

Graham& Doddsville

WINTER 2021

An investment newsletter from the students of Columbia Business School

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Rodrigo De Paula, MBA 2021

Matt Habig, MBA 2021

Alison Tien, MBA 2021

Bill Ledley, MBA 2022

Tom Moore, MBA 2022

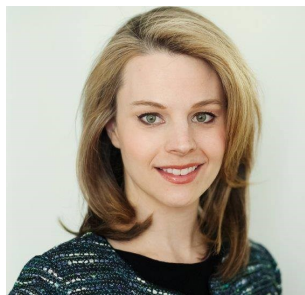
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Welcome to Graham & Doddsville



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



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

We are pleased to bring you the 41th 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).

We first interviewed **Arthur Young**, portfolio manager and co-founder of Tensile Capital Management. We discussed Mr. Young's investing principles and founding of Tensile, his approach to generalist value investing, idea generation, and Tensile's unique blend of public and private investing. Mr. Young also shares his views on the attractive aspects of investing in software businesses.

Next, we interviewed **John Huber**, Managing Partner and founder of Saber Capital Management. Mr. Huber shares his early experiences with investing, his decision to start Saber, and the evolution of his investment style. Mr. Huber is a very thoughtful investor whose firm is modeled after the original Buffett Partnership fee structure. His thoughts on business quality, portfolio construction, and developing as an investor are excellent.

Lastly, we interviewed **Wilmot Kidd and John Hill** of Central Securities. Central is a closed-end fund that's operated since October 1929. We discussed the evolution of markets during Mr. Kidd's long career, the importance of taking a long-term approach to invest-

ing, and management quality and capital allocation. Mr. Kidd discusses his early experiences with the semiconductor industry, which shaped his unique and successful long-term approach to investing.

We continue to bring you stock pitches from current CBS students. In this issue, we feature three contest-winning pitches. Amitaabh Sahai ('21) shares his long idea on DXC Technology (DXC). Will Husic ('22), Harrison Liftman ('22), and Cathy Yao ('22) share their buy thesis on Live Nation (LYV) as an attractive covid-19 recovery idea. Finally, Nathan Shapiro ('22), Levente Merczel ('22), Kyle Heck ('22), Kirk Mahoney ('22), and Vineet Ahuja ('21) share their long thesis on RealPage (RP).

Lastly, you can find more interviews on the *Value Investing with Legends* podcast, hosted by Professor Tano Santos. Professor Santos has recently conducted interviews with guests including Howard Marks, Jan Hummel, Mohnish Pabrai, Samantha Greenberg, and David Marcus.

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

G&Dsville Editors

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Arthur Young, Tensile Capital Management



**Arthur Young,
Tensile Capital
Management**

Arthur Young is the Portfolio Manager of Tensile Capital Management, a firm he co-founded in 2012. Tensile employs an opportunistic value approach to investing in the public markets, managing a concentrated portfolio and working closely with management teams to enhance shareholder value. Tensile also makes select private investments.

Editor's Note: This interview took place on January 6th, 2021.

Graham & Doddsville (G&D): Can you start by telling us about your background and how you got into investing?

Arthur Young (AY): From an early age, I've always been intrigued by numbers, puzzles, problem solving, and game theory. And if you think about it, that's what investing boils down to ultimately. It's a complex interplay of these elements along with judgment, experience, and humility. And although I majored in economics and studied markets extensively in college, I actually went to law school at Berkeley. The education, rigor, and structure that I learned there had a profound impact on how I analyze issues. But it was really during that time in law school that I realized that my passion was in investing. I probably spent more time reading the Wall Street Journal and Barron's, and

attending or auditing business school classes at Haas, than learning the law school case studies.

Armed with a law degree but also a hefty student loan balance, I was fortunate to land an offer from a well-regarded firm in my hometown of Miami. I learned and developed some critical skills working as a securities and commercial litigator that helped me down the road as an investor. Because you come in after the problem has manifested itself in some form or fashion, you learn a lot about the consequences of certain decisions, how the sequencing of events can impact an outcome, and ultimately, how things can go wrong.

You also recognize the importance of gathering your own facts and evidence, as you will, to support your case. Hearsay doesn't cut it, so if you think about what we do as investors in gathering primary research, which our process is very heavily dependent on, that's incredibly important.

Of course, the skills you develop in taking depositions and cross-examining witnesses come in handy when you interview management teams, competitors and experts. You're trained to listen to certain words and read body language. You learn to identify when management teams are being evasive. And you also learn when they have true

conviction. But I think most importantly as a litigator, you learn to respect both sides of an argument. As a lawyer, it's plaintiff versus defendant. As an investor, it's the bull case versus the bear case. And whether you're on the long side or the short side, you should respect both.

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All that said, being a commercial and securities litigator doesn't exactly lead to Fidelity knocking on your door offering you a job. Fortunately, after paying off my student loans and starting to look for opportunities, right around that time McKinsey announced that they were opening a Miami office and ramping up their efforts to recruit non-MBA graduates. At McKinsey, I was able to learn the nuts and bolts of businesses and how to work with senior management teams.

Shortly after I was

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promoted at McKinsey, Fir Tree Partners, founded by Jeff Tannenbaum, opened an office in Miami. I was the first, and really only hire in the Miami office during my two years there, which allowed me to work side-by-side with the late Andrew Fredman, who was actually a Columbia MBA; I believe he was one of the best, under-the-radar investors of our generation. His energy, bandwidth, and ability to just distill a complicated investment thesis into two sentences was amazing. Under his tutelage, I learned to do everything from capital structure arbitrage, to distressed debt investing, to short selling.

Subsequently, I went to a firm, Blavin & Co., where I learned the power of concentration and truly deep value investing.

Afterwards, I led the public equity investing effort at Blum Capital, where I was able to hone my skills in working with management teams and boards in a collaborative manner to drive shareholder value. One of the best things about my experience at Blum Capital was working with my now partner and co-founder of Tensile Capital, Doug Dossey, who leads our private equity investing at Tensile. Doug's ability to negotiate, work with management teams, and create win-wins was instrumental to our success at Blum and at Tensile as well. He's also

the ideal partner from a "devil's advocate" perspective, given his experience and natural skepticism. Blum was also where I joined a public company board, JDA Software – which was instrumental to my development in understanding the importance of corporate governance and learning about enterprise software.

G&D: What are the principles behind the origin of Tensile Capital, and what kind of value investing approach do you take?

AY: Doug and I felt that we could combine the best of our shared and individual experiences in forming Tensile Capital in 2012, and that's really the opportunity to invest on behalf of like-minded investors and institutions in an opportunistic and selective fashion over a long-term horizon. At Tensile, we have two classes in our fund – a public-only class and a hybrid class, where we invest in both public and illiquid securities. While the hybrid class's commitment is longer – seven years versus one year for the public only – the strategy and time horizon for investing is ultimately the same.

At Tensile, we have incorporated a lot of the things that I've been fortunate enough to have learned at my prior firms and combined that with our ownership mentality. Going back to Fir Tree, it's really casting a wide net and understanding that there

are a lot of different ways to look at companies, to look at different securities throughout the capital structure, to be creative in your due diligence, and to be persistently Socratic about every position that you own. At Blavin, it was a focus on deep value and concentration. And at Blum, I furthered my recognition of the power of working with management teams and boards. Thus, when you think about Tensile today, we do all of those, and none of them are mutually exclusive. It's really a value orientation we call opportunistic value, combined with concentration – and in certain instances, working with management teams and boards to drive shareholder value.

“It's really a value orientation we call opportunistic value, combined with concentration – and in certain instances, working with management teams and boards to drive shareholder value.”

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

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AY: In certain areas, particularly regulated industries, you'd be at a material disadvantage if you weren't a specialist. The advantage of being a generalist, which is how we think about ourselves, is you can apply a disciplined absolute value approach, and you can come at a problem with a perspective or proposed solution that the person who's deep in the weeds can't necessarily see because they're so focused on that particular sector.

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In addition, industries are always evolving, so you may look at one industry today that was where another one was five to ten years ago, and be able to apply what you learned there as a framework.

One example would be software. As a generalist

value investor, you can appreciate a software company growing "only" 10% organic top-line with "only" 30% EBITDA margins and very low capital intensity – to a generalist that financial profile is amazing. If you're a technology or software-only investor, you're oftentimes seeking 40%+ growth and not worrying about profitability. Situations like that enable you to cross pollinate not only your research process but also your ability to identify opportunities and calibrate them against a broader set.

One of the few industries we do not invest in is healthcare. And the reason is that every three or four years, we see a healthcare company that looks cheap. We spend a day or two on it, and then we realize that given how complicated the regulatory framework is around healthcare, as well as the fact that we're competing against healthcare investors who are between 50% to 100% focused on that sector, we're really going way beyond our circle of competency. We have invested a small amount in companies that have a recurring revenue stream from their technology sales into healthcare but aren't subject to the same regulatory risks.

We also don't do early stage technology for the same reason. And so that's how we think about being a generalist. There are areas where we think there are

advantages to being a generalist, but we also recognize that there are others where it's a disadvantage.

G&D: Can you talk to us about how you approach idea generation and sourcing? Given that you have a relatively lean team, how do you ensure that you're allocating your time to the names that really have a chance at making it into the portfolio?

AY: Given our concentrated strategy, we're really looking for the three to four best ideas a year. Therefore, the strategy necessitates an even more discerning and disciplined eye, and thus, we cast a pretty wide net. We've reviewed and back-tested our performance, and we've done a pretty good job in avoiding errors of commission. But of course, we came up with several instances of passes in situations that probably warranted more work. And part of that is a necessary byproduct of our philosophy – avoiding the permanent impairment of capital as a starting point. At the same time, you also have to acknowledge that we've been in a bull market going on 11 years now, and you wouldn't want to over-extrapolate what's happened.

We generate ideas from a plethora of sources – industry contacts, newsletters, investment clubs, screenings. We

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also generate ideas from our LP base, which consists of several former CEOs with whom we've invested behind, former business partners and other investors. We will occasionally generate ideas from our private equity practice and network.

Finally, given that we have an experienced analyst team, we've also developed an informal list of 200 to 250 companies that we're constantly monitoring. Generally, we focus on small to mid-cap companies in North America, but we also invest in other countries where we can find companies that are similar to the types of companies that we'd invest in in North America. First, these foreign companies would need to have a high return on invested capital, structural competitive advantages, and a solid management team. Second, we would need to be able to conduct the type of due diligence on the company as we would on one in North America. Third, the company would need to be trading at a substantial discount to a similar company in North America. Our main focus when we start is valuation with an emphasis on the downside case. And at the same time, in parallel, a dive on the management team not only on their backgrounds, but also on their incentives, motivations, and ultimate aspirations. In this market, the

valuation screen, combined with a view on quality of business, probably eliminates 90% of the ideas where we take a first pass. In the initial screen we're actually looking for reasons not to own it rather than to own it. If you think about it, our most precious asset is our time, and we're constantly asking ourselves throughout our process, "Does it merit more work?" And what is our ROIT (return on invested time)? Once we believe that the company is potentially ownable based on valuation and a high level view of the quality of business, we utilize a multistage process for diligence really focused on the value of the product to the customer.

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G&D: Can you walk us through your diligence process from idea generation all the way to capital deployment?

AY: I'm fortunate to work with a very talented analyst team and a former investigative journalist – Shelley Neumeier – with whom I've worked for nearly 20 years. Notably, if you were to look at our investment team's backgrounds, you'd find them to be pretty nontraditional and very diverse, and that's purposeful because of how dependent our process is on fundamental, primary, "gumshoe" research. We have people with backgrounds as management consultants, accountants, lawyers, bankers and investigative journalists. So we're confident that if we can focus on an idea at the outset that may meet our criteria, then we can do a very good job researching the company.

The first stage of diligence is really focused on determining whether we believe a margin of safety against permanent capital impairment exists. And this process starts with a detailed source document review which begins with SEC filings – we're pretty old school there. It then evolves into reviewing company transcripts, earnings releases, presentations, industry research and trade journals, conducting calls and meetings with the senior management team, and interviewing customers, competitors, business partners, and industry

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experts. We also start doing background checks on the second layer of management, researching the board of directors and corporate governance, and ascertaining the validity of the short case.

We'll also do product demos and embark on store and facility visits. And then of course we'll build a relatively high-level financial model of the subject company to sanity test a bear, base and bull case, based on the unit economics of the business. The granular model comes later in the process.

This phase of our research typically takes anywhere from a few weeks to a few months. And along that spectrum of time, it usually concludes with a decision to move forward or reject the investment idea outright. In looking back at our early-stage memos, we probably reject more ideas because we realize that the steps necessary to gain conviction for a core position are going to be very difficult, if not impossible to diligence, and the company is just not a fit within our circle of competency, more than a belief that the company is a short opportunity.

Ultimately, we may initiate a starter position, which is usually a 1% to 2% position, while conducting further due diligence—or we could place the company on our watch list.

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Over the past few years we've often thought that things were a little too expensive, but given where interest rates have gone and given the market in general, we could respect the contrary argument – and so we document those findings in a short internal memo.

If we're revisiting a company from our watch list and we're considering whether to make it a starter position because it's hit a certain price, we really immerse ourselves in further due diligence and analyses that are tailored to the specific situation.

In addition to reviewing additional documents, we'll build a much more granular model. We'll conduct a lot more store and facility visits. At that

stage, there are instances where we'll retain industry experts, and we'll attend user conferences and industry trade shows. We really dig into any thoughts that former employees may have regarding the company and the industry. We'll start our own surveys or focus groups. Existential risks are tough to diligence, but at the same time, it's something you have to be aware of. And hence, we do spend a decent amount of time researching regulatory and legal issues as well. Furthermore, to the extent we identify potential ways that we can create long-term, enduring shareholder value, we begin to explore these avenues as well.

G&D: Can you talk more about the role that Shelley Neumeier, the Director of Research who was formerly an investigative journalist, plays in the diligence process?

AY: Every analyst, myself included, has a bias. To deny that you have a bias means you're flying blind. And Shelley and our other investigative journalist's role is to help mitigate that bias. She does not really get involved in developing the initial investment thesis or the modeling, but instead, she helps us “prosecute” our thesis. She is instrumental in researching issues that could undermine our

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entire thesis, without a bias, because she's not influenced by the weighting of the different parts of our investment thesis, per se.

We have a great deal of respect for the training that journalists undergo. They are very open-minded, curious, and are not afraid to pick up the phone – rejection does not phase them. They know how to ask the right follow-up questions. They know how to read people. And that experience is critical to the way we invest.

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G&D: You mentioned your law background has helped you develop your ability to assess someone's character.

How do you judge management teams and determine if they are people you want to back?

AY: I'm not sure that it has helped assess someone's character so much as identify inconsistencies or holes in a statement or projection that gives you pause. You're never going to have a 100% hit rate, and you have to acknowledge that you're ultimately making a bet on your perception of that person. We also tend to invest in businesses that do not necessarily need the best CEOs to make the investment work.

Having said that, reference checks and an understanding of the company's culture are crucial. For instance, there was a company we were researching that had a Chief Information Officer who happened to be the son-in-law of the CEO. Shortly after we invested, the CIO was promoted to CEO – so obviously, that begged questions about nepotism.

Fortunately, we had met him previously while he was the CIO during a product demonstration at the headquarters, and were impressed by his knowledge of the business well beyond just the technology. Nonetheless, though we had a file and notes on him, in researching his background, we had to “re-underwrite” him, because obviously his role had changed and

become more significant. So we found people with whom he knew or worked, going back to high school, and learned about him as a person. We learned through talking to those people and others that he had started at the bottom and had worked his way up the corporate ladder, step-by-step. If anything, his father-in-law probably made it harder on him and gave him an appreciation for the culture of the company.

And so that type of research is not going to make your investment, and you don't necessarily invest because that is your primary thesis, but it does give you a little confidence in thinking about how the person will act in difficult situations. Are you really prepared to have him steward \$50 million to \$100 million of your investors' capital for you?

In addition to reference checks, we also like to focus on the report card rather than the student, i.e., the track record in terms of creating shareholder value, profitable revenue growth, capital allocation, and stock price performance, as well as secondary metrics such as customer satisfaction, employee turnover, safety, etc – all those metrics that you would look for that you would say are indicators of an

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effective management team or CEO and CFO that has built a great culture. That's actually the easy part. I think the difficult part, is really when you're sitting across the table from him or her, asking the right follow-up questions, trying to think through why he/she answered a question a certain way and trying to understand the competency and motives of the CEO and CFO.

Every time we leave a meeting and we say, "Wow. That was a really good meeting. The CEO's great," we take a step back, and we remind ourselves, "If the CEO didn't sound great, he or she wouldn't be the CEO." There's a reason why that person is the CEO, and so we go back to the report card – you're balancing the report card against your assessment of the person.

G&D: Once you decide you like a certain company, how do you determine how large of a position to take and how long the hold period is? And how it fits in relative to the other ideas that you have?

AY: Typically eight to twelve positions comprise up to 90% of our invested capital, and we look at every investment on at least a three-to-five-year time horizon.

At the same time, we have starter positions, which are usually 1% to 3%. And so when we're

first researching a company and reach a preliminary conclusion that it's a good business with a great value proposition to the customer, trading at a significant discount to intrinsic value, we will often put on a starter position. And the way we think about it is: just because you're utilizing a private equity approach—investing for the long term and in a concentrated fashion—doesn't mean that you shouldn't avail yourselves of the advantages of the public markets.

If you like a stock you can just buy it. And so we'll trade around the edges of certain positions and initiate a position where we're expressing a view that can't necessarily be found in our current portfolio, or where there's a near term catalyst.

“Just because you're utilizing a private equity approach—investing for the long term and in a concentrated fashion—doesn't mean that you shouldn't avail yourselves of the advantages of the public markets. If you like a stock you can just buy it.”

But in terms of making it a core position, it's really an iterative process. Businesses are dynamic and face new challenges every day. In managing a concentrated portfolio, we have both the benefit and the responsibility of knowing our companies very well. And as a result, we are always looking at where it's trading on an absolute and relative basis. That doesn't mean we just sit in front of our screens, but we're very much aware of the valuation multiples.

Therefore, in terms of increasing a position from a starter to a core position, our confidence in the thesis and in the downside protection at the beginning will dictate how aggressive we are going into the position. In this market, obviously focusing more on the upside has generated better returns, but as value investors, we want to sleep at night, understand the downside and make sure that the position is protected.

We'll scale up when there's a material positive change to our thesis, or when there's a price dislocation whereby the discount to intrinsic value is substantially greater than when we initiated the position. Selling is the exact mirror opposite of that in most cases.

G&D: How you think about cash in the portfolio? How does that

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play into portfolio management? Are you always fully invested or do you scale cash up or down based on where you think you are in the cycle?

AY: We view cash as both a hedge and as a weapon. As absolute return investors, we judge our performance on a security-by-security basis, on return on invested capital. And so, ideally, we'd probably have a 5% cash position, because we don't use leverage either – that's another consideration.

We've been as high as 20 to 25% but ultimately, our cash balance has not been a reflection of our view of the market per se, but rather just our bottoms-up view of a current situation or company. The luxury we have of being long term investors with committed capital is that we can look for those investments we think that are going to double over the next three to five years, even though there might be significant volatility in between.

We like to be opportunistic with our cash and though it has diluted our returns since inception, we believe that it is a good risk management tool.

G&D: Is there a certain threshold at which a well-performing company becomes too big a portion of the portfolio

and you'll trim it back?

AY: That's a great problem to have! We limit ourselves to 15% of cost for any one position. We wouldn't have a problem if it more than doubled, particularly if something in the fundamentals has changed for the positive.

So, we don't have hard and strict rules. But, that's where we'd probably say: even though it's really attractive, let's consider if it's becoming a little overweight here and either trim it or hedge it, subject of course to the reason why the stock has appreciated. We've never run into those limits to date at Tensile. There are instances where it has run up well beyond our estimate of intrinsic value and we'll sell it during that rally.

G&D: Let's say you've held onto an investment for a year or two and there's a new development that is pretty contrary to your original thesis, but maybe there's other points that have paid off that you didn't consider or something else that went right. How do you think about events that are very contrary to your thesis with regards to selling out?

AY: It's very situation specific, and as always, we think about it in the context of valuation. How contrary the events are to your thesis may be a matter of degree.

For example, a couple years ago, Crown Holdings, a leading beverage and food can manufacturer, went out and acquired a transportation packaging company, Signode, which was arguably a pretty cyclical company.

The existing shareholder base was outraged because it was contrary to their purpose for holding Crown – most people who owned Crown Holdings at that time did so because it was a defensive, non-cyclical stock. Beverage cans basically grow in-line with GDP.

We looked at it and said, "Well, if I was a shareholder, the first thing I'd ask is why did they do it." I could agree or disagree. But the second thing we looked at was the valuation, and what happened was the market cap collapsed to a point where you could actually buy the stock of Crown Holdings and create the acquisition that they just made for half the multiple that they had paid. In addition there were secular trends, such as sustainability and a favorable supply/demand imbalance, which we felt were being overlooked due to the angst around the deal.

We feel fortunate in that we haven't had too many surprises like that. We've had some positive developments over time. For example, our

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investment in Euronext, a pan-European exchange group with operations in 16 countries. When we first invested in 2014, the thesis was largely predicated on an off-the-run, under-the-radar spinoff that would benefit as an independent entity in driving margins through cost-cutting and other efficiencies. Since then, the company has demonstrated an aptitude for expanding its platform via acquisitions and has consistently delivered synergies above expectations.

In terms of facing developments that are really contrary to our theses, we want to approach management with a very open mind and hear their rationale, while also wearing that prosecutorial hat. And I think the times where an unexpected development resulted in us selling were more because we didn't believe the management team.

Thesis creep is a matter of degree and something that we're hypervigilant about. At the same time, if we have invested in a company after the amount of research we've done on both the company's strategy and management team, we do want to give them a little leeway in explaining why an acquisition makes sense, why they decided to divest a certain division, or why they entered into a certain partnership. Ultimately, if an

unexpected development does impair your thesis, the action itself may not be what undermined your investment thesis. It was your assessment of the management team.

“Thesis creep is a matter of degree and something that we’re hypervigilant about... Ultimately, if an unexpected development does impair your thesis, the action itself may not be what undermined your investment thesis. It was your assessment of the management team.”

G&D: Can you talk about your views on software investing?

AY: I started studying software around 2009. At the time, it didn't fall under the traditional value bucket due both to the stigma around technology in the value investing world, as well as accounting conventions that didn't really express the efficacy and scalability of the business.

After spending months studying software companies, largely by interviewing several people in the software ecosystem, I was really

struck by the power of the business model—and mainly the fact that the customer relationship and high switching cost of the product for a mission critical software company is ultimately the asset.

We've invested in several software companies over the last decade. Though we've had a few that would be considered high-flying SaaS companies, we've really had three eras of investing in software.

I'll start with what I call our 1.0 strategy in software. These were companies that were simply great businesses, not ascribed proper multiples, and were dislocated for one reason or another. We invested in two of them at my prior firm: Tyler Technologies, which drew down due to an analyst's prediction of a looming municipal bond crisis, and JDA Software, which was hit with a jury verdict for damages equivalent to nearly twenty percent of their market cap.

The next iteration of that, our 2.0 strategy, was around the 2012 to 2015 timeframe. That's when we found many companies that were growing 30% a year and spending a ton of money on marketing, suddenly hitting a wall in growth.

They were growing “only” 12 to 15% a year. Despite the slowdowns, often these management

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teams would continue plowing money into S&M and R&D with no real return, trying to grasp at what had become an ephemeral 30% growth rate. Oftentimes that growth isn't realistically achievable due to competition, a shrinking TAM or a simple law of large numbers. Also, by proving out a market, a company may not be able to quite capitalize on that first mover advantage since it actually attracts more experienced and better-capitalized competition.

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In this case, as a value investor, you're seeing zero profitability, and as a high growth software investor you see the ultimate death knell in your framework – slowing growth. So these “orphaned” software stocks fit neither the growth nor the traditional value investing bucket. But a lot of these companies could easily get to 30 to 40% cash flow margins and maintain up to 12 to 15% growth, which is a terrific business, so that was really our software 2.0 strategy, which

included Informatica.

Our software 3.0 strategy started in 2014. Obviously, there's a little overlap with 2.0, but our 3.0 strategy is based on transitions from a perpetual license model to a subscription model as well as long-term compounders. Examples of the former include Aveva, PTC and more recently, Software AG. When you successfully execute that transition, the economic value of this recurring revenue stream is tremendous.

G&D: Can you walk us through an example of a high conviction software idea?

AY: Sure, let's talk about Avalara, which is currently our largest holding. Avalara essentially solves the problem of tax collection and remittance for small and medium businesses through software and automation. We see it as more of a service business than a technology business. Though they started in a specific niche – sales tax calculation – the company is now positioning itself to be a full-blown platform for compliance across the globe.

We studied Avalara pre-IPO and were impressed by the fact that the company addressed the increasing need for mid-market businesses to automate transaction tax compliance, had a large, addressable and

unpenetrated TAM, and was continuing to widen its moat by leveraging its content base and vast network of partner integrations.

We initiated our position shortly after the IPO due to two things. First, there was a short report that came out that led to a drawdown in the stock. Second, the Supreme Court issued a ruling, *South Dakota v. Wayfair*, which basically redefined the term “economic nexus”. The decision overturned a 1992 ruling, *Quill v. North Dakota*, thereby effectively enabling states to collect income tax from out-of-state sellers.

Prior to the Wayfair decision, if a company was selling online to residents in 45 states with headquarters in Washington and only one distribution center in Nevada, the company only had to file and pay sales tax in those two states, because *Quill* had effectively defined economic nexus as a physical presence. But *Wayfair* redefined that and said a state can actually collect taxes from an out-of-state seller, regardless of a physical presence, based on a reasonable economic threshold, whether it's the number of transactions or the dollars. In fact, in delivering the majority opinion, Justice Kennedy even referenced software as a practical difference between

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today and 1992, when *Quill* was issued.

So once we saw that occur, we realized that this was going to exponentially expand the company's TAM over several years due to the time it would take for states to roll out programs and implement enforcement. At the extreme, you would have a company that originally only had to file in one state eventually having to file in every state that calculates sales tax.

In addition, shortly after investing, founder Scott McFarlane hired three pedigreed and experienced senior executives. With founder-led software companies you often have a founder and core team that grew the company to 250 million in revenues. But as a company tries to scale up to a billion in revenues, it needs a different skill set. A founder (and the board) isn't likely to replace himself or herself, but you'd at least want him/her to hire great people, and that's what Scott (CEO & Co-Founder) did.

So, because of that, we felt that the company had a much longer runway, and they were really planning for the long-term and an even greater opportunity going well beyond sales tax. As a margin of safety, the company's retention rate was in the high 90s due to the mission critical nature of the software and the difficulty in switching as

they were ultimately competing with paper-based systems.

And so, from a downside perspective, we were very comfortable initiating our position at about \$30 a share. It's run up substantially and we've done some portfolio management around the position, but we think it's one of these compounders that's going to be here for the next decade and continue to grow over 25% for the foreseeable future.

“As a margin of safety, the company's retention rate was in the high 90s due to the mission critical nature of the software and the difficulty in switching as they were ultimately competing with paper-based systems.”

G&D: With a company like that, that still has plenty of runway left trading at >20x NTM revenue, how do you think about valuation? How many years out are you looking?

AY: There's certainly a difference between Avalara today and when we first bought the stock. When we first looked at the company, we focused on the fact

that it's a very high gross margin business with a very sticky product and a large and underpenetrated TAM. We did a lot of work calling different departments of revenue around the country, attending sales tax conferences, and immersing ourselves in this ecosystem of sales tax accountants and compliance experts. As a result, we felt that this management team was making the right move in reinvesting every dollar in sales and marketing, and R&D, given it was essentially a land grab.

As value investors, we looked at the company and thought about their sales and marketing and R&D as essentially growth capex given the high switching cost and value to the customer. Essentially their investment capital sat on the income statement rather than the balance sheet.

And so, as we got comfortable with the product, we surmised that we have a company that three to four years from now should do \$600 million of revenue, and it could continue to grow at ~30%. With a lot of favorable tailwinds, even if they choose not to aggressively spend to grow 30%, they could grow 15% and given the high gross margin – which incidentally should improve due to the integration of an AI company that they had

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acquired – print 40 to 45% cash flow margins almost in perpetuity. It was a no-brainer, valuation wise.

Now, in terms of where it sits today, it is absolutely more expensive. Part of the multiple expansion is justified because they've actually grown faster than they've guided, but more importantly, they've really expanded their TAM and they've also made a couple very good acquisitions, as they position themselves to be the leading multi-product compliance as a service platform. They've not only increased the number of integration partners, but they're starting to go up-market to the enterprise space, while also expanding into other types of compliance such as insurance tax, certificates and e-invoicing, and internationally as well.

Their profitability from a long-term perspective will be greater than we originally modeled, and their white space is wider than we first looked at it. And so, as we sit here today, it looks like it's trading at 15x FY2022 revenue (2 years out) which is still expensive in vacuum. But in a high growth company like this – where the market opportunity is virtually assured – you're buying down that multiple, and while we use EV / EBITDA – Capex and EV / FCF for all of our companies, we also make adjustments based

on what we think the company should earn or what type of free cash flow they should generate if they were growing at various rates, i.e. what should the multiple be if they chose to turn off that growth spigot. Again, we look at it on a three to five year horizon and we think it will continue to generate a solid IRR over that period.

G&D: Does Tensile do any sort of constructive activism with Avalara given that you own a sizable minority position?

AY: Avalara's an example of how we are selective in our approach, as there's really no reason to do so in this case. The management team's done exactly what we would want them to, as they proactively went out and made senior management hires in anticipation of opportunities, reinvested in the company and expanded into adjacent markets that are synergistic and accretive. The way their strategy has evolved completely makes sense to us. I remember a conversation with Scott (CEO & Co-founder) a few years ago where I said, "I'd probably sell half the companies in our portfolio if I could get a 50% premium on them tomorrow. But if a PE firm or strategic came in tomorrow and offered a 50% premium on Avalara, we would not want you to take that deal." We've probably

done as much work on Avalara as any company in our portfolio, and we've had plenty of interaction with the senior management. But at the same time, we're pleased to watch them execute their plan against that long runway they have ahead of them.

G&D: Can you walk us through a non-software name in your portfolio?

AY: Sure. Valvoline was a spinoff from Ashland in 2016 and would fall under more of the traditional value bucket. Today, it's trading at around the same price at which it spunoff, despite what we think has been terrific operating performance. It's headquartered in Lexington, Kentucky, and does over \$2.4 billion in annual sales with a 20% adjusted EBITDA margin. It has a market cap of approximately \$4.3 billion. The company trades today at approximately 9x forward EBITDA and 14x earnings.

Now, when you think of Valvoline, you think of the brand that you see on TV, in stores such as Walmart and Advanced Auto Parts, and now the DieHard battery with Bruce Willis. But the crown jewel of the business and what our thesis is predicated on is the quick lubes business, or VIOC (Valvoline Instant Oil Change).

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We're fortunate to be able to study these businesses via our private equity network given the sheer amount of mom and pop businesses that are involved (most of them are privately held).

“We're fortunate to be able to study these businesses via our private equity network given the sheer amount of mom and pop businesses that are involved (most of them are privately held).”

The VIOC business is approaching 50% of the company's EBITDA. The company entered this business in 1985 and today services about 18 million customer visits per year across its 1,500 stores. When VIOC was buried within Ashland, they hardly grew it, despite the fact that it was a really good business. VIOC has never had a down year in same-store sales: they did 4.4% in 2008, 6.8% in 2009 and they did 2.3% this past fiscal year, even with COVID.

A VIOC box has terrific unit economics—it does over 45 transactions a day with an average ticket around \$80, and typically an owned unit investment of 1.5 million creates high teens cash IRR. A VIOC franchise costs about \$150,000

with about 30% cash IRR, and we estimate 4-wall EBITDAR margins start in the low-twenties.

Now since the IPO, they've had a revenue CAGR of 15% and they've added over 400 stores. We believe there's a lot of runway as well despite the obvious and looming threat of EVs. In the United States, there's about 450 million DIFM, or “do it for me” oil changes per year—VIOC is number two, but they still only have a 4% market share, so it's a very fragmented market.

When you put it all together, we believe it compares very favorably to retailers that trade at significant premiums to the implied multiple of VIOC. Auto retail peers such as O'Reilly or AutoZone, comp at low to mid single digits with 17 to 22% margins, while VIOC comps in the high single digits with higher margins. While the entire Valvoline company trades at 9x, even if you ascribe a 6 to 7x multiple to the other cash cow business lines, the Core North America and International segments which produce and distribute the Valvoline oil brand, the VIOC segment is very cheap.

But you could go further and say, “Well, their numbers are not only better than auto retail peers, but even other retail peers.” We comped VIOC against what we would call “growth

retail”. Typical growth retail peers trade at about 21x EBITDA, with an EBITDA margin of ~18% and same store sales growth of ~12%.

So you have this terrific business that's buried within Valvoline today. The question is how do you catalyze the value? Even though there are synergies, you could spin off or sell Core North America to highlight the value of VIOC. You could also focus more on franchising, rather than owning, the VIOC stores. Moreover, Driven Brands just recently IPO'd. Driven Brands's numbers are not as good as Valvoline Instant Oil Change—lower comp stores sales and lower margins and VIOC outperformed Driven Brands during COVID. However Driven Brands is currently trading at >20x PF EBITDA. And thus, the IPO and resulting increased coverage should highlight the significant discount to intrinsic value at which Valvoline is trading.

The other reason why it trades where it does is due to sell-side coverage. You have analysts whose primary sector coverage range from headline retail to chemicals to consumer packaged goods companies to auto retail. I've never seen such a hodgepodge of analyst coverage.

A lot of these analysts

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are good, but Valvoline is being comped against everyone from Advance Auto Parts to Ollie's Bargain Outlet, Clorox, Helen of Troy, Estee Lauder, Berry Global and Ashland. You'll see a chemicals analyst saying, "Why would I invest in Valvoline when I could invest in this chemicals company for six times EBITDA?" They would be overlooking the crown jewel of Valvoline Instant Oil Change. You'll see another analyst saying, "Why would I invest in Valvoline when they have this really boring supposedly cyclical oil business, when I could be investing in Ollie's Bargain Outlet?", while ignoring valuation. It's in no-man's land. But we think the Driven Brands IPO, along with continued execution of the Valvoline Instant Oil Change business and better capital allocation should ultimately be positive for the stock.

G&D: How do you think about their competitors in the market? Is Valvoline doing some sort of roll-up strategy? And how do you think about disruption from EVs?

AY: They're the number two player in the market with 4% share. Number one is Jiffy Lube, and their market share is only slightly higher than Valvoline's; it's a very fragmented market.

EV's are accelerating no doubt, but if you look at how long it will take for EV's to make a material

difference to the car parc, it's going to be several years. If Valvoline had 50% market share, you'd be a lot more worried. But given their inherent advantage against the small players, we think they have a long runway, even with EV's.

"We invest in disruptors, but not that frequently. The times we have, the disruptor has probably been further along in maturity than an early stage growth investor would invest in it. The disruptors that we've invested in usually have a business model where it's not necessarily dependent on underlying technology, but rather the ability to leverage a service."

In terms of store growth, they've made two large acquisitions recently and are guiding to acquiring, building or franchising 140-160 this year, which we think is actually a bit light. Valvoline essentially offers a drive-through oil change. The typical process of an oil change is such that you drop off the car, go to a

booth, fill out a form, wait in the waiting room, and then they put your car on a lift. You may or may not leave for a few hours with a loaner. With Valvoline's drive-through, you stay in the car while they change the oil from a pit underneath the car, rather than on a lift. The benefit of this during COVID is, they already have a process in place where you don't need to get out of the car – the employee approaches the car wearing PPE, you lower the window, pass him your credit card, have the oil change done, and then you go. During the height of COVID, the last thing you are going to do is get an oil change at a place where you're unnecessarily put yourself at risk.

G&D: It seems like with EVs there's maybe some disruption in the industry that investors are overemphasizing. You also invest in disruptors yourself, so how do you balance that analysis of investing in the disruptor vs. looking at a space where perhaps the threat of disruption is overstated?

AY: We invest in disruptors, but not that frequently. The times we have, the disruptor has probably been further along in maturity than an early stage growth investor would invest in it. The disruptors that we've invested in usually have a business model where it's not

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necessarily dependent on underlying technology, but rather the ability to leverage a service, more than anything else.

If you think about Avalara, it's really a service business – it's very understandable to us and the unit economics are sensible. They calculate taxes for you, and then they do the filings. The reason why it's a disruptor is the need is already there, they're not creating it, and taxes will be around forever. You can absolutely have a great company that creates a new need and capitalizes on that. But for us, when the need is already there, it is easier to understand and forecast as a value investor.

“Being on the other side of that, because we’re contrarian by nature, we find companies that are supposed to be disrupted but are actually positioning themselves to not only bolster their position but capitalize on the very trends that are supposed to impair their business”

Being on the other side of that, because we're

contrarian by nature, we find companies that are supposed to be disrupted but are actually positioning themselves to not only bolster their position but capitalize on the very trends that are supposed to impair their business – for example, Dick's Sporting Goods. We invested in Dick's a year or so after Sports Authority had liquidated, so Dick's was coming off what was perceived as a one-time boost and analysts were worried that Amazon would disrupt the sporting goods industry. Though that had been the case with a lot of brick and mortar retailers, we had a completely different perspective based on several research observations.

First, we mapped out the industry – literally with regard to store footprint. And the fact that the Sports Authority had gone out of business, and the fact that their number two competitor at the time was over-leveraged bode well for Dick's Sporting Goods – they would be the survivor. The second thing we liked about Dick's at the time was they had a rock solid balance sheet. Now, having a strong balance sheet over the last decade has not been rewarded as an investor, but given our ethos, it gives us the ability to sleep at night, and we recognize that there's always going to be unknown unknowns and also existential risks that you can't diligence, so the balance sheet,

particularly for a company that is presumed to be disrupted, gives some comfort.

The other thing that we liked about Dick's Sporting Goods was we had seen this movie before.. Best Buy had actually fended off Amazon in consumer electronics at that time, and had laid out a playbook where a brick and mortar in a particular category could succeed. So Dick's had the advantage of learning the plays that worked for Best Buy such as price matching, as well as the plays that didn't work.

As we reviewed all of the old 10Ks, we noticed that they started changing their lease terms probably about 10 years ago, which suggested to us that there were a lot of leases expiring between 2019 and 2021. Given the duration of those leases, we realized very quickly that they were probably signed at the top of the market which was confirmed by our bottom-up analysis of their properties which included calling local commercial real estate agents. So they had this margin cushion, just based on renewing the leases, or being able to leverage their position with struggling landlords.

We said, "Okay, the space is being disrupted but actually, Dick's Sporting Goods is going

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to be the survivor and should ultimately be the 800 lb. gorilla in the space." Dick's has done well ever since, because their CEO acknowledged that they were behind on their e-commerce and he also acknowledged that they had to move fast. If you looked at Edward Stack (the CEO), you might put him in this bucket of, "Oh, this is a person who doesn't get it. He's been around since the 1980s." And you'd almost use that bias against him, given his age. But the fact that he was so open-minded and recognized both the threat and opportunity in front of him, was a good indicator as well.

And so now, they've thrived during COVID because they had recognized their shortcomings in e-commerce a couple of years ago and were very well-positioned when COVID hit. Their e-commerce sales, which now exceed \$2 billion, was up 95% in the last quarter, and they have a thriving, high gross margin private label business. They're really capitalizing on the buy-online, pickup-in-store model, and they should see a bounceback with team sports as we come out of COVID.

G&D: How do you view the current macro environment of the market, especially now that there is promising news on COVID vaccines? How has this period in the markets been similar to or different from other

periods of volatility that you've seen throughout your career, and how has that affected your views on portfolio construction?

AY: When you're in the moment, whether it was the 2015 Greek financial crisis or other bouts of volatility that have occurred over the last several years, you think, "Oh my goodness, this is unprecedented." And this heightened volatility is something that is difficult to wrap your arms around.

But then when you take a step back, and you reflect on the last decade you realize, "Well, there really hasn't been *that* much volatility." When you view it top-down over the last decade, obviously March 2020 was very volatile. This period is very unique, because I've never seen such a bifurcation between markets and the economy.

Just like the underlying economy, in terms of stock price performance, you basically have 1) the disruptors – the digital companies that have thrived, and 2) nearly everyone else. And the question you have to ask yourself as an investor is: are there companies in that second bucket that will thrive in a post-COVID environment? These are companies that may not have had four years of growth and adoption pulled forward.

We're not macro economists, but we obviously follow global macro and political developments on a daily basis. The extreme outcomes of our macroeconomic view are factored into our analysis. But for the most part, we think about the macro more from a top-down portfolio construction perspective than we do from a bottom-up company-by-company basis.

"The question you have to ask yourself as an investor is: are there companies in that second bucket that will thrive in a post-COVID environment? These are companies that may not have had four years of growth and adoption pulled forward."

We're evaluating each security and investment on a standalone basis, but we also don't want to end up with a portfolio where, because we think home builders are great, we own six home builder companies.

From a risk management perspective, having a concentrated portfolio for a long-term period, we're able to do overlapping analyses in terms of industries – not

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the traditional SIC code overlap, but literally on a segment-by-segment, geography-by-geography and market-by-market basis.

What that leaves us with is a portfolio that has a few very macro sensitive companies – though with strong balance sheets – as we are constructive on a sharp, post-COVID bounceback in travel and experiences in particular. We own an airline that obviously had a tough 2020, but it's actually the best capitalized airline, with latent earnings power from its frequent flyer program.

An example of how we factor-in the macro environment on a company-by-company basis is Avalara. When we first underwrote it, we thought that the Street was overweighting the cyclicity of the company: presumably, since Avalara is tied to the collection of sales tax, it should suffer in an economic recession since people spend less money.

What's interesting though is Avalara gets paid roughly on a per transaction basis, in tiers. We had a completely opposite view: we studied credit card data over the last several cycles and recognized that in a downturn, consumers do spend less money but the number of transactions actually doesn't decline substantially because

what happens is consumers spread out their purchases. The consumer, instead of shopping only at Safeway or only at Whole Foods, is now suddenly buying their paper towels and milk at Walmart, their meat at Safeway, and their liquor from Bev-Mo.

We also learned that in downturns, the revenue base of state and local governments declines due to lower income tax and property tax receipts. And as a result, they need to pull more from sales taxes, and they actually increase their enforcement of sales tax collection, which is one of the triggers for somebody to purchase sales tax software and start filing returns. Ultimately, when we looked at Avalara we spent a lot of time on that from a macro perspective and if anything became even more constructive on the company.

G&D: How does the private equity side of your business influence your thinking on the public side?

AY: Our private equity side has a very accretive and valuable impact on our public equity investing. While our strategy is primarily public equity-focused, we have the flexibility to execute private equity investments and invest up to 50% of our hybrid class in such investments. One big difference between us

and a traditional private equity fund is that once we make the investment, it is side-pocketed – there's no pressure to deploy capital in private investments to raise another fund, as the hybrid fund is evergreen. Thus, we can wait for that fat pitch while our capital is working in the public markets.

“We think that being able to invest in the private markets and anywhere in the capital structure makes us better investors because we want every single investment in the book and every prospective investment to compete for capital.”

We think that being able to invest in the private markets and anywhere in the capital structure makes us better investors because we want every single investment in the book and every prospective investment to compete for capital. We want them to compete for the precious capital that our investors have given us the privilege of stewarding, and by having that window into private equity, that

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enables us to raise the bar.

A great example of this was our investment in Keraben Grupo, a leading family-owned manufacturer and distributor of floor and wall tiles headquartered in Spain. We had over a decade of knowledge and experience in the industry from our prior public equity investment in Mohawk.

That helped us get up to speed and position us well versus some of the competing bidders, but it was ultimately my partner Doug's ability to work with the family and lead a highly complex restructuring of Keraben's debt and equity that created a great entry point, valuing the company for approximately 4.9x EBITDA. By contrast, at that time, Mohawk was trading at 11.5x. Though we weren't going to buy Mohawk anyway, Keraben had to essentially "compete" for that capital.

Over the ensuing two years, we led an aggressive turnaround plan and sold non-core assets, and the management team grew revenues well above plan. EBITDA margins expanded from the mid-20s to the mid-30s, and so we exited just short of a three-year holding period. And between the increase in EBITDA and multiple expansion, we yielded a >6x return.

And so we have those instances where we're looking at a public company and see it's trading at a lower multiple on the private side and we have relevant industry expertise from our public company experience. On the flip side, for a public company investment like Valvoline, most of the field work that informed our view on unit economics was through private equity.

"Given the bull market we've been in, I can't tell you how many pieces I've seen regarding how to find a successful multi-bagger or a disruptor. Those are terrific, but you should also be focusing on mistakes and why investments didn't work out. And in this bull market that we've been in, I think there's been a lot lost there."

G&D: What advice do you have for students interested in a career in investing?

AY: When I reflect on my career and those of others whom I've been fortunate to meet and know through investing,

there are some common themes.

One is to eliminate distractions and block out the noise. A lot of firms that struggle do so not because of their investing but because of everything that's going on outside of the investment process – firm politics, status, envy – don't get caught up in any of that. Just put your head down, focus, and work on your self-development.

Second, develop an investment philosophy that not only capitalizes on your skills but also fits with your personality and psychological makeup. If you're patient, love to dig, get excited when you have a contrarian view in anything (whether it's politics, sports teams, or stocks), you should probably gravitate towards being a long-term value investor. If you love watching the markets on a constant basis, you're intrigued by geopolitical developments, then maybe macro is better. But just be honest with yourself.

Third, study bear markets and unsuccessful investments not only as much as, but more than your successful case studies. Given the bull market we've been in, I can't tell you how many pieces I've seen regarding how to find a successful multi-bagger or a disruptor. Those are terrific, but you should

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also be focusing on mistakes and why investments didn't work out. And in this bull market that we've been in, I think there's been a lot lost there.

Fourth, expand your horizons beyond traditional investing. Whether it's taking a history class on World War II strategy, doing a stint as an Uber driver, getting a master's degree in philosophy, reading Ben Franklin's biography, the beautiful thing about investing is that it's a discipline where not only is knowledge power, but one where a unique perspective, assuming your perspective is correct, can lead to exponential returns.

And you find that a lot of those perspectives, the ones that are truly unique, come from outside the field of traditional investing. I also believe that as a long investor, having experience shorting and having experience being on a board or even as an observer or at a private company, is very helpful.

Bringing this full circle to the legal side, there's a reason why a lot of the most successful defense attorneys started their careers as prosecutors.

The last thing is to make sure you're truly passionate about investing. Investing is a highly competitive field, and unlike a lot of professions where you

can make a good living being average or maybe even subpar, in this field that won't cut it in the long-run. You're going to get kicked out if you're subpar or even average. If you view it as work, you shouldn't be in this field. It should be fun and it needs to be your passion because those people that you're competing against on the other side, it's their passion.

G&D: What do you like to do outside of investing?

AY: I've always been involved in coaching my kids' sports teams. By next year I'm going to have two of my three in college, so that should free up some considerable time. I have done some philanthropic work and served on a few charity boards in the past, and I recently joined a board at my alma mater.

I also enjoy exercising and like to hike with my wife Stephanie. I also like to read – when I was younger I'd assiduously seek out and devour virtually every investment book I could find. Recently I've been going farther afield.

G&D: Thanks so much for a great interview!

DXC Technology (NYSE: DXC) - Ongoing Turnaround - LONG 2021 Artisan International Value Stock Pitch Challenge - Winner

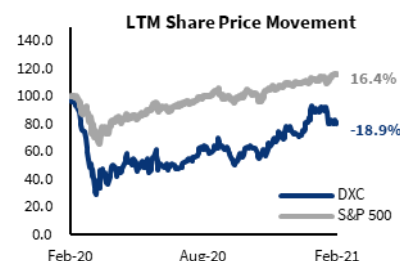


Amitaabh Sahai '21

Amitaabh is a 2nd year MBA student at CBS and a member of the Value Investing Program. Over summer 2020, Amitaabh interned at Citadel covering technology stocks. 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 teams in New York and London. Amitaabh is currently interning at Coast Capital, an activist and event-driven hedge fund.

Amitaabh Sahai
ASahai21@gsb.columbia.edu

| Trading Stats (as of 12-Feb-21) | Financials (FYE Mar) | FY20A | FY21E | FY22E | FY23E | |
|---------------------------------|----------------------|----------------------|--------|--------|--------|--------|
| Share Price (\$) | \$25.71 | Revenue ex-HHS | 18,063 | 16,783 | 17,425 | 17,743 |
| Market Cap (\$ Mn) | 6,541 | Growth % | (6.8%) | (7.1%) | 3.8% | 5.7% |
| Net Debt | 2,639 | Adj. EBITDA | 3,041 | 2,222 | 2,556 | 2,759 |
| EV (\$ Mn) | 9,180 | EBITDA Margin % | 16.8% | 13.2% | 14.7% | 15.6% |
| 52-Week High | \$31.00 | EV / EBITDA | 3.02x | 4.13x | 3.59x | 3.33x |
| 52-Week Low | \$7.90 | Adj. EBIT | 1,739 | 823 | 1,358 | 1,599 |
| 1-Month ADTV (\$ Mn) | 91.1 | EBIT Margin % | 9.6% | 4.9% | 7.8% | 9.0% |
| % Free Float | 99.2% | Adj. EPS | 5.61 | 2.27 | 3.67 | 4.36 |
| Short % of Float | 2.9% | Price / EPS | 4.6x | 11.3x | 7.0x | 5.9x |
| EV / NTM EBITDA | 3.65x | Levered FCF (LFCF) | 1,765 | 770 | 886 | 1,322 |
| Price / NTM EPS | 8.11x | LFCF Yield to Equity | 27.0% | 11.8% | 13.5% | 20.2% |



Investment Thesis:

Recommendation to long DXC Technology ("DXC" or the "Company") with a 3-yr target price of \$70 (2.72x money multiple, 39.6% IRR), due to (a) ongoing earnings stabilization led by the new CEO appointed in September 2019, (b) undervalued Luxoft segment which represents a \$5 Bn valuation opportunity, and (c) attractive current valuations given DXC's earnings stabilization and asset-light, cash generative operations

Business Description:

DXC is a provider of outsourced IT services to clients primarily in the US and Europe. Key services include IT infrastructure outsourcing, IT applications outsourcing and software engineering services. The Company was formed following a merger of CSC and HPE (HP Enterprise Services) in April 2017, and subsequently renamed DXC. Following the merger, the Company faced three years of sequential decline and the share price plunged from its highs of \$107.31 in Mar-18 to \$32.48 in Sep-19. The Company appointed a new CEO in Sep-19 (Mike Salvino) who is catalyzing a turnaround, led by stabilizing earnings, streamlined operations and a healthy balance sheet (by divesting three non-core businesses and using proceeds to pay down debt).

Key Investment Factors:

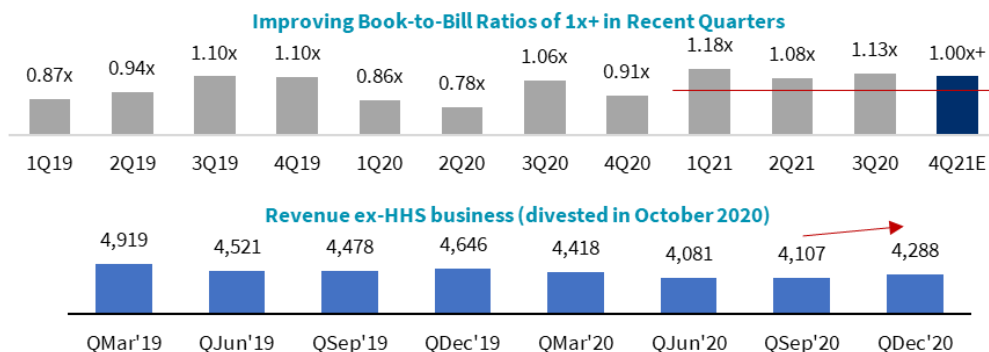
Global spend on IT services is vast at \$1 Tn growing at ~4%; market is overly bearish on core TAM

- Global spend on IT services is vast at \$1 Tn and growing at ~4-5% p.a led by strong demand for digitization and tech-enablement
- DXC's core services of legacy IT infrastructure outsourcing is a mature and declining industry (as clients move to the cloud and automated solutions which require less manual labor)
- However, the industry is declining at low single digits as compared to DXC's historical decline of high single digits (which was due to DXC-specific issues around poor client service delivery)
- This greater-than-market decline is fixable by DXC, and the new CEO has focused on improving client relations and winning new business (which are both showing strong green shoots of a recovery)

"Our revenue run-off was **not caused by cloud trends**...instead, this run-off was due to **suboptimal customer delivery and weakening relationships**...The good news is that this problem is **absolutely within our control and fixable**."
- Mike Salvino, new CEO, QMar'20 earnings call

New CEO (Mike Salvino) is catalyzing a turnaround and earnings stabilization

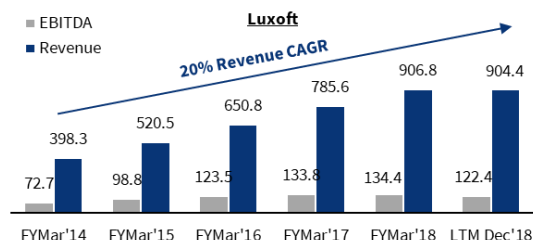
- Mike Salvino comes from a background at Accenture (where he stabilized their Operations business)
- At DXC, Mike has divested three non-core assets for total cash proceeds of \$4.1 Bn (at ~12x EV/EBITDA) and used the proceeds to paydown ~\$3.5 Bn of debt
- As a result, the Company's net debt / EBITDA ratio has decreased from 2.4x in Sep-20 to 1.2x in Dec-20
- Furthermore, he has renewed client relations with 38 of the 40 most troubled accounts by making personal visits to the CIOs and ensuring high service quality through any disruptions caused by COVID-19
- Since his appointment, the Company has maintained a book-to-bill ratio of 1x+ in the last three quarters and earned its first quarter of sequential revenue growth in QDec'20 (growing ~4% QoQ)



DXC Technology (NYSE: DXC) - Ongoing Turnaround - LONG

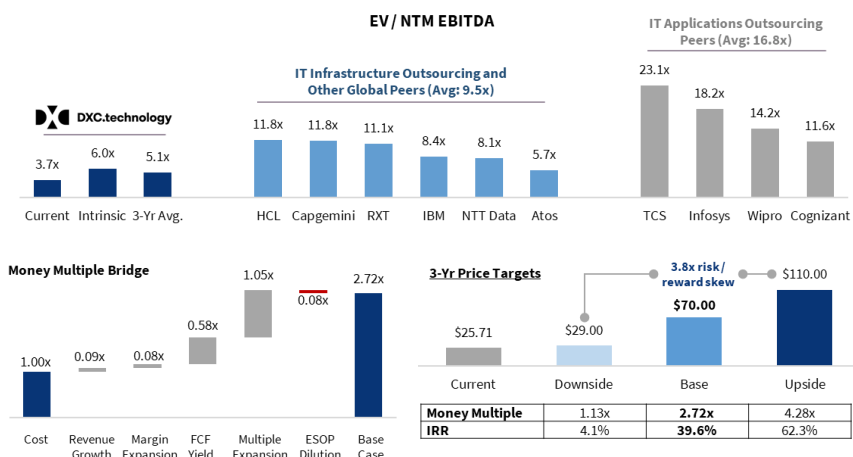
The market is not valuing the Company's rapidly growing and highly valuable Luxoft segment (\$5 Bn opportunity)

- Luxoft is an Eastern Europe based provider of high-end software engineering services (clients include DB, UBS, Mercedes Benz etc.)
- The TAM for Luxoft's services is sized at \$150 Bn and growing rapidly at 15% due to strong client for software enablement, digitization and technology enablement; between FYMar'14 and LTM Dec'18, Luxoft grew at a 20% CAGR
- DXC acquired Luxoft in January 2019 at ~15x EV / EBITDA
- Luxoft's peers (EPAM, Globant, Endava) are currently trading at ~33x EV / EBITDA; assuming a ~\$150 Mn EBITDA for Luxoft (6% of DXCs total EBITDA), this would imply a valuation of ~\$5 Bn for the segment alone (for reference, DXC's total EV is only \$9.2 Bn)



Current valuations are highly attractive for a stabilizing company with asset-light, cash generative operations

- Following the debt paydown in October 2020, DXC is now trading at **3.7x EV / NTM EBITDA** and **8.8x Price / NTM Levered FCF**
- This is at a deep discount to both (a) trading peers and (b) intrinsic / historical valuations
- My base case valuation for the Company is at 6x EV / EBITDA (in-line with low-growth peers such as Atos, IBM and NTT Data)



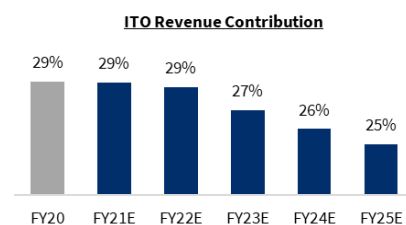
Returns Overview:

Exit Date: Dec-23 (~3-yr holding period)
NTM EBITDA: \$2,781 Mn (NTM as of Dec-23)
Base Case Exit Multiple: 6x EV / NTM EBITDA
Base Case Price Target: \$70
Upside Case Price Target: \$110
Downside Case Price Target: \$29

Risks and Mitigants:

Decline in core IT infrastructure outsourcing (ITO) business

- DXC's core IT infrastructure outsourcing services is a mature and declining industry
- However, the industry is declining at low single digits as compared to DXC's historical decline at high single digits
- High single digit decline for DXC was due to company-specific issues under the previous CEO that are now being rectified by the new CEO: client traction is improving as evident in strong recent deal wins (especially within DXC's ITO segment)
- Lastly, IT infrastructure outsourcing accounted for ~30% of DXC's revenues in FYMar'20, down from 50%+ in prior years when DXC's share price decline began; my base case expects this segment to decline to ~25% of revenues in the next four years

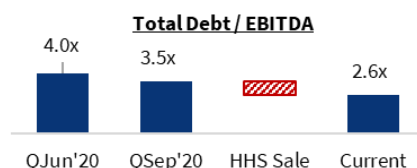


Key man risk around new CEO

- New CEO's compensation has been structured with 'golden handcuffs'
- 91% of the new CEO's salary is based on performance-based incentives:
 - 51% in performance-based RSUs
 - 22% in time-based RSUs to ensure longevity
 - 18% in cash incentives based on meeting EPS and free cash flow incentives

Leverage risk: high debt balance can result in declining FCF and potential Ch. 11

- This was historically a risk for the Company
- Post \$3.5 Bn debt paydown from recent sales, total debt / EBITDA has decreased from 3.5x on Sep-20 to 2.6x on Dec-20
- DXC now has a net debt / EBITDA ratio of 1.2x and total debt / EBITDA ratio of 2.6x
- Base case assumes that debt balance will continue to decrease as the Company generates levered FCF (~10% yield currently), and that management will soon reinstate its shareholder return policy (expected in mid-2021)



Quality of earnings risk: large bridge between adjusted and reported numbers

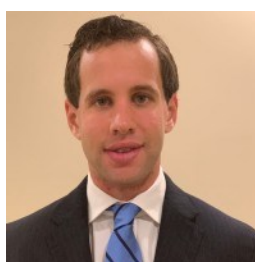
- Base case assumes that certain cash charges continue into the medium-term as DXC executes on its turnaround plans
- Base case valuation and returns are calculated on reported levered cash flow basis, net of all cash adjustments

Live Nation Entertainment, Inc. (NYSE: LYV) - Long 2020 Darden at Virginia Investing Challenge: COVID-19 Recovery



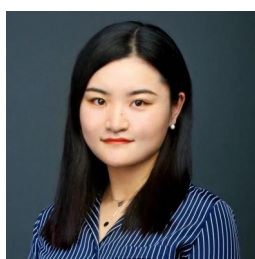
Will Husic '22

Will is a 1st year MBA student at CBS. Prior to CBS, he worked at Point72 Asset Management covering healthcare equities. He started his career as an Investment Banking Analyst at Deloitte Corporate Finance LLC (formerly McColl Partners).



Harrison Liftman '22

Harrison is a 1st year MBA student at CBS. Prior to CBS, he worked at L.E.K. Consulting, focusing in the private equity practice. Harrison graduated magna cum laude from Brown University with a BS in Applied Mathematics - Economics.



Cathy Yao '22

Cathy is a 1st year MBA student at CBS. Prior to CBS, she worked as an M&A banker at UBS Securities, and later as a strategic investor at KE Holdings, Inc. (NYSE: BEKE).

Will Husic
WHusic22@gsb.columbia.edu

Harrison Liftman
HLiftman22@gsb.columbia.edu

Cathy Yao, CFA
MYao22@gsb.columbia.edu

Trading Information (\$mm, mm except per share data)

| | | | |
|---------------------|------------|-----------------------|----------|
| Date | 10/23/2020 | Market Capitalization | \$12,418 |
| Price | \$57.16 | Enterprise Value | \$16,231 |
| 52wk High (close) | \$76.08 | Shares Outstanding | 217.3 |
| 52wk Low (close) | \$29.50 | Shares Short | 14.9 |
| Avg Volume (shares) | 2.1 | Short Int % of Float | 10% |



Recommendation:

LONG LYV for 69% upside with an 18-24 month price target of \$96 and a Base/Bear Risk/Reward of 1.5x based on a DCF with a TGR of 2.5% and WACC of 8%.

Business Description:

LYV is the world's largest live entertainment company comprised of three business segments:

- Concerts:** (~80% of rev, lower-margin) is centered on global promotion of live music events in owned or rented venues.
- Ticketing:** (~15% of rev) is served by Ticketmaster providing services to primary/secondary markets for 12,000+ clients.
- Sponsorship & Advertising:** (~5% of rev, high margin) allows businesses to reach customers through performance assets (i.e. AMEX pre-sale).
- Competitive position:** LYV US concert and event promotion share is ~23.5% (next biggest player AEG has ~6.9% share) and its US online ticket sales share is ~32% of the primary market and ~17% of the secondary market.

Investment Thesis:

I. Outsized Winner from COVID Recovery:

- Street estimates and expectations are at the low end of Mgmt.'s guidance for an uncertain environment.
- Channel checks with ex-LYV Mgmt. and customers indicate higher-than-expected event count and attendance numbers as soon as 1Q/2Q20 similar to the strong recovery in other geographies such as Japan, Taiwan, and mainland China.
- LYV's flywheel model supports a strong rebound across all three core business segments creating EBITDA upside.

II. Status Quo Case Provides Support and Upside:

- Upside to Street estimates using midpoint of Mgmt.'s verbal guide of 70-90% of '19 levels by Summer '21.
- LYV's balance sheet is strong with \$1.8bb of free cash and a ~\$1bb revolver (~15+ months of cash).
- 2020 OpEx cuts are not reflected near-term numbers.

III. Attractive Valuation and Risk/Reward:

- LYV's near-monopolistic business model, pricing power, and the long-term MSD-HSD% industry growth creates a long tail supporting an attractive DCF valuation with implied forward multiples in line with pre-COVID levels.

Situation Overview:

- Performance:** LYV was down >(60%) from pre-COVID highs to March lows, and has recovered almost ~100% from the \$30 close price low to 10/23/20 close of \$57. Prior to COVID-19, LYV was considered a "consensus long" and the recovery off the March lows is in part to early secured financing and a positive view on LYV's business model. LYV is covered by 17 sell-side analysts, with a price target of \$54 (11 buys, 5 holds, 1 sell).
- Bull Case:** Bulls believe in LYV's scale and long-term growth rates (HSD%). Bulls also point out pent-up supply from artists needing to perform and potential industry consolidation benefitting LYV.
- Bear Case:** Bears are playing for a re-opening delay, noting LYV will need to raise additional capital if shutdowns and significant capacity constraints are pushed beyond Mgmt.'s Summer '21 expectation. Bears also prefer more predictable B2B exposure in the current environment vs. LYV's consumer-driven business.
- Catalysts:** Positive news on vaccines, treatments, and re-opening the economy and LYV delivering strong financial performance in '21 and '22 will drive share price up. Our implied 14.4x 2023 EV/EBITDA multiple is in-line with the 2yr forward multiple pre-COVID.

Base Case: Recovery Valuation Summary (\$mm)

| | Price | EV | |
|-----------------------------|----------|----------|----------|
| Price Target | \$96 | \$26,993 | |
| Current Price | \$57 | \$16,231 | |
| <i>Upside / (downside)</i> | 69% | | |
| | 2021 | 2022 | 2023 |
| Estimated Revenue | \$11,068 | \$14,128 | \$15,474 |
| Street Revenue | \$8,065 | \$11,751 | \$13,596 |
| <i>Beat / (miss)</i> | 37% | 20% | 14% |
| <i>Estimated EV/Revenue</i> | 2.4x | 1.9x | 1.7x |
| <i>Street EV/Revenue</i> | 2.0x | 1.4x | 1.2x |
| Estimated EBITDA | \$1,262 | \$1,565 | \$1,878 |
| Street EBITDA | \$651 | \$1,059 | \$1,211 |
| <i>Beat / (miss)</i> | 94% | 48% | 55% |
| <i>Estimated EV/EBITDA</i> | 21.4x | 17.3x | 14.4x |
| <i>Street EV/EBITDA</i> | 24.9x | 15.3x | 13.4x |

Live Nation Entertainment, Inc. (NYSE: LYV) - Long

Scenario Analysis/Valuation:

I. Base Case (PT: \$96, 69% upside):

- A "recovery" scenario would pull Street expectations forward >2 years. Our FY22 revenue is close to Street FY24 (~\$14.1bb vs. \$13.7bb). With upside to numbers and an attractive long-term DCF valuation, we see potential near-term price appreciation and multiple expansion to pre-COVID levels.
- Channel checks with ex-LYV Mgmt. and current LYV partners point to stronger and faster than expected rebound. Ex-LYV President of On-Site Products believes attendance could be 5k-15k in ~1H21 which is significantly higher than expectations. This is supported by the SVP of Revenue and Marketing for the New York Jets, noting when arenas such as MSG open up, >20,000 fans are expected to attend. Per ex-LYV Mgmt., food and beverage is high-margin and higher capacity would drive significant AOI upside. Per ex-Ticketmaster ED, Ticketmaster/LYV dominates the arena business and should see a strong bounce back in '21, supporting our estimate of LYV selling ~97% of tickets in '21 relative to '19.
- Relevant analogs imply LYV will be one of the first to recover. Mainland China recovered robustly following issued guidelines for venue reopening. Since July, tours and festivals re-emerged and sold out immediately at higher prices. The Strawberries Music Festival has ~70% of '19 sessions this year with ~9% higher ticket prices, >10,000 fan concerts were held in Aug. '20 in Taiwan, and baseball games drew >13,000 fans in Japan with relaxed of crowd size limitations.
- LYV's scale and flywheel model set-up a disproportionate recovery rebound. LYV Mgmt. highlights artists pushing album releases given tour success is connected to album release timing. Artists make ~70% of income from tours, and post-COVID artists will rely on LYV's logistics and scale to quickly set up tours. In a recovery, LYV will have ample cash flow and can make acquisitions of distressed promoters/ venues that will be accretive in a recovery.

II. Status-quo Case (PT: \$71, 24% upside):

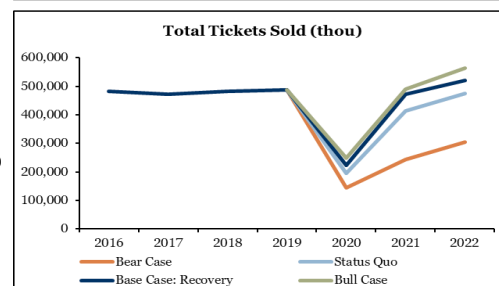
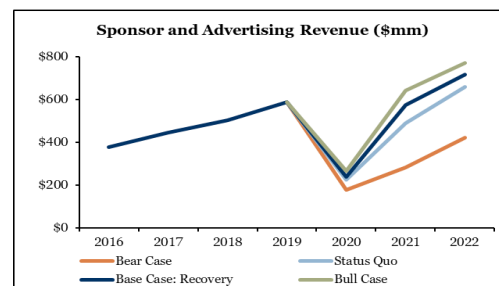
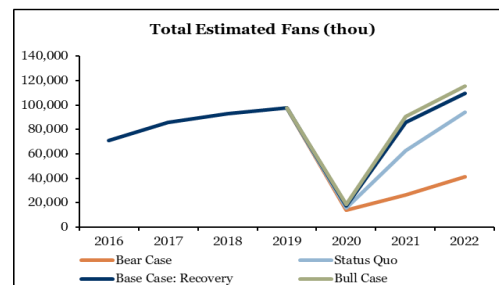
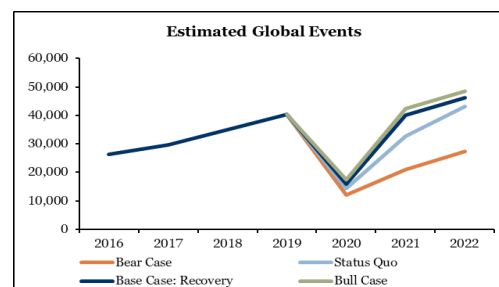
- Industry data points imply 2021 is within Mgmt.'s verbal guide of 70-90% of '19 levels. In 4Q20 LYV's Spark Arena in New Zealand will be at ~73% of 4Q19. As of 2Q20, 86% of fans kept tickets for 2021 rescheduled shows, and 2/3 of fans kept tickets for canceled festivals. Mgmt. notes ~95% of '20 cancellations were rescheduled for '21 and 60% of amphitheater inventory is a social-distancing friendly lawn.
- Cash burn, cost cutting, and liquidity guidance not reflected in Street numbers for '21 and '22. Mgmt. guided to reduce costs by ~\$800mm in FY20, we estimate ~\$598mm in direct cost reductions and are \$70mm ahead of '20 Street EBITDA estimates. Mgmt. expects ticket sales to ramp in quarters leading up to Summer '21 shows and conservative assumptions imply that LYV will have ample liquidity and only need to draw ~\$287mm from their \$965mm available revolver.

III. Bull Case (PT: \$125, 119% upside):

- Pre-COVID long-term thesis remains intact. Mgmt. laid out a path for an incremental \$730mm of AOI from '19 levels and these long-term goals remain attractive with potential room for upside post-COVID. These include: higher pricing (\$100mm), 25mm new fans (\$80mm Concert, \$100mm Ticketing, and \$150mm Sponsor & Ad), growing on-site ancillary revenue per fan across venues (\$125mm), growing Ticketmaster global share (\$100mm), and growing sponsorship market share (\$75mm).
- Superior technology, data, and analytics support continued price increases beyond AOI guidance. The SVP of Revenue and Marketing for the New York Jets noted that LYV has the "largest and best" dataset and Price Master's ~\$10k cost is easily recouped when tickets go on sale. Primary and secondary ticket market ownership creates stronghold for Ticketmaster. LYV has the ability to accelerate pricing growth given pent-up demand for live events.

IV. Bear Case (PT: \$32, 35% downside):

- Prolonged restricted indoor event activity. Per an ex Marketing & Events Coordinator for LYV, concerts now are on average at 15-20% capacity. LYV could incentivize artists to perform more events at lower capacity with higher pricing, but in the near-term, events would be breakeven at best. Continued shutdowns will result in industry consolidation. LYV is one of the only scale players able to withstand longer shutdowns and artists would further rely on LYV to arrange tours and sell tickets. Given LYV's scale and flywheel model, sponsor and advertising revenue will continue to maintain high margins over time. Ex-LYV SVP of Finance noted even if there is less traffic, LYV owns eyeballs and sponsors will continue to come.
- LYV liquidity will be constrained with delayed re-openings. The bear case model assumes LYV maxes out their \$965mm revolver and has to raise ~\$1.3bb of equity. Dilution is included in DCF valuation.
- Qualitative, thematic risks include live streaming popularity increases or shifts in consumer demand; lawsuits, i.e. LYV as a monopoly. and other COVID-related risks.





Nathan Shapiro '22
Nathan is a 1st year MBA student at CBS. He was previously an equity research analyst at Berenberg Capital Markets and a consultant at EY.



Levente Merczel '22
Levente is a 1st year MBA student at CBS and worked previously at IB and PE firms in Hungary for 7 years.



Kyle Heck '22

Kyle is a 1st year MBA student at CBS. He was previously a senior economic litigation consultant and senior financial analyst for a



Kirk Mahoney '22

large credit union. Kirk is a 1st year MBA student at CBS. Previously he was an associate at Catalyst Investors, a growth equity firm focused on technology



Vineet Ahuja '21

firms. Vineet is a 1st year MBA student at CBS. Previously he was an investment analyst in the New Delhi office of Caisse de dépôt et placement du Québec.

RealPage (NASDAQ: RP) - Long 1st Place—2020 MIT Sloan Investing Series (November 4, 2020)

Nathan Shapiro, CFA, CPA
NShapiro22@gsb.columbia.edu

Levente Merczel, CFA
LMerczel22@gsb.columbia.edu

Kyle Heck, CFA
KHeck22@gsb.columbia.edu

Kirk Mahoney

FMahoney22@gsb.columbia.edu

Vineet Ahuja, CFA

VAhuja21@gsb.columbia.edu

\$s in Thousands except per share amounts; data as of 11/04/2020

| Key Stats | | |
|------------------|-----------------------------------|------------------------------|
| Share Price | \$60.18 | Market Cap \$6,190,867 |
| 52 Wk Hi - Lo | \$70 - \$37 (Net Cash) / Net Debt | \$545,320 |
| FDS (K) | 102,872.49 | Enterprise Value \$6,736,187 |
| Float % | 88.2% | EV / 2021 Revenue 4.6x |
| Short Interest % | 5.1% | EV / 2021 EBIT 43.1x |

Recommendation

At the MIT Sloan Investing Series Stock Pitch Competition, we pitched a long position in RealPage (RP) with a 1-year price target of \$85, reflecting 41% upside and a 15% IRR over a 4-year investment time horizon. We believed that RP's stock price did not reflect (a) its ability to gain share in a underpenetrated and fragmented property management market; (b) an accretive M&A strategy that has rapidly expanded the breadth of its servicing capabilities; and (c) strong business moats that enable client acquisition and retention.

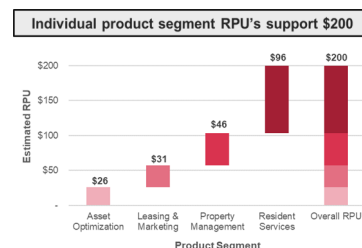
Business Description

RP provides software, data & analytics and tech enabled services to the property management sector within the US. RP focuses on managers serving multi-family residential properties, as opposed to commercial or industrial properties. RP has grown both organically and through M&A to expand its product offerings beyond its initial core ERP focus and enter adjacent verticals beyond mid-market property managers. RP's core ERP system serves as the system of record for property managers and as such is extremely sticky, with ~97% historical annual renewal rates. Relative to its primary competitors (Entrata and Yardi at the enterprise level, AppFolio at the SMB level), RP is differentiated by its open architecture model, that enables integrations into third party applications, and its focus on ancillary services beyond ERP, such as rent payment processing, analytics for pricing benchmarking, and marketing software.

Investment Thesis

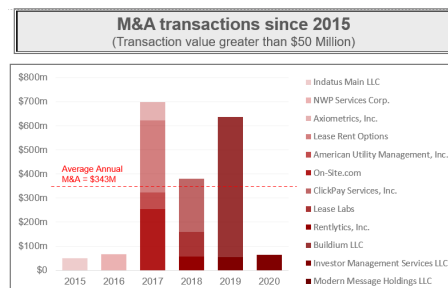
I) RP is gaining share in a fragmented and underpenetrated market

Management estimates the TAM to be \$18.9bn which we view as slightly aggressive as it assumes 100% market penetration and 100% product adoption. Our research suggests a more realistic serviceable addressable market of \$7bn based on more conservative assumptions regarding unit penetration (35mm vs 65mm) and RPU (\$200 vs \$292) supported by an analysis of RP's product segments. This results in a penetration rate of only 15%, leaving significant room for expansion. The company has driven significant revenue per unit (RPU) growth through a well-executed land and expand strategy. Over the past 10 years, RP has grown their units and RPU significantly faster than the market. The revenue per unit has compounded despite a massive increase in units which demonstrates the success RP has with cross-selling and up-selling its products. This is more pronounced in the top customers where product adoption accelerates and customers utilize more of RP's solutions.



II) Accretive M&A expands servicing capabilities and market size

Since 2015, RP has spent an average of \$343 million annually on M&A and closed 21 deals at an average purchase multiple of ~6x EV / Revenue. We believe these acquisitions have strengthened the breadth and value proposition of RP's property management software. RP has primarily focused on buying ancillary property management solutions that it can quickly integrate into its unity platform. This has created a unified user experience and enabled lucrative cross-selling opportunities. Historically, RP has acquired businesses with niche property management applications that have limited customer bases. RP then quickly integrates these companies and cross-sells these ancillary applications across its portfolio of over ~19 million units. This has led to an impressive return on investment. Our proprietary analysis suggests that RP has been able to achieve a 40%+ IRR over a two year time horizon across its 2017 and 2018 acquisition cohorts exceeding the 25% IRR hurdle rate that the company targets.



RealPage (NASDAQ: RP) - Long (Continued from previous page)

In November 2019, RP announced the acquisition of Buildium, a competitor operating in the SMB market. The resulting 11% drop in RP's stock price suggested that the market was skeptical of RP's ability to successfully acquire and integrate a competitor. However, the acquisition allowed RP to expand into the SMB market. Through our discussions with several property managers, the SMB market is primarily paper-based and penetration rates will quickly scale as generational demographics evolve. As a result, we believe the Buildium acquisition will provide a critical source of future growth.

III) Strong competitive moats protect returns

RP has a virtuous cycle of moats that leads to ever improving unit economics.

Virtuous cycle of moats: RP has sticky and customizable products that are easy to sell and hard to get rid of, leading to their market dominance of 18.9m units. Their market dominance led to high brand awareness, also generating a strong data cycle. The more clients they have, the more data they generate, the better analytics they can sell. This virtuous cycle leads to strong network effects and high switching costs. Clients report 2-3% immediate revenue growth as soon as implementation happened. Given the high switching costs and strong value proposition, RP has a 97% retention rate. Good and improving unit economics: The positive feedback loop leads to good and improving unit economics – increasing margins and improving organic LTV/CAC ratio. We estimated the ARR and backed out inorganic growth by each product segments, factored in the specific product life cycles, and the different gross margins, resulting in 4.3x LTV/CAC in 2017 that increased to 5.9x in 1H2020.

RP has established a dominant position in the corporate and enterprise markets and is expanding into the SMB market.

RP focuses on customizable, ancillary products for enterprise clients, along with its closest competitor: Yardi. Although RP dominates this segment and there is no other real competitor, RP's biggest threat is AppFolio (APPF). For enterprise accounts ERPs are important. According to testimonials of clients and ex-employees ERP systems can only be changed if the organization is prepared to endure significant data loss, therefore ERPs are very sticky. RP's ancillary products can connect to any other competitor's ERP, acting as a door opener for RP. As most enterprise accounts have ERP already, this is a potential avenue to slowly convert their core ERP. Yardi is stuck as an ERP provider with a strong accounting focus. RP on the other hand is very much focused on the data and supporting services. AppFolio is trying to enter the enterprise market, but they have a closed, one platform system. This is less compatible with the enterprise accounts as they are sophisticated users of proptech software products and have their own established ways. RP, as mentioned above, acquired Buildium recently, directly threatening APPF from the lower end of the SMB market.

Valuation

Our valuation was based on both a relative valuation and a returns analysis. For our relative valuation, we comped RP to other vertical SaaS public companies and take privates. We ran a regression on the relationship between LTM revenue growth and EV / LQA Revenue. We then applied a multiple of 7.0x LQA based on a discount to the 9.0x supported by RP's ~10% annual organic growth. In our returns analysis, we forecasted the business to 2024 and modeled an exit at a 30.0x trailing EBIT, reflecting the valuation of a mature software business. We then discounted the business back to the present at a rate of 10%. Both valuation methods supported a valuation of \$78 per share.

Key Risks

COVID-19 Pandemic: The Pandemic has significantly impacted real estate markets and created uncertainty around leasing velocity, vacancy and renewal trends. However, RP's SaaS-based business model has proven resilient and led to significant increases in platform usage and adoption. We believe the Pandemic has accelerated discussions around digital innovation in real estate markets.

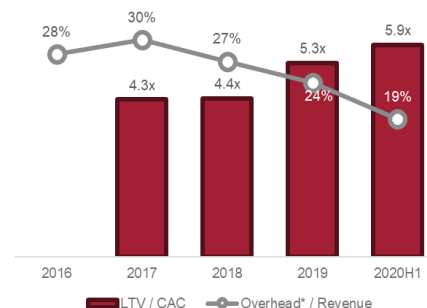
Competitive pressures could impact client acquisition trends: Given the stickiness of RP's highly customizable ERP platform, we believe that RP has a strong competitive advantage. We expect that both RP and its primary competitive threat, APPF, will benefit from continued digital innovation and the accelerated adoption of property management software solutions.

A sustained low interest rate environment could create a shift towards home buying: While this is a risk, there has been little evidence to suggest that the recent low interest rate environment has led to de-urbanization and increased home buying.

Investment Update

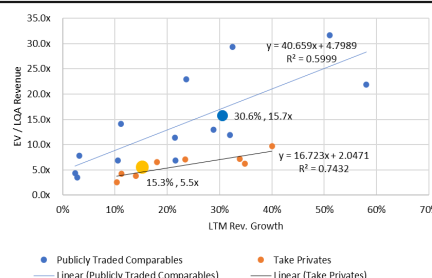
On December 21st, 2020, Thoma Bravo announced that they would acquire RP for \$88.75, representing a 31% premium (prior day close). The deal valued the company at \$10.2 billion which equated to a 8.1x EV / forward Revenue and 28.7x EV / forward EBIT multiple.

Unit economics of Real Page



* Includes Product Development and General and Administrative

EV / LQA Revenue Relative to LTM Rev. Growth



John Huber, Saber Capital Management



**John Huber,
Saber Capital
Management**

John Huber is the Managing Partner of Saber Capital Management. Saber manages an investment fund modeled after the original Buffett Partnership fee structure. Investors in the fund pay no management fees, and Saber only gets compensated for returns that exceed 6% annually. John and his family have nearly all of their net worth invested right alongside investors. Saber's approach is based on the simple observation that in the long run, the best investments come from the best companies. Our strategy is to carefully study and selectively invest in high-quality businesses that we believe will compound value over time. Prior to forming Saber in 2013, John spent nearly a decade investing in real estate.

Editor's Note: This interview took place on January 15, 2021.

Graham and Doddsville (G&D): How did you become interested in investing in the first place?

John Huber (JH): I got into investing because it's the synthesis of a number of subjects I really enjoy. I've always loved math, statistics, and numbers generally. I love sports and games involving strategy. I love

geopolitics and current events. And finally, I love studying human achievement and observing and learning from people who excel at their craft, not just in business, but in other walks of life. I think business and investing are at the intersection of all of those things.

Initially, I didn't think I'd actually pursue investing as a career because I went to school for journalism; I thought I'd pursue investing as a hobby. My dad was an engineer by trade, but he was an avid investor for his own account, and I thought I'd follow that path. But I picked up a book called "The Warren Buffett Way" at the library one day in college, and that was the first time I'd ever read anything on Buffett's approach, and it was just one of those game changing moments.

That book articulated a concept that I superficially understood but didn't fully have ingrained, which was the idea that a stock shouldn't be thought of as a number on screen, but rather as a piece of a real business run by real people with real assets, and real cash flows. A stock is a pro rata share of all of the future cash that that business will generate.

This is the simple logic of value investing. This led me to study Berkshire Hathaway, and it motivated me to get into business. I actually

wanted to get into business as a way to make money so that I could invest and maybe form a partnership along the lines of what Buffett set up in the '50s. I spent about seven or eight years investing in real estate prior to setting up my partnership, and that was a great learning experience and a way for me to build up capital that I used to seed the investment firm that I wanted to set up. By about 2013, I had felt like I had enough personal capital saved to launch the partnership. That's when I started Saber Capital.

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G&D: While you were spending those years investing in real estate, were you still keeping a pulse on equity markets, still doing equity investing on the side? Were you still developing and learning as a public market investor

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throughout this time?

JH: Yeah, absolutely. I got into real estate in 2005, right at the peak of the bubble. But I got lucky because by the time I cobbled together enough capital to do anything to speak of, it was probably 2007, which was the beginning of the foreclosure boom. That gave me an opportunity to really capitalize on a once in a generation type of a market.

Most of my personal capital was getting plowed into real estate investments that I thought were severely discounted. There were a lot of forced sellers; we went around to different banks and picked up assets for 50 cents on the dollar. Our investments were all in the single-family and multi-family sectors.

But during that period, I also spent a lot of time studying the markets and learning. I debated going back and getting an MBA, but at that point, I really valued my time and the autonomy I had. Once you get used to having autonomy, it's hard to give it up. You realize how extremely valuable it is. So, I didn't want to give that up.

I was here in North Carolina, and I didn't want to move to New York or uproot my family. I liked where I was at, and I thought that with the autonomy that I had, I could develop my skill set and

advance my learning curve at the maximum rate possible by studying the things I wanted to study and working on the projects I wanted to work on and so forth.

I was actively learning and engaging in the markets during those years, studying business models and reading financials and just growing as an investor while also trying to build up capital.

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G&D: Who were some of your biggest mentors, either personally or from afar?

JH: My dad was the biggest hands-on mentor in terms of somebody that I had contact with. He was an engineer and was never a professional investor, but was still one of the best investors I knew. He taught me two key things. One is to think independently, and don't be concerned with conventional wisdom.

The other thing he taught me is the value of being concentrated. Great ideas in all walks of life are very rare, and that definitely applies to the investing world. You have to seize those great ideas when they come along. You can't dilute those great ideas with lots of other mediocre ideas.

Outside of my Dad, I've learned a lot from all of the great investors in the value investing community. Like so many others, Munger and Buffett have been the inspiration behind my general investment philosophy and the way I've structured my firm. There are some key takeaways you get from every investor. Buffett taught me that a stock should be thought of as a piece of a business and the importance of having a long-term time horizon. Charlie Munger taught me the importance of patience, really waiting for the obvious ideas and doing nothing in between. Peter Lynch taught me the importance of focusing on great businesses that can compound over time. The simple idea is that if you can find one or two big winners, they can do a lot of the heavy lifting for your portfolio over time, and they can make an enormous difference. Those are all philosophies that are core to my approach today.

G&D: Early in your investing career, it

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seems you were more attracted to cheap stocks and the methodical Graham / Walter Schloss approach, but over the years your philosophy has changed and has become more oriented to quality. Can you walk us through that transition?

JH: I definitely have a transitioned towards the great businesses. I think every investor goes through periods of evolution where you learn new things, and the world changes, and you have to adapt. You have to, I think in all fields of business, in all walks of life, you're trying to improve over time and get better at what you're doing. My empirical observation at the core of my philosophy with Saber is that the best investments in the stock market will come from the best businesses over time. I like the methodical nature of some of the investors like Ben Graham and Walter Schloss, but I think the reality is the world is dynamic and ever-changing. The speed at which information travels is so fast. Competitive advantages that used to be very durable and very long term in nature are now getting attacked and disrupted. I think a lot of the techniques that statistical value investors used to use are no longer relevant. For example, price to book is no longer relevant because most of the assets on a company's balance sheets are intangible assets now. The world has just

changed. As an investor, I think you have to be cognizant of that and you have to be willing to change your views and change your mind as you go.

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G&D: What was it like actually starting Saber? You said you'd saved up enough capital and raised external capital as well. Were there any unique challenges to that process that you didn't expect, and can you talk a little bit about why you chose the structure you did?

JH: I started Saber with the goal of compounding my own capital, for a very long period of time. I've always viewed Saber like a family partnership, initially comprising my own capital and some from family and friends. My idea was that if I do well, other investors might want to join me. I didn't necessarily have a strategy for raising

capital, but I knew very early on that I wanted to set it up in a way that would maximize my chances of reaching my two goals. One is to become the best investor that I can be, and to reach my full potential as an investor. The second is to produce superior results for the investors that have entrusted their capital to me. I wanted to set my firm up in a way that would maximize my chance of reaching those goals.

I'm a big sports fan, and I love learning about great players and coaches, their practice habits, their work ethic, how they go about getting better at their craft. I'm a Buffalo Bills fan. As a Bills fan, I've unfortunately had a front row seat to the brilliance of Bill Belichick, the head coach of the New England Patriots. Of all the great decisions Belichick has made, my favorite of all time was one that most people would describe this as a relatively insignificant play, but to me, it was a game changer. It was a 2009 mid-season game against the Colts. Belichick decided to go for it on fourth and two from his own 30-yard line with just a few minutes left in the game, even though the Patriots had a six-point lead.

This was highly controversial, because if you don't get the first down, you give the Colts the ball with a short field and a chance to win. So,

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the conventional decision with a six-point lead on fourth down late in the game is to punt the ball. Most people would view that as the safe decision. Punt the ball and make the Colts go the length of the field in a short period of time. But Belichick decided to go for it. In fact, the Patriots did not get the first down, the Colts got the ball back with a short field and eventually scored a few plays later, and the Patriots lost by one point.

I've never forgotten that play because it told me three things about Belichick. First, he didn't outsource his thinking. Second, he cared about making the correct decision, even if it was highly unconventional. Then finally, I think the most important thing that I learned about Bill Belichick from that particular play is that he had no career risk. There are 32 head coaches in the NFL and 31 probably would have punted on that situation, because they'd be too concerned about failing unconventionally, and possibly losing their jobs as a result.

By that point, Belichick had won three Super Bowls. So, he had no career risk, which gave him the freedom to make the right choice even if it was an odd choice. I really immediately realized the significance of that play call and I always kept that in mind when forming Saber Capital. I

think the learning lesson is to be successful in such a competitive business, like investment management, I had to put myself in a position where I had the freedom to disregard the norms if need be and make the decisions that I thought were best, not necessarily the decisions that someone else thinks are best.

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G&D: Could you talk a little bit about your portfolio construction at Saber?

JH: As I said before, Saber's philosophy is really simple: invest in great businesses. There are two main categories of investments that I think my portfolio has had over time. One is what I call dominant moats. These are really durable, high-quality, strong businesses with great balance sheets and very entrenched business models. They also tend to be mature. They're not necessarily growing at fast rates. But these are businesses that have what Buffett would call a really strong

moat.

The great thing about the stock market that stock prices fluctuate to a much greater extent than the underlying business values. This is common knowledge, but it's worth pointing out. I have a chart that I've updated over the years that has the top 10 mega caps in the S&P 500. It shows you that in any given year, even the largest stocks in the market, the top 10 most valuable and most well-followed companies, have stock prices that fluctuate by 50% or so.

That tells me that stock prices move around much more than underlying values do. Therein lies the opportunity as value investors; there will be times where you can buy these great, mature, well followed businesses at a discount. Those tend to come around every so often, and I have a watch list of companies that I follow. From time to time, you're able to buy these great businesses at a discount. If you can buy a dollar for 70 cents, and the dollar is growing at 7% or 8%, that can be a nice investment over the medium term, as the market tends to revalue that over time.

Then the second category are what I call emerging moats, and these are the compounders. These are the companies that have

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really high returns on capital, long growth runways, and are developing a strong lead. Oftentimes they exhibit characteristics like a network effect, or some sort of feedback loop that grows stronger as the business grows, and, they have a long runway for reinvestment. Classic examples of this are stocks like Walmart, Home Depot, Starbucks, back in the '70s, '80s, and '90s, where they could reinvest capital into new store locations at 30% returns for a very long time. That leads to a very high rate of compounding over the long run.

Today, the examples might be companies like Copart, Etsy, or Facebook. One key difference with many of today's compounders are that their products are often digital, which can be created and replicated instantly at very low marginal costs. Returns on capital of these companies aren't tethered to constraints of the physical world, and this means many internet businesses can grow to global scale very quickly and can become much larger than we would have previously thought possible. I think of the portfolio like a barbell and it's filled with companies that fit into one of those two main categories.

G&D: How does position sizing differ between the two categories?

JH: My biggest positions tend to be the ones where I think there's the lowest likelihood of permanent capital loss. The positions that I have highest conviction on tend to be the largest positions. It doesn't necessarily mean that emerging moats are always smaller, because sometimes you can have a business that has an enormous amount of growth potential, but is uncertain – in some ways, those can be like call options. But the current business might be valued at a level where you have a huge margin of safety, and you get a lot of that growth for free, or you're not paying for a lot of that embedded value of that call option.

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Sometimes that can lead to an attractive situation where you can have a very big position in a

business that still can grow very fast. Obviously, that's the home run type of investment. But typically, the emerging moats, there's more uncertainty. When there's more uncertainty, I tend to have slightly smaller positions.

G&D: How high are you willing to go with a position as far as a percent of your portfolio?

JH: I don't have any constraints. It goes back to the career risk point I made earlier - I try to structure my firm in a way where I don't face career risk. I have certain soft guidelines for position sizes, but I can say my portfolio typically has between five and 10 stocks. I think the average position in my portfolio is probably around 10%. I consider a double position, or a very high conviction position, to be upwards of 20%. If the business continues to perform well, and the fundamentals continue to move in the right direction, I tend to let those businesses continue to compound over time.

That's one thing I've learned – when you have a great business, the best thing to do is sit on it and don't touch it. The natural outcome of this is that the best investments in your portfolio become a bigger percentage of the pie and become more

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meaningful over time. I've written about this idea called the "coffee can" portfolio where you stick stocks in the coffee can and you just let them do their work. I don't necessarily hold positions forever, but I have that mentality when I go into a new investment. I view it as a business that I plan to hold indefinitely, and I want to let that business compound until I find maybe a better idea, or I discover that I made a mistake or that something fundamentally has changed.

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G&D: We wanted to talk through an investment that we know has been highly successful for you that you've talked about in the past, which is Apple. Can you walk us through your thesis there and what created the opportunity?

JH: Apple is an example of a concept I talk a lot about, and it's how you don't need an informational edge to gain an edge in the stock market. I think there are a few different ways to gain an edge. One is informational, but the internet has changed the game to where information is now a commodity. That edge is very difficult, especially for an investor like me, and I'm never going to be able to compete with the resources of some of the larger funds out there in terms of getting information faster than they can. But I don't think that type of information is all that valuable anymore, or certainly not to the extent it was in decades past.

I think the best edge today is to have a long-term time horizon. This goes along with the idea that I spoke about before, to be able to act unconventionally, to be able to act without career risk. I think this is what causes mispricings in some of the largest, most well followed companies in the market, and Apple is an example of that.

When I first invested in Apple in 2016, it had a valuation of around \$500 billion. In two years, it went to a trillion. Then inside of three months, in late 2018, it went down 40%, shedding about \$400 billion in value in just one quarter. Then from there, it went back to \$1.5 trillion in just a

year, up 150% from \$600 billion. All of this was before COVID.

It just goes to show you how the largest, most well-followed stock in the world can fluctuate far more significantly than the underlying value of the business. Why is that the case? Why is there an opportunity with Apple? I think one reason is time horizon –some people didn't want to own Apple because they were worried about the next quarter.

In 2016, the word was iPhone sales had peaked, and there was competition coming from Samsung and other places, and people worried that the next quarter was going to look bad. But most people acknowledged that the long-term future was bright for Apple. There wasn't a lot of disagreement that Apple was going to be fine, it's a great company. But even the people that agreed on Apple's long-term prospects, still, in some cases, wanted to wait it out for a few quarters and didn't want to get in the way of a bad earnings report. If enough people share this view, it can create a mispricing.

I think there was also an analytical edge with Apple; this refers to looking at things through a different lens than others. In this case, I think some people were

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looking at Apple like a computer hardware company. A computer hardware company sells a commoditized product, margins will revert to the mean over time, and any excess returns on capital will be fleeting. They'll revert to the mean, and you'll never produce any excess profitability.

The other way to look at Apple was to view it as a consumer brand, along the lines of a Starbucks or a Nike. Nike makes a product from commodity inputs, manufactured overseas. Most of their products are essentially replicable commodities, but they get a 75% markup over their costs to make those products, and those gross margins exist because of the brand that Nike has.

I thought Apple's brand was more valuable than Nike's, I thought its products are more differentiated. I've never understood why it traded at such a discount to the market, or to these great brands like Nike for so long, because I thought the brand was probably more valuable, and I thought the products were actually more differentiated. The innovation at Apple is so great.

If you think about the first time you picked up an iPhone, it was probably a life-changing experience, right? Same thing with the Air Pods – they're head and shoulders above any other product out there

on the market. And the same applies more recently to the M1 chip that they're developing. There's an incredible amount of human capital inside that organization, and the collective value of that asset is sometimes underappreciated by the market.

So the Apple thesis for me, in a nutshell, was that it's a great brand, it's a highly sticky ecosystem, and the high retention rate in the hardware is very valuable, like a subscription software business in terms of the recurring nature of the revenue. The hardware isn't one-time revenue, it's actually recurring. If you own an iPhone, your next phone will be an iPhone. Same goes for Mac and Apple Watch and iPad, the Air Pods and the rest of the product lineup.

I think the combination of short term time horizons and thinking about Apple in a different way created an environment that resulted in a stock that was significantly undervalued, even though it was the most widely followed company in the market.

G&D: Today, it seems like more people appreciate Apple's brand and appreciate the transition to the services business model. How has your thesis changed and where do you stand today?

JH: When I first invested in Apple, all of that stuff that I just spoke of made me question why the business was trading at 10 times free cash flow. One of the greatest businesses ever created with one of the most valuable brands and the most powerful moats, should trade at 30 times.

It eventually did get revalued to that level and is somewhere around there today. I think Apple is probably more fairly priced now. I do still own Apple, but I have trimmed it. It was my largest position at one point. It's no longer a large position. The tricky thing about investing is when to sell. I don't have a good answer for it, but I've learned over time to be very patient with my investments, because I've made a lot of mistakes in selling a great business too soon.

The nice thing about great businesses is that they tend to compound over time. Apple is not compounding its intrinsic value at a very high rate anymore, but it's still a great business. It's got a strong moat, it's got enormous free cash flow, it's buying back shares, and so the value is still compounding, just at a lower rate.

Unless you have a better idea, you're almost always better off holding these great businesses, because they work for you over time. I've learned that you have to

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be very careful with that. Opportunity cost is a big factor in investing. Sometimes you make a mistake when you buy a stock, but the most costly mistakes can be when you sell something that you should have kept, because the opportunity cost of forgone profits can grow to become many times the size of a loss incurred by making a bad investment.

So the key is to minimize those opportunity costs, which I view as real costs that impact long-term results as much or more than actual losses. When you own great businesses, like Charlie Munger, you just sit on them and let them do their work.

G&D: Are there any examples of that come to mind of times where you've sold too early in the past or any businesses that you studied and really liked, but passed because of valuation and regretted?

JH: Yeah, too many. NVR has a great business model and is an example of one of the things I look for in a great business, which is what Buffett would call the royalty on the growth of others. NVR gets high returns on someone else's capital.

The third-party land developers put up the capital, do the heavy lifting, and take a lion's share of the risk, and NVR gets to extract high returns on that capital instead of owning the

land themselves. The business model reduces a lot of the risk that's inherent to the homebuilding industry – risk is amplified when you have a lot of assets your balance sheet in a highly cyclical industry. So, NVR removes a lot of that. It's very well managed, it's got a great culture, and it's a very cost-efficient, well-run business. We do own NVR now, but I watched NVR from the sidelines for years before investing, despite being well aware of these advantages.

“You should demand a margin of safety over an accurate assessment of the business and its value, but your goal should not be to conservatively analyze the business, your goal should be to accurately analyze the business.”

As far as selling too soon, one example that comes to mind is VeriSign. VeriSign is a business I owned in 2016. I call it the toll road of the internet. They collect an annual registration fee for every dot com and dot net domain. It's recurring and very high-margin revenue, and since they have exclusive rights on these domains, the business has monopoly-like economics. The

company requires no capital, and uses all of its significant free cash flow to buy back shares.

This monopoly on dot coms is a great asset to own, but the company is not growing very fast. So, this would fall into the category of mature, dominant moats. So, I sold when I thought it reached a fair valuation level, but both my analysis of the business quality and my valuation have proven to be too conservative.

One of the mistakes that I've made over time is being too conservative, I think. Conservatism, for good reason, is considered a virtue in the value investing community. I'm a conservative investor by nature, but there are drawbacks to being too conservative. I just read a note by my friend, Rob Vinall who runs a firm called RV Capital. He made a great point – banks that are aggressive when underwriting loans end up going bust, but so do banks that are too conservative over time, because they'll miss writing the loans that are most profitable, which is needed to pay for the inevitable mistakes. As investors, our goal should be accuracy when evaluating a business. You don't do yourself any favors by being overly conservative at the expense of being accurate.

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You should demand a margin of safety over an accurate assessment of the business and its value, but your goal should not be to conservatively analyze the business, your goal should be to accurately analyze the business. I've noticed that a lot of my mistakes have come from when I've been conservative at the expense of accuracy, and this has carried a heavy opportunity cost over the years.

G&D: You wrote a post a few years ago on how to think about the compounding of the intrinsic value of a company, and you emphasized the incremental reinvestment opportunity and the ROIC on that reinvestment. At the same time, many of the mature, dominant moat companies you've mentioned here are deploying capital more into share repurchases as opposed to reinvesting. How do you think about those uses of capital in a business?

JH: I think the best businesses are the ones that can grow without capital. That's the royalty on the growth of others idea I mentioned before. The next best situation is when a company can reinvest its earnings back into the business at high rates of return. The intrinsic value growth rate of a business is going to compound at the rate of the incremental return on capital, multiplied by the reinvestment rate.

I have another friend, Connor Leonard, who coined the term reinvestment moat. The classic example would be Walmart in 1975. They focused on being more efficient than competitors, passing savings to customers which naturally led to volume growth, and they reinvested all profits into building new stores in adjacent markets. They had a small footprint in Arkansas but were expanding across the country by replicating this simple business model. Walmart had very high returns on incremental capital, and it could reinvest 100% of its capital back into the business. I estimated the incremental returns on capital were 30% on average, and since they could reinvest all of those earnings back into the business, the earning power, and the underlying value of the business, was growing at 30%. Those are obviously great businesses to own if you can find them.

I think the great reinvestment moats of today are companies that are investing in ways that show up on their income statements in the form of sales and marketing expenses or product development costs, and much less through their balance sheet in the form of capitalized physical assets like store locations and inventory. Walmart showed GAAP profitability, but negative free cash flow, because it was taking on debt to

invest in more locations, which were capitalized and amortized over time. Today, internet companies are growing by investing in product development and through sales and marketing, which are expensed on the income statement as they are incurred. They don't need to lay out money for new equipment, new factories, new stores, or new physical assets. But, just like the reinvestment moats of yesterday, these companies should continue to reinvest if they're earning high returns and if the lifetime value of the customers exceeds the cost to acquire those customers.

In any case, you want to understand the returns that any capital outlays are achieving and what the prospects might be. When a business gets to a certain maturity level, the smart thing to do would be to return capital to shareholders through buybacks or dividends. But if a business can create value by reinvesting back into the business, regardless of how those investments are accounted for, then they should make those investments. In other words, a lot of companies today are showing losses on their income statements just as Walmart was showing losses on its cash flow statement, but the steady state profitability of their model could be quite profitable.

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G&D: What are your thoughts on just the general stock market environment today? And how do you think about cash in the portfolio in this environment?

JH: The way I think about cash allocation is American business is the best asset class I can invest in over the long run, given my circle of competence. It doesn't mean it's going to be the best asset class every year. But the S&P 500 produces 12% or 13% returns on capital and it retains and reinvests about half of its earnings, and so that should generate 6% or 7% earnings growth over the long run.

Then the rest of the earnings can be returned to you as dividends and share repurchases. If you can get 6% earnings growth in the long run, plus a couple percent from dividends and buybacks, then you're going to achieve a high single digit rate of return by owning that asset class in the long run. Obviously, it's going to be very lumpy, but if you have a long term, 10-year plus time horizon, that is the rate of internal compounding that I think American business will continue to achieve over time.

And so I think American business is probably going to outperform all of the asset classes, including real estate, commodities, gold and oil, bonds, and certainly cash. I think you're better off owning great

businesses that can compound at higher rates than cash in the long run, so I tend to be fully invested.

“I think you're better off owning great businesses that can compound at higher rates than cash in the long run, so I tend to be fully invested.”

I don't really have a view on the current market. I do think that there are a lot of opportunities and this is a stock picker's market. I think the opportunity set is going to be rich for some time. It doesn't mean the market is cheap, or even that stocks in general are cheap, but I think there are a lot of opportunities.

COVID has been obviously an Earth-shaking catalyst that has unlocked an enormous amount of value in certain companies. In some cases, the market has been too generous and many stocks are way overvalued. In other cases, I think the market is directionally correct, but not correct in magnitude. This happens many times in the market. For instance, the market was directionally correct about Google when the stock price soared after its IPO. The shares were priced over 100 times earnings at that point, but Google should have

been priced at a much higher multiple than that, even. I think there's a similar dynamic playing out in the stock market today with a select number of companies where the market is directionally correct but off in magnitude.

“When it comes to companies that have benefited from COVID, there's two main categories; those that have pulled forward demand, and then those that have borrowed demand from the future, and have to pay it back.”

When it comes to companies that have benefited from COVID, there's two main categories; those that have pulled forward demand, and then those that have borrowed demand from the future, and have to pay it back.

The latter category might be something like Lowe's or Pool Corp. You might install a deck this year or put in a pool, but if everyone that was planning to do this over the next few years does it all this year, then there's going to be some value that is created by getting paid now instead of later. But there isn't necessarily a step function change in value

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creation.

On the other hand, if you have a two-sided marketplace, and you pulled forward five years of demand, then all of a sudden, you've fast forwarded into 2025. Your business took a giant leap higher, and now you will grow off of a much higher and stronger base. That growth rate might not necessarily slow down. It might be lumpy for a year or two, but some businesses have seen their moats and the returns on capital expand, and the nature of many of these businesses are that the strong often get stronger. If your network effect has gained the equivalent of five years' worth of strength in one year, then not only will your revenue growth be much faster, but your business has also achieved a much more solidified position in the market.

If you've acquired five years-worth of customers, thanks to COVID, for very little cost, you've created enormous value because those habits have changed, and that would have taken many years and much marketing expense to achieve those same changes that have occurred.

A similar dynamic exists at the other end of the spectrum, where companies have been beaten down because of COVID. In some cases, these are permanently

impaired companies and COVID has hastened their demise, and those are obviously the situations that you want to stay away from. But I think there are other, very high-quality businesses that have taken a hit this year, but will be fine long-term. In some cases, they might actually be able to capitalize on the turmoil that exists in their industry by buying competitors or taking share. Overall, there are real opportunities across the landscape for stock pickers right now, and I think it's an exciting time to be a curious investor.

G&D: Can you walk us through a recent idea you're excited about?

JH: One relatively new investment we made last year is Etsy. Etsy is a two-sided marketplace that provides a platform for individual entrepreneurs to make money from their labors of love. The platform has 3.7 million sellers, 69 million buyers, and 80 million listings. Etsy's niche is specializing in handmade products that were manufactured by these 3.7 million sellers. They're very unique products. Etsy is benefiting from a few key trends that I think are gaining strength as time goes on, including a trend towards individualism, a desire to be unique and a desire to support small businesses and local merchants.

Etsy is a global business

and a global platform. But when you buy something at Etsy, you're supporting a small individual producer. I think that trend is in Etsy's favor and provides a nice tailwind. The other big trend benefitting Etsy is the long runway ahead for eCommerce generally. Etsy's got a very small piece of a very big market, and it's developing a strong moat.

Two-sided marketplaces are perhaps my favorite business model, for four main reasons. First, these businesses tend to produce high returns on someone else's capital. Etsy's sellers put up their own capital, they make their own products, they fund their own inventory. FedEx and UPS pay for the trucks, and the distribution centers that ship and store that inventory. Etsy simply takes a cut of all the business that occurs on the platform. It collects cash upfront from buyers, it keeps about nine cents of every transaction dollar for itself as a fee and then passes the rest along to the sellers. This is a very valuable asset because growth has very low marginal costs, which is a big reason why Etsy is highly profitable with 30% plus free cash flow margins.

The second thing I like about the marketplace business is network effects. The more people

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that join the network, the more valuable it is for everyone else. In Etsy's case, the more sellers on the platform, the better and wider the selection for buyers, which brings in more buyers, which attracts more sellers, and so on. COVID has supercharged this network effect. The network has grown from 46 million to 69 million buyers in just the last year, which is a 50% increase but an exponential increase in what I think the durability and future earning power of the network will be.

The third thing that I like in marketplaces is what I call a data feedback loop. In the world we live in today, customer data is one of the most valuable assets that a company has. Data helps you understand your customers better, allocate your resources more effectively on product development, and that helps you make better products, which attracts even more customers.

That feedback loop is very valuable, and the more data you can collect and analyze, the better your products get. This increases the value you can offer your customers, and this can help grow your business. There's an investor named Nick Sleep who coined the term "scaled economies shared". Sleep used Costco as an example of this mental model. Costco used the economies of scale inherent to the retail

business model to pass savings along to customers in the form of lower prices. It kept its gross margin constant, but as volume increased over a fixed cost base, it would lower the unit prices for the products that it sold.

I think concept also this applies to digital companies and the use of data. A company like Etsy is using the data that they collect to improve the products that they're offering customers. The more people that use the product, the more they can invest in R&D, and spread those costs across an ever growing amount of customer base. That leads to better products that benefit all of the existing customer base.

There are billions of events that occur on Etsy's platform every single day, which generates an enormous amount of data. They're improving their search relevance and reliability, which leads to better user experience and also improves their advertising business.

The fourth characteristic I like about two-sided marketplaces is that these businesses tend to get better and stronger as they grow. Network effects and data feedback loops strengthen the moat of a business as it grows. These forces act like a magnet, attracting more customers and the magnet gets stronger

with each and every new customer. When you combine these forces with the economics of internet companies, which can deliver digital products with no marginal costs, you get really powerful businesses that get more profitable as they grow and can reach global scale in very short periods of time. I think that's one reason why companies have become much larger and much more valuable than we would have predicted using prior paradigms.

“Network effects and data feedback loops strengthen the moat of a business as it grows...When you combine these forces with the economics of internet companies, which can deliver digital products with no marginal costs, you get really powerful businesses that get more profitable as they grow and can reach global scale in very short periods of time.”

Etsy's market today is, by my estimates, around \$150 billion. The company thinks it's going to be \$400 billion

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over time, and Etsy's platform did \$10 billion in gross merchandise sales. Etsy's business grew 117% in the most recent quarter, but it's got a very small piece of a very big market that itself is growing fast. I think those tailwinds in combination with the profitability of the business model and the moat it's developing will lead to a lot of value creation over time.

G&D: One thing about Etsy that's interesting, compared to a lot of other very high growth businesses that you see in the market today trading at high prices, is that Etsy is very profitable and generates a lot of cash flow. How do you think about the margins of that business and what it will look like at maturity? Are there any other two-sided marketplaces that you compare it to that it might look like one day?

JH: Facebook is the poster child for the value that a platform business and network effect can create, but it is unique. I don't think there'll be another Facebook, but just a couple of years ago, Facebook had 50% operating margins and 80% gross margins.

Going through the drivers of margins, I think Etsy's gross merchandise sales could be many multiples the size it currently is. If the network continues to grow, then I see no reason why the free cash flow margins couldn't equal or exceed what they are now, which is

about 30%. Again, there's some benefit they've achieved to the rapid growth they've witnessed this year because it's a negative working capital model. The growth means cash comes in from buyers faster than it goes out for payables, and so their 30% free cash flow margins are higher than their 26% EBIT margins currently, but given the fact that incremental growth has very low marginal costs, Etsy should become more profitable over time.

I think they can achieve 50 billion in GMS in the medium term, and that would still be a very small piece of a very big market. Their take rate right now is 16%. I think the take rate will tend to rise over time, as advertising grows, and as some of the other service revenue grows. It's possible that Etsy does \$10 billion in revenue in five or six years, at which point they could be generating \$3-4 billion in free cash flow. The current valuation is around \$25 billion. I think if the company continues to execute well, there's a lot of potential upside.

G&D: You mentioned take rates – how do you think those will evolve, especially with more competition from Amazon or eBay. Do you think if Etsy increased its take rates, it would make them less competitive to those other platforms or increase seller churn?

JH: It's a great question. There are two key things I'm watching with Etsy. One is the size and the strength of the network – the number of buyers, sellers, and listings. The other is the inherent conflict that exists between the business, the customers, the employees, and the suppliers. There's a certain amount of value that a business creates, and how that business shares the value with its ecosystem is always a tricky situation. We mentioned Costco, which shares an enormous amount of value with its customers, and obviously keeps a fair share of value for itself. But in that particular business model, whether it's Costco or Walmart, or even Amazon, you could argue the suppliers get the short end of value distribution.

I think how Etsy balances that will go a long way to answering the question of how valuable and large the network becomes. There is a risk that if they continue to increase the take rate, the sellers would migrate to Shopify or would leave and try to set up their own shop. Etsy's take rate is still below eBay's, and although it's hard to calculate Amazon's exact third party take rate, I think Etsy's is well below Amazon's take rate as well.

I think there is upside in Etsy take rate, but it wouldn't be smart to increase their 5%

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collection fee at this point. They have said that they might raise it on different product lines, but on the core business, I think the 5% will probably be static for some time to come.

Etsy also has other potential monetization streams. They take roughly 3.5% as a payments charge for what they call Etsy payments and then they have advertising and additional services. Once again, due to the data feedback loops, advertising should monetize more over time as they offer a better return on investment to sellers. Etsy's advertising revenue right now is growing at 95% and I believe that growth will continue to be robust for some time, and this is very profitable revenue that will increase take rate and free cash flow margins.

G&D: Given the autonