
NTM P/E	33.6x
<b>3-Yr Target Price</b>	<b>\$221</b>
Upside	53.1%

### Share Price \$



### Recommendation

The recent market selloff provides an opportunity to invest in a high quality compounder. Our investment thesis is threefold: 1) Verisk has a dominant and sustainable economic moat leading to strong pricing power, 2) the company operates in a large and growing total addressable market with potential to cross-sell, and 3) the company's energy segment is expected to stabilize after recent downturn. We have a price target of \$221 for 53% upside/17% IRR.

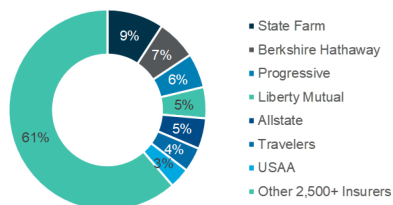
### Business Description

Verisk provides mission critical data analytics products to the insurance (71% of revenue), energy (22%), and financial services (7%) industries. In its core insurance segment ("ISO"), Verisk aggregates premiums and claims data from P&C insurance companies, analyzes this data, and calculates expected losses to help insurers price their policies. The company has amassed a dataset over 47 years that is over two times larger than the nearest competitor's. Verisk sells its insurance products through a recurring subscription model (80%+ of revenue) with 3-5 year contracts and retention rates over 95%. The company is the market leader with all of the top 100 US P&C insurers as customers.

### Thesis 1: Dominant Economic Moat

Verisk has a significant data advantage, which creates a dominant and sustainable economic moat. The P&C industry is highly fragmented with the top insurer (State Farm) having less than 10% market share and a long-tail of over 2,500 insurers. Accurately calculating expected losses is important because loss ratio is the biggest driver of insurer profitability. Individual insurers only have information on customers in their book of business and therefore rely on Verisk's database, which captures over 90% of industry premiums, to price accurately. There is no competitor of scale to Verisk ISO as alternatives are non-profit rating bureaus (AAIS, NCCI) that have significantly less data compared to Verisk. In-sourcing is also often not an option: 1) the cost of using Verisk is only ~2% of an insurer's operating expenses and 20%-80% less than in-sourcing for most insurers, and 2) insurers do not have the same depth of data that Verisk does. This creates high customer lock-in that allows the company to sustain annual price increases.

### P&C Market Share (2019)



### Transactions Added to Database (2019)



### Thesis 2: Cross-Selling in a Growing Total Addressable Market

Verisk has been acquisitive from 2015-2018, growing its addressable market by offering new products to its existing insurance customers. The average number of products an insurance customer uses has increased 40-70% from 2013 to 2018 and the company has a high win rate for new contracts (50%-75%). M&A and cross-selling will grow Verisk's total addressable market size and the company's share of wallet. The total addressable market for Verisk is approximately \$1 trillion of gross written premiums in 2019. Verisk's take rate has grown from 0.07% in 2007 to 0.18% in 2018 and we expect this to grow to 0.28% in 2024 driven by M&A activity and cross-selling.



**Yi Cheng '21**

Yi is a 1st year MBA student at CBS. Prior to CBS, she worked as a sell-side equity research associate at UBS in New York, covering U.S. medical supplies and devices equities. She will be interning at BlackRock Global Allocation Fund for the summer.

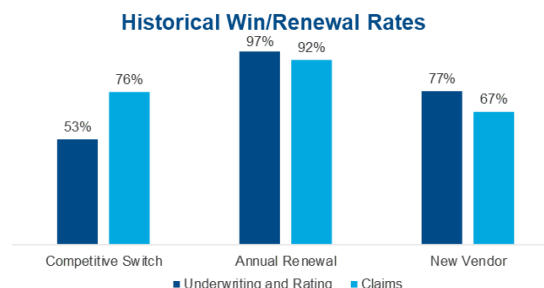
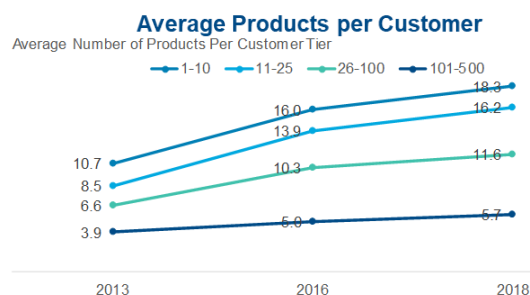


**Mark Hu '21**

Mark Hu is a 1st year MBA student at CBS. He previously worked in private equity and asset allocation at CPP Investments and ICONIQ Capital. For the summer, he will be interning at Fidelity International UK in equity research.



## Verisk Analytics (NasdaqGS:VRSK) - Long (Continued from previous page)



### **Thesis 3: Stabilization in Energy Segment**

There have been market concerns regarding Verisk's energy segment given the industry headwinds. Verisk's energy segment consists of Wood Mackenzie, PowerAdvocate, Genscape, and several other specialized businesses. The products are primarily recurring research subscriptions that are sold to energy companies (upstream, downstream, utilities), financial services firms (PE firms, trading firms), and metals/mining companies for financial/strategic planning and fundamental/investment research. Historically, 70% of revenues have come from subscriptions, and it is a sticky product (90%+ retention rates). In the 2015/2016 downturn, with capex spend declining by 41% and oil prices declining 52%, Wood Mackenzie still grew organic revenues in the low single digits (1%) on a constant currency basis. Since then, the company has further diversified its customer base through acquisitions. The PowerAdvocate acquisition expands Verisk's customer base to utilities and the procurement departments of oil and gas companies seeking to streamline their procurement spend. The Genscape acquisition expands the customer base to commodity hedge funds and trading firms seeking real-time data on inventories/commodity movements. Verisk's energy business today offers a sticky subscription product to a diverse set of customers, which is a mitigant to the headwinds faced by the upstream energy sector.

### **Valuation**

Verisk currently trades at a multiple (20.1x forward EV/EBITDA) slightly above a comp set of data analytics/information services comps (~17x forward EV/EBITDA). However, we believe Verisk is a fundamentally better business that merits its premium multiple. First, Verisk operates in a more attractive end market and offers a unique value proposition to customers. This has allowed the company to drive faster growth than the comps (5.5% organic versus comps around 3-4%) and resulted in stable organic revenue growth during the last economic downturn (~9.2% organic versus comps between -2% and 5%). Second, a higher percentage of Verisk's revenues come from sticky and recurring subscriptions (~80% versus comps between 50%-80%). Third, Verisk's data sources for the core ISO business are proprietary (i.e. directly from insurers), while comps rely on both proprietary and publicly scraped data. Publicly scraped data invites more competition and Verisk's insurance margins are substantially higher than the comps' (54% versus 20%-42%). Finally, while the company trades at a high valuation relative to historical levels, the multiple is justified by improved fundamentals in the insurance end market. Both US P&C premium growth and pricing growth have accelerated to mid-high single digits in 2019 after the catastrophe events in 2016/2017. This should be a tailwind for Verisk's customers and allow the company to continue driving price increases/cross-selling.

We have a base case target of \$221 and believe the fan of outcomes (bear/base/bull) is highly attractive.

	Bear	Base	Bull
2022E NTM EBITDA	\$1.41B	\$1.79B	\$1.87B
NTM EV/EBITDA Multiple	15x	21x	23x
2022E Enterprise Value	\$21.1B	\$37.5B	\$43.0B
2022E Net Debt and Leases	(\$3.0B)	(\$2.6B)	(\$2.6B)
2022E Market Cap.	\$18.1B	\$34.9B	\$40.4B
Shares O/S	164.9M	164.3M	164.2M
2022E Target Price / IRR	\$113 (-8.5%)	\$221 (17.0%)	\$254 (23.2%)

### **Key Risks and Mitigants**

1. There can be potential disruption from insurtech players. However, Verisk's insurer customers have very high switching costs. From our VAR calls, any potential switch would involve a costly multi-year transition in which an insurer needs to pay for two providers (legacy and new) to reconcile model input/outputs. Furthermore, Verisk's core ISO database was developed over 47 years and management estimates that it would take at least 20 years for a new entrant to amass a dataset comparable to Verisk's.
2. Verisk has been paying high prices on recent acquisitions, driving down ROIC. Despite high purchase prices, recent large acquisitions are high quality businesses: proprietary data sets, subscription model with high retention rates, embedded into workflows, and access to new customers. Increased cross-selling can increase returns on assets over time. The company has been able to drive meaningfully higher ROICs for its acquisitions historically: the AIR acquisition grew ROIC from 15% in 2005 to 31% by 2017. The Xactware acquisition grew ROIC from 12% in 2009 to 27% by 2017.

## Mountaineer Partners Management



**Mountaineer**  
PARTNERS

**Mark Lee**

**John Hallowell**

**Greg Williams**

**Cum Laude, from Harvard College.**

**John Hallowell is a Principal and Assistant Portfolio Manager for Mountaineer Partners Management, LLC. From 2005 until leaving to launch Mountaineer, John was a Senior Vice President and Analyst at Contrarian Capital Management, a multi-billion dollar hedge fund, where he worked with Mark Lee. From 2003 to 2005, John was an Analyst in the Private Equity Division of Lehman Brothers and began his career in 2002 as a Junior Analyst in the High Yield Department at Bear Stearns. John received a BA from Georgetown University.**

**Greg Williams is an Analyst for Mountaineer Partners Management, LLC. From 2011 to 2014, Greg worked at Symphony Asset Management, where he was an Analyst supporting absolute return products investing across the capital structure. From 2007 to 2009, Greg was a Senior Associate at Stanford Management Company (Stanford University Endowment) focused on real assets. He began his career as an Analyst in the Equity Capital Markets group at Banc of America in 2006. Greg received an MBA from Stanford University and a BA from Yale University.**

**Editor's Note: This interview took place on March 24th, 2020.**

**Graham & Doddsville (G&D): How did you get your start in investing?**

**ML:** I joined Contrarian Capital in 1999. When I joined, it was a smaller firm than it is now. Contrarian, right now, is a \$4-5 billion hedge fund focused primarily on distressed debt. When I joined it was a much smaller firm and I worked directly for the founders Jon Bauer, Janice Stanton, and Gil Tenzer. I was there for quite a long time - until the end of 2011. And John was there for five years with me. We've worked together quite a long time.

**G&D: Did you have any mentors early on who shaped how you think about investing?**

**ML:** As far as mentors go, I would say Jon Bauer, who's the managing partner at Contrarian, has been the greatest influence on me. He taught me about company analysis, but he also helped really frame how to think about investing. He always used to say, "Worry about the downside and put yourself in a position to get lucky." That shapes how we think about asymmetry, and how we think about both the amount of downside compared to the amount of upside, as well as the probability of the downside, compared to the probability of the upside.

When I was at Contrarian, I ran two different funds for them. I started the Contrarian Long Short Fund and ran that for eight years before I left. For two years before leaving, I also ran the Contrarian Distressed Equity Fund. Mountaineer Partners invests with the same investment philoso-

phy that we had at those two funds - we're looking for companies that are going through fundamental changes. So we're looking for companies that are going through cyclical changes, or secular changes, or some type of hard event or financial change. It's our view that a lot of backward-looking analysis has been automated at this point, so you really need to find companies that fundamentally look different in the future than they have in the past.

And we think the types of changes we are looking for mark the turning points in a company's evolution. If you look at cyclical changes, we're looking for supply and demand and imbalances within an industry - bottlenecks in production or overhangs in capacity. We find that people underestimate pricing power around those inflection points. With secular changes, we're looking for long-term shifts to how goods or service are delivered. We're looking for really long-term changes in how businesses are operated. Those kinds of changes are hard to find and can get rapidly priced in, so it's a lot of digging through food chains of companies, trying to find underappreciated companies that have exposure to those second order changes. For hard events our two favorites are financial distress and spin-offs. We've been investing in distressed and spin-offs for a well over a decade now, and those two areas continue to be incredibly fruitful for us.

I think everyone comes with a predisposed view on investing; for me it was really learning how to deal with incomplete information. I started out as a private equity investor, and as

(Continued on page 23)

## Mountaineer Partners Management

a private equity investor you have enormous access to information. In the public markets, you have a lot less information. A lot of how my investing has changed over time is, learning what information is important, how much information is important, and how to really streamline the process to focus on the things that matter quickly and ignore the noise. Some of that is digging for information and a lot of that is eliminating opportunities where you'll never get to a suitable conclusion. I think we've gotten much better at looking at situations, knowing what is important and what isn't, and digging for that information quickly.

**G&D:** Could you walk us through an example of an early investment?

**ML:** When I was at Contrarian, I was leading an unofficial creditors committee for an Enhanced Equipment Trust Certificate in Northwest Airlines. This was essentially a securitized structure that owned a number of airplanes when Northwest Airlines was bankrupt. The two insights we had there that were variant from the market were that the deficiency claim would be much higher than people expected, and that you could receive your recovery much faster than the marketplace was expecting. We were the first people to really push a restructuring of these certificates like this. The basic notion is that, you own the airplanes so you have asset value in the airplanes. We were buying bonds at 70 cents on the dollar. Those bonds were senior in the structure, and there was also a junior bond and a little

bit of equity. Our insight was that your deficiency claim was not just the amount that your bond wasn't paid, but also the amount that the junior bond and the equity had contributed in the structure. People were dramatically underestimating the size of the deficiency claim. And if you did your math right, it was pretty easy to see that you are going to get close to

***“...it helps demonstrate how we think about downside and our idea that it's not necessary to know exactly how much upside you have, if you can quantify the downside.”***

par, at least, on the recovery of those bonds. The other insight we had was that if you had your claim recognized by the court immediately, you could then turn around and sell your unsecured claim rather than waiting for the bankruptcy process to be resolved. In the end, we were able to make a 50% return in six months.

Now going back to thinking about downside, I spent a lot of time calling used plane brokers and asking them what the liquidation value of these aircraft were. The broker would tell me, “I think the planes are worth X.” It was pretty clear that the planes were worth pretty much what we were paying for the bond, and we were getting a chance to get a chunk of upside on the unse-

cured recovery. That one worked out great for us, and it helps demonstrate how we think about downside and our idea that it's not necessary to know exactly how much upside you have, if you can quantify the downside.

**G&D:** Tell us about your decision to start Mountaineer Partners

**ML:** I'd always wanted to start my own hedge fund. I had a lot of freedom at Contrarian, but there's nothing like doing it on your own. The timing was really driven by having the opportunity to do it right. Starting a hedge fund now demands a lot of infrastructure, and a lot of time to do the fundraising, and build up to scale. And so it was really when I thought I had enough resources to give ourselves a legitimate chance. That's when I left. And John joined me, we left together to start Mountaineer.

**JH:** One of the things about Mountaineer that is probably very unique in today's world is that we were an old-fashioned hedge fund startup. When Mark asked me to go with him and leave Contrarian, we didn't have seed funding in place at the time. We left and started with friends and family money, our money, and then all the main partners of Contrarian Capital invested and we started with that small base. It was really Mark's substantial personal commitment to starting Mountaineer that gave it the chance to succeed. So, we started day one, despite having a small amount of capital, with an institutional infrastructure with analysts and employees that we needed to be a success from the start. As a result,

*(Continued on page 24)*

## Mountaineer Partners Management

we've been able to grow our AUM up to around 150 million to date with two great anchor partners.

**JH:** And then regarding alignment of incentives, I think Mountaineer is unique because of its culture. Mark has made a point of implementing a culture of honesty and rigorous analysis, and when you're looking at special situations and distressed investment opportunities, things can change on a fly. And you have to be able to say we need to stop, and that's hard to do. And you really need to have a level of honesty and trust with each other to be able to do that. And because of Mark really stressing that culture, I think that's why we're able to be successful.

**GW:** Also, versus a lot of my friends in the industry and the prior places that I worked, I think the intersection of debt and equity that we have at Mountaineer differentiates us. We all come from a background of substantial debt investing, and as a result are very focused on dimensioning and understanding the downside. That focus as well as understanding convoluted cap structures results in a pretty differentiated book. We get involved in a lot of situations that peers generally steer away from or outright ignore. And that that generates a lot of opportunities and creative thinking. We've had prior experiences where I think equity markets did not understand bankruptcy-remote debt, and so thought certain subsidiaries could tank a company. And without being able to diligence the debt, you wouldn't know that it was actually bankruptcy-remote. You also see situa-

tions where operating companies and physical assets are separated, and at times of stress, both the physical asset

***“Our comprehensive view of a company’s capital structure, which many others generally do not incorporate, is key to our investment process and sets us apart.”***

entity and the operating company entity sell off at comparable rates. But risk and upside are substantially different between the two. Our comprehensive view of a company's capital structure, which many others generally do not incorporate, is key to our investment process and sets us apart.

**G&D:** Given your backgrounds in debt investing, what is the typical debt/equity composition of Mountaineer's book?

**ML:** Prior to starting Mountaineer when we were at Contrarian, about half of what we did was equity and half of what we did was debt. When we started Mountaineer, it was after the financial crisis (we launched in early 2012) and there really wasn't and hasn't been much distressed debt for us to do. So, we've purchased one or two bonds since starting Mountaineer. Until recently, there haven't been many good opportunities to be invested in distressed. The only two big opportunities to invest

in distressed were the oil crisis and Pacific Gas. We did own some Pacific Gas bonds briefly, but they rebounded quickly after the company filed for bankruptcy, and the overwhelming best risk-reward then was in the equity of another company, Clearway.

In the oil crisis, we researched many different high-yield and distressed oil bonds. And we concluded that the opportunities were better in the equity markets than in the debt markets during the oil crisis. We wanted companies that had the ability to weather low oil prices for a while without having to restructure. In the restructuring process, there's a lot of leakage for fees and also as a company enters distress, there's a chance that as an unsecured bondholder, you can be pushed down the capital structure as DIPs come in or second liens come in, or other securities. So, we didn't want to take that kind of risk. And we wanted liquidity. We're very aware that commodities move very quickly and you don't want to be trapped in the security, wanting to sell it for months and being unable to sell it. You want to be able to turn around and sell when you want to. We knew we could do that with the equities that were buying, and we weren't as confident that we could do that with the bonds.

All of those things led us to invest in equities during the oil downturn, not distressed debt. We looked at a lot of distressed debt during the oil downturn, but we ultimately decided that equities are better risk reward at that time. We tend to be very agnostic

(Continued on page 25)



## Mountaineer Partners Management

about what part of the capital structure we're buying. We're very aware of how they trade differently and what the risks are. We take all that into account when we do our analysis, but we'll look through a whole capital structure when we need to, to find the position that we like best.

We're anticipating a better distressed market going forward, and we've been looking at a lot of the distressed situations, but we're still finding better opportunities in the equity market right now. We're hopeful that we'll find better distressed opportunities. Given that the spreads are blowing out and we'll be in a recession for at least a number of months, there should be

***“We're anticipating a better distressed market going forward, and we've been looking at a lot of the distressed situations, but we're still finding better opportunities in the equity market right now.”***

more to look at. Whether or not it becomes very interesting, we'll just have to wait and see. We love distressed debt; it's probably our single favorite type of investment. But we're not going to force it. We're going to do it when it's there and when it's good, and we're not going to do it when it's not.

**GW:** It is also helpful that we all have substantial experience reading and even originating new credit docs. In oil and gas, there were a lot of weak documents that if things muddled along you could get primed, and there are grey areas on the security side that are very state by state driven. When I say security, I mean whether or not you have a perfected lien in the underlying assets and how that evolves as you drill out a field. It is not automatically clear that you would have a perfected lien in holes drilled after documents are signed and UCCs are filed. There are also critical questions about what agreements could survive bankruptcy like prior royalty deals. You need a lot of feet on the ground to really do the proper deep work there. And so that is a nuance that you don't necessarily have in some of the other distressed scenarios that also made us a little more apprehensive looking at the debt side.

**G&D:** Can you describe the investment process you follow at Mountaineer?

**ML:** In terms of idea sourcing, we're looking for those secular changes, those cyclical changes, and those financial changes. When we find things that meet those criteria, that's when we start getting interested in the industry. For hard events, we'll actively look through companies that are doing spin-offs, and companies that are going to financial distress or some other types of abrupt hard financial changes. I think the key to the idea process, for us, is being able to evaluate ideas quickly. Our goal is to not

spend time on things that will not be fruitful.

Three areas of focus when we're starting analysis are asymmetry, safety and analyzability. Asymmetry is pretty straightforward, and safety I think is pretty straightforward. A situation is analyzable when a small number of factors will drive the outcome of an investment and we are able to research and have an opinion on those factors.

Then as we start to dig further, we're really focused on trying to figure out how much downside there is in a position and the probability of the downside. The downside estimates drive our position sizing. Our largest positions are not the ones that necessarily have most upside, but are the ones that we think have the lowest downside and the lowest profitability of downside.

**G&D:** On the analyzability point, does that mean you tend to avoid with heavy macro or commodity exposure?

**ML:** If we think we can have a legitimate opinion on a commodity or a macro point, we will take a position, but we only tend to invest in those types of situations when they're really dislocated. For instance, we typically don't have much oil exposure, but during the downturn a couple of years ago we had a big chunk of oil exposure. When we think things become analyzable, we'll be in those industries, but they're not industries that we'll run with constantly.

**G&D:** Do you have hurdle rate or risk-reward skew that you look for in an investment?

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**ML:** It manifests itself in position sizing. Our core positions will be 4-6% of the fund at initiation. For those we're looking for 50% or greater upside over a two-year period with no more than 25% downside, and we'd like to be right 70% of the time. Then we have positions that we call outsize positions, which we'll initiate at 8% or bigger. There we're looking for 30% upside of or greater over two-year period. The key to those positions is that we're looking for no more than 10% downside, and we'd like to have a 90% hit rate with those. And then finally, we have speculative positions, and we're really looking for positions that could go up multiples - two, three times. Realistically you can't have a hit rate of more than 50% in something like that. Those tend to be much smaller, no more than 2% of the fund at initiation.

**G&D:** How do you think about when to sell?

**ML:** When we go into an investment, we'll talk about both the timeline and the price for exiting. Then we'll also talk about what would confirm or refute our thesis. So we go into an investment with a roadmap of how we hope it plays out. We are flexible in that sometimes positions evolve better than you expected, so you can't just adhere to a strict price target. But what we have no tolerance for is thesis drift. If the thesis breaks, we get out as fast as we can.

As far as on the upside, it's really an interplay between how rapidly the thesis is playing out and how rapidly the

stock is appreciating. Sometimes we have situations where a stock's outrunning a thesis and we'll start to exit the position, and then there'll be times where the thesis is evolving exactly as we hope, and the stock price will be a trailing, and then we will be holding it or increasing the position size.

**G&D:** What causes a speculative position situation to arise, is it just because the downside is based on something that is unknowable?

**ML:** Sometimes there are binary things that occur in a bankruptcy or in a legal process. Sometimes there's just a level of due diligence that you can't achieve to get a higher likelihood of success on the probability side. Those are the types of situations that arise. So, for instance, there was once a retail company that we thought could file for bankruptcy, but that was showing

***"We are actually quite bullish on a number of names right now. And if you have the view that we will emerge from a quarantine or social distancing within a two-quarter period, there are companies that we know well that are priced as if they will go bankrupt."***

some very good store comps. If it survived, it would go up multiples. But there was no way to really diligence what was driving comps, and say with certainty that those would continue. So you had kind of a one down, six up scenario with a very difficult probability of downside to predict.

**G&D:** Can you share some thoughts on quantifying downside and how you've navigated today's Covid-19 world? [Reminder: interview conducted on March 27th].

**ML:** At the beginning of the year, valuations were high. We didn't feel like we needed to be leaning into that at all. We're usually 45 to 75% net, and we came into the year at the very low end of that range. When we saw the virus hitting in China, we pulled back a little more based on how we were thinking about the future's prospects. Then when the virus hit Italy, we started reducing net exposure further. We got down to less than 10% net, and now we're about 40. In 16 years of managing money, the last time net exposure was that low was before the financial crisis.

We are actually quite bullish on a number of names right now. And if you have the view that we will emerge from a quarantine or social distancing within a two-quarter period, there are companies that we know well that are priced as if they will go bankrupt. So if you can do a bit of work on their liquidity, on their prospective cash flows, even under the dire situation that we're in now, and have the view that they survive, these companies

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would go up two to three times in value. Some of them are small mid cap companies that we've known for a while, and some of them are things like Boeing. Boeing was essentially trading as if it was going to have a massive liquidity problem. And now, in just a matter of days, it's gone up 70% in a one week session.

We think that in this type of environment you can find high quality companies with very good market positions, that will survive and that have the opportunity to go up two or three times in value. While it can be difficult given the extreme volatility, we actually think it's a good time to deploy capital.

We are believers that there'll be some resolution and that it may take a couple quarters, but on the backside of that, you're going to have an economy that went into a recession with no fundamental, real issues. We had some bubbles in venture valuations. We had high valuation in terms of the equity market, but we didn't have any structural problems in the economy. We didn't have rapid inflation. We didn't have financial institutions with issues. We had a solid economy that was humming along when we went a recession. So coming out you'll have an economy that's been damaged, obviously, by a multi-month shut down. You'll have some destruction or balance sheet damage done, both to personal balance sheets and to corporate balance sheets, but you'll also have 0% interest rates that will exist into the foreseeable future, and you will have had a multi-trillion dollar stimulus package. We think that

there'll be a reasonably rapid recovery coming out of this, and that valuations and earnings will recover pretty quickly.

**G&D:** How do you think about trying to time the bottom amid all the market volatility?

**ML:** There are many different answers to that question, but what really drove us to buy were compelling valuations in things that we were familiar with. For instance, there is a materials company that we think the equity's worth north of \$20 that's in a very, very good market position, and that stock was down in the low single digits. If we think that company will survive, from its current stock price it's going to be a double or triple pretty easily. And it's those types of valuations that really got us interested in getting longer again. With the valuations we were seeing there wasn't a lot of room for them to move on the downside, given the quality of the company, and they had an enormous amount of upside.

There are some other indicators we look at for a market bottom. Some of those things were satisfied. Some of them have not been satisfied. There's absolute stock levels that we would be interested in and just flat out being as long as possible. We haven't hit those levels yet. We may not hit those levels. We may, we may not. We were looking for the correlation to breakdown in the marketplace. We wanted to see some stocks go up, and some stocks go down, and that hadn't been the case for over a month - the entire market sold off.

**G&D:** How do you approach hedging?

**ML:** We're directionally short, single name securities. There will be times when we'll be using derivatives, but our goal is to be directionally short stocks that we think will be return generating. We're not big fans of pair trading. We think it's a really good way to convince yourself you don't have risk and it introduces an enormous amount of basis risk into your portfolio. We tend not to pair trade. We prefer to look for things that we think are going to make us money on the short side.

**G&D:** How do you think about shorts in the context of your focus on downside protection for longs?

**ML:** Shorts are tricky because you're kind of inverted on that. We manage that by keeping our short position smaller. You need to have room for your shorts to go against you a little bit. Our short positions are half the size of our long positions, and we don't do things that we've characterized as speculative shorting. We try to avoid valuation driven shorts. We're really looking for things that have supply overhangs that are developing, secular stories working against them, those kinds of shorts, rather than looking at things that are overpriced, which we find to be a dangerous way to short.

**JH:** You have to trade them a little bit more, in addition to keeping them smaller. You have to be willing to just recognize that the market is going

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against you and get out of it, or when it's successful you've got to cover and take your profits. An example there that we've looked at in several industries, just structurally, is certain industries supply chunks come on in meaningful amounts. And there are times that securities don't reflect those new, meaningful amounts of supply hitting the market. And you can take a short position ahead of that supply hitting the market, and then cover as it comes in. And we've done that with a number of names.

**G&D:** Can you talk about an idea you are excited about right now?

**ML:** Our biggest position is in a company called Clearway, which is an independent power producer that produces electricity. It has a lot of renewable energy capacity, so a lot of solar and wind. It's a company that we found through the Pacific Gas bankruptcy. We had been following Pacific Gas for over a year when it filed for bankruptcy. We hadn't been involved with Pacific Gas, as we didn't think the risk-reward was very appealing, but when Pacific Gas filed for bankruptcy, we looked through all the different Pacific Gas securities, and we looked at other companies that were getting hit because of the Pacific Gas bankruptcy. After doing that review we decided the Clearway equity offered the best risk-reward.

Clearway sells about a quarter of its generating capacity into Pacific Gas. As a result of that, the company had to cut its dividend because the bankruptcy at Pacific Gas created a technical default on their pro-

ject level debt for the projects

***“...we looked through all the different Pacific Gas securities, and we looked at other companies that were getting hit because of the Pacific Gas bankruptcy. After doing that review we decided the Clearway equity offered the best risk-reward.”***

that were supplying electricity into Pacific Gas. Pacific Gas was and continues to perform on those contracts, so Clearway is getting paid, but because of the technical default, the cash that they're generating at those projects is trapped at the project level. As a result, they weren't able to fund their dividend, so they had to cut it. That caused the stock to drop 40%.

In an extreme downside scenario, we thought the stock was worth \$16-17. At that time the stock was trading at \$15, so we thought it had way overshot even a horrible downside scenario. We bought it, and because of the downside protection, it was and is our largest position at this point.

The analysis on that is twofold: One, we don't think that the power contracts will be rejected in the bankruptcy process,

and two when PCG comes out of bankruptcy, the dividend will go back up to where it was before, and even under the depressed valuations that exist in the marketplace now for their competitors, there's more than 40% upside in the stock just from comp valuations right now, without a normalization in the marketplace. If the market normalizes, the stock is almost a double from current trading prices, just south of \$20. And mind you, we were buying the stock at \$15 a year ago. In the case that the power contracts are rejected, which we think is highly unlikely, Clearway would get an unsecured claim in the Pacific Gas bankruptcy, and because of the size of that claim, we think that the company would be no worse off than if those contracts were renewed on a cash-flow basis.

Then in order to get to our downside scenario of mid-teens, the harshest assumption was that the Company would get a 50-cent recovery on those unsecured claims; however it's pretty clear that those unsecured claims are worth par right now. After really punishing our downside scenario, we thought we came to a stock price that was higher than where it was trading, at only a dollar or two lower than where it's trading right now. That's what really drove the additional sizing of the position, and we think it's still one of the best risks-rewards in the marketplace.

**G&D:** Do you think forced selling due to the dividend cancellation was what caused the initial 40% sell-off or more fundamental concerns?

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**ML:** They're fine on cash flow and liquidity. I think that it's owned by income driven funds and as they cut the dividend, it was punted out by the retail investors or long-only vehicles that are in it for dividends.

**GW:** It's also worth noting, we've talked to a lot of people who have been and continue to be involved in PG&E, and I think there was a lack of awareness on how analyzable Clearway was. Clearway has private contracts with PG&E and their other buyers, and PG&E isn't going to give them to you, but if you go to the Public Utilities Commission, you can acquire all those contracts via effectively Freedom of Information Act requests. We got all the contracts, and went through each contract to build up what the claim was, and to really understand what all those underlying cash flows were, and that was a level of work I think most people were unaware you could actually do.

**G&D:** What motivation would Pacific Gas have to reject the contracts?

**ML:** California has put regulations into place saying they need to be at 100% zero-carbon by 2045 and there are interim goals that they have as well. In order to reach those metrics, we didn't think it would be possible for them to walk away from these contracts. In our downside scenario, we assumed that they would re-contract these renewable energy plants at market pricing and they would get an unsecured claim for the difference. But it's really difficult for them to simply just reject these things and walk away from them. The governor

had made a strong commitment to renewable power, and it seems very unlikely that they would blame the California forest fires on global warming and then turn around and reject renewable power contracts and embrace natural gas or coal.

**GW:** Also, in a standard bankruptcy, as you all know, the company has the right to reject contracts and correspondingly create deficiency claims against the estate. Rejection is based on business judgment, and there's a lot of deference provided to management in that process. What was unique here is that PG&E, while being the legal counterparty, actually takes no monetary risk on these contracts. By statute in California the contracts are 100% pass through to customers as a result of the Enron crisis California dealt with 20 years ago. So there's strong reason to believe that even if PG&E attempted to cancel these contracts in court, that the judge would disallow that. The judge himself even laid out this logic in an adversary proceeding that basically made clear to PG&E that he probably would not let them cancel these contracts if they tried. And that's relatively unique in bankruptcy. If they cancel these contracts, no cashflow or EBITDA improvement would be achieved at the company, but a material claim would attach to the company's estate. And so that's why it probably would not pass the business judgment test.

But again, we could dimension the size of the liability because we had all the contracts. Without the contracts you could dimension what the immediate

cashflow loss was, but you couldn't dimension the claim that you would get. And since

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all of these projects have debt associated with them, it was unclear to the average investor if you could hold onto those projects in a cancellation scenario. Would you receive enough in a claim value to pay off the debt? Our analysis was, generally speaking, you would actually receive more than enough cash to pay off the debt.

**G&D:** When do you expect a resolution of the PCG bankruptcy that will allow your thesis to play out?

**ML:** June 30th is when they required the bankruptcy to be resolved. The disclosure statement was just approved by the court. It's getting mailed out so they're on track for that right now. The risk right now is that they need to issue some new securities to come out of bankruptcy, and given the mar-

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ket conditions, I don't know how easy it will be to place those securities, but there are some backstop agreements, and some bridge agreements, and so we think that they should be able to get through it all. That's our favorite position. It's difficult to find things with that limited downside and that much upside.

**G&D:** Are there any other ideas that you are excited about right now?

**ML:** The other one that we really like is an old position that we just reinitiated. We exited because it hit our price target last year. We reentered it because it's gotten to a compelling valuation. It's a company called Ingevity. We started buying it when it spun out of WestRock, the paper and packaging company. We identified it early on as something that had an incredibly good secular story. The company does two things. It takes waste from trees and makes specialty chemicals, and then it takes sawdust from trees and it makes a specialty charcoal that goes into a filter that's in every car in the United States.

When it was spun out of Westrock, because of issues it was having on the chemical side of the business, it was viewed as a declining commodity chemicals manufacturer. But we'd done a lot of work on it, and what we had identified was an incredibly strong secular growth story on the auto filter side. On that side of the business, they take sawdust and they make a high-end specialty charcoal. That specialty charcoal goes into a device that's in people's cars that captures gasoline that's evaporating

from your gas tank so that when you open your gas tank to refill it, the vaporized gasoline doesn't evaporate into the air. Gasoline in the air combines with other pollutants to make smog, so this is something that's heavily regulated by the EPA.

What we were able to identify, which was not highlighted in any of their SEC documents, was a regulatory change in the United States that takes us to near-zero emissions on gasoline vapor emissions. What that meant was that Ingevity, who has almost a monopoly position in this product was

***"If you go through the Form 10, this huge regulatory ramp was mentioned maybe five times very much in passing. However, if you do a deeper dive as we did, you could see it was going to be a big factor. It just took a lot of digging."***

going to double its content per vehicle as a result of this regulation that was on the verge of rolling out. The filter business, which was half the profitability of Ingevity, we expected to double in profit in the near term. When the company started trading, initially, we saw that ramp-up was not recognized at all in the marketplace.

**JH:** I think it really speaks to the analyzability aspect of investing for us. As we dug into Ingevity, everybody knew of the Pine Chemicals business, and it had a recently acquired public comp that everybody was looking to as a reference case. People weren't doing as much work on the entire business, specifically this Performance Material segment that created the wood-based activated carbon going into the gasoline emission canisters. And the reality was, it wasn't easily identified in SEC documents. If you go through the Form 10, this huge regulatory ramp was mentioned maybe five times very much in passing. However, if you do a deeper dive as we did, you could see it was going to be a big factor. It just took a lot of digging. You had to focus on the Performance Materials segment's demand driver being regulatorily driven and figure out new regulations were coming into effect. You then had to go through the environmental regulations and read the EPA Tier 3 regulations and even go back through the details of prior Tier 1 and Tier 2 regulations to understand the economic impact of each step to really build up the model. After doing all this digging you find out that the newer Tier 3 solution requires an additional product that builds on their Tier 2 product to provide a higher capture of vapor emissions. We also had to do technical research on activated carbon to better understand why their wood-based product was a better fit for this type of solution. So, it was really all encompassing, and once the company spun off we were really in a position to understand the huge growth tail-

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winds that were present in the performance material segment. We were the largest buyer of the stock early during the when-issued period, almost 70% of volume we think.

We also wanted to really stress test our downside, so in that case we assumed that we would have an auto OEM production decline almost on-par with the financial crisis and found that they were still able to grow earnings as a result of the regulatory-mandated content that only Ingevity could provide. Then once we were comfortable with the downside, we put ourselves in position to have further good things happen to us. With Ingevity, they were able to acquire Georgia-Pacific's Pine Chemicals business, further consolidating that industry into an oligopoly with Arizona Chemical. Then on top of that, they were able to get their products regulatory-mandated into China, where China copied the older US Tier 2 regulations, which really used Ingevity's activated carbon as the base and one of the few materials that can really meet the performance characteristics that were designed into those regulations. Not only did we get the identified US tailwind, but as that was starting to work, we get a second boost from China.

**ML:** Just to clarify that, when we initially made our investment in Ingevity, in our forward projections, we had not incorporated any sales in China. We were aware that China was considering enacting automotive air quality emissions regulations that resembled the regulations that the United States was moving off of, but it

was very hard for us to have a view as to the likelihood of timing of those changes. Later, after we had established a position in Ingevity, they instituted those rules, which were pretty strict. And that increased our upside estimates of what the company was worth.

Then relating back to a couple points that we had discussed earlier, that's why I said you can't just have a price target and not be flexible and incorporate new news. Because it was a really material increase in possible profitability when the Chinese regulations were put in place.

We also talked about analyzability – our Ingevity investment is a great example of analyzability because it has a limited number of things that would

***“...our Ingevity investment is a great example of analyzability because it has a limited number of things that would really drive the business, and those were the regulatory change and the impact that that would have on Ingevity. And that change was very certain and very material.”***

really drive the business, and

those were the regulatory change and the impact that that would have on Ingevity. And that change was very certain and very material. It was so material it would swamp a lot of other possible downdrafts that Ingevity might incur. So, it made the company to us, analyzable and incredibly asymmetric.

We also talked about putting yourself in the position to get lucky or un-priced in free optionality. In Ingevity, that takes the form of further regulatory tightening for gasoline emissions and other geographies. The US is quite tight, China has adapted our prior gasoline emission standards. Europe is still on a very loose gasoline emission standard. There's even further opportunity for the company on a go-forward basis. Those are the kinds of things we're looking for.

**G&D:** Did you see the rise of electric vehicles as a risk to the thesis?

**JH:** That was one of the biggest risk factors. We have been constantly watching electric vehicle adoption. When we first invested in the company, for us, the ability for global auto production to really shift to being all electric was really technologically limited. But, it's clearly a risk and something we continue to watch. Also, as you move to hybrid vehicles, they will need Ingevity's product. So, a lot of the step changes will still include Ingevity's product, and that gave us comfort even if you had a more rapid shift, as long as it wasn't to 100% EV battery vehicles, you were still going to have the regulatory growth tailwind.

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**ML:** We initiated the position at \$24 and exited the position at nearly \$100 last year as we had hit our price target and at that point, at the price it was trading at, it didn't really account for the electric vehicle risk. Now the stock is down to \$33, so we re-initiated it. At this lower price, it now reflects the risk from electric vehicles, as well as a lot more risk that we don't think is warranted, so we're back in it.

**G&D:** Did this regulatory tailwind entice any competitors to enter the market and increase capacity?

**JH:** For the newer Tier 3 solution it is an additional product that builds on their Tier 2 product to provide a higher capture of vapor emissions. The EPA is requiring 100% compliance with Tier 3 regulations by 2022. Ingevity has a patent on that product through 2022; however a recent ITC ruling may weaken their IP protection. That's one of the other new risk issues that Mark talked about as they'll have competition in that piece of the market. So that's something that they're managing to, as competition in Tier 3 will come. However, we believe Ingevity can offset any future competition in Tier 3 products by leveraging their monopoly like position in their Tier 2 product.

Ingevity's product to meet Tier 2 regulations is no longer patent protected and hasn't been for a while. Anybody can try to enter. We've talked to all of the various activated carbon competitors to gauge their ability to produce the products at scale, and none of them had really been able to do it, even

though they'd all kind of looked into it. So that gave us comfort when we initiated the position.

**ML:** There was a competitor that a number of years ago tried to enter this Tier 2 market in the US, and that competitor failed miserably to provide the quantity and quality that OEMs needed. Even though Ingevity's Tier 2 carbon is not patent protected, it's been very difficult for competitors to enter the marketplace. It's difficult for a competitor to come into a market like the United States because of the automotive cycle. New auto models roll on over a number of years. It's not like the entire fleet of cars gets redesigned every year. If you were to try to build a plant in the United States, even if you were a winning business, it would take a number of years before you could fill that plant just because of the contract cycle in the United States.

In China, it was a little bit of a different story as they were launching. When China launched their Tier 2-like regulation all OEMs had to be compliant by a certain date. There were a lot of jump ball possibilities in China, and the company dealt with that by building a scale facility in advance of the regulations in China, so they were able to satisfy that marketplace. There are other competitors who are trying to compete, but nobody can offer the quality and consistency and quantity that Ingevity has, so Ingevity has enormous market share in China as well.

**JH:** In addition, the regulatory penalties for failing to meet these environmental require-

ments in China are quite high. And in the US, as we saw, especially with Volkswagen, not just the financial penalties, but also the hit to your brand's reputation.

There is also a unique pricing story that may play out in the near future. Now that China is reaching full adoption of their Tier 2 regulations on July

**“...the regulatory penalties for failing to meet these environmental requirements in China are quite high. And in the US, as we saw, especially with Volkswagen, not just the financial penalties, but also the hit to your brand's reputation.”**

Ist, we think Ingevity has a unique opportunity to raise pricing for its Tier 2 products globally. Ingevity's Tier 2 carbon product using round numbers is only \$10 a car. Given its monopoly-like position globally we think Ingevity could increase that number and more than offset any potential future competition in its Tier 3 product.

**ML:** Since we're talking about Ingevity and it's a spin-off, I also wanted to highlight, just doubling back on our short discussion that spin-offs will both provide attractive long

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and short opportunities. Obviously, spin-offs can and will oftentimes include relatively small underappreciated assets. It will also oftentimes include assets that are jettisoned be-

***“The spin-off market in the last few years has changed pretty dramatically. If you go back 10 years, companies would spin-off good businesses. And more recently, you see some of that, but you see a lot of people just getting rid of bad businesses—just punting what they don't want.”***

cause they're about to turn down, or sometimes assets that are attached to really undesirable long-term liabilities. Spins are a fertile hunting ground for both long and short opportunities. Again, that requires generally a lot of work that's not obvious in a 10K or a 10Q. And so it builds upon our ability to dig deep into ideas and themes.

The spin-off market in the last few years has changed pretty dramatically. If you go back 10 years, companies would spin-off good businesses. And more recently, you see some of that, but you see a lot of people just getting rid of bad businesses - just punting what they don't

want. In the spin-off world, you have to be much more selective than you were 10 years ago because people I think are much more comfortable with the reputational damage that they're going to take by spinning-off a failing business, or spinning-off chemical liabilities. And what that means is that you cannot be a passive investor in spin-offs anymore - you really have to do the work in order to not get caught holding the bag in one of these things.

If you go back a number of years, most spin-offs were successful to some degree. Either they were okay or they were really good. And now you're seeing value creation for the parent company by spinning-off, call it environmental liabilities. And those kinds of things didn't really take place if you go back years and years. People seemed hesitant to take that kind of reputational damage and spin-off the failing business; whereas now they're quite willing to do it if it benefits the surviving entity.

**G&D:** *Are there any activities or organizations you take part in outside of the investing world?*

**JH:** In part of my free time - I have two young children, so it's kind of limited - I work on the advisory board for Cristo Rey New York High School which provides a college preparatory education for families who otherwise could not afford it. The way the school goes about creating that opportunity is through both the support of a number of great education focused foundations and charities, as well as its students working one day a week

at corporate partners to both get real-world working experience and help pay for their education.

It's a wonderful school. I've been involved in it since before Mark and I started working together back at Contrarian. And it's amazing. These are families that make on average \$30,000 and are living in New York City. Cristo Rey is able to give them the opportunity of a college-prep education. All of its students in the 2019 graduating class all went to four-year colleges, a lot of them on full-rides or just with aid. Cristo Rey is even supporting families now being hit with the virus spreading all throughout New York. With all the schools being forced to close because of the Governor's orders, Cristo Rey and its supporters really stepped up. There are kids whose families needed help just getting food. Some families needed help getting internet access and the school was able to step in and give them laptops or help give them hotspots that can allow them to access internet and do the e-learning that all these private schools are currently transitioning to, which enables them to continue getting a great education.

**G&D:** *Do you have any advice to share with MBA students pursuing a career in investment management?*

**GW:** My main recommendation is just get reps and pay attention to the market. Even if you're not putting money to work, trying to pick ideas and, and dig on them anyways, just to get mental reps and see why things fail or why they work.

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Then you have a base of knowledge to leverage when

***“...look for things that can survive automation. We're in a world where information technology is automating a lot of security analysis, equity analysis. And so really listen to what people's strategies are, and be honest about whether or not that's something that will be enduring...”***

you're talking to investors looking for a job. If you come in with one idea and that's all you can really talk to, that's not that helpful for a manager. But if you could talk through three things that you followed in detail and had a thesis, even if you weren't putting money to work, if you can show a depth of understanding, I think that is very helpful.

**JH:** I would say just from my personal, professional experience, obviously you want to get to an opportunity, and I imagine coming out of business school you will have a target industry or firm. What I would say is, people really matter, and I would strongly recommend working with better people over trying to maybe do something that you think is exactly what you want to do. If you work with good people, great things are much more likely to happen.

**ML:** I would say, look for things that can survive automation. We're in a world where information technology is automating a lot of security analysis, equity analysis. And so really listen to what people's strategies are, and be honest about whether or not that's something that will be enduring for a number of years, because the change is happening, and it'll continue to happen. We would love to do things that were written about in Klarman's book, but a lot of those types of opportunities don't exist anymore. You have to find value. You have to dig harder and be a little faster to find the value that that exists out there. And you have to be more prospective because anything that's retrospective pretty much can be automated. So yeah, that's how we view the world.

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

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### Graham & Doddsville Editors 2019-2020



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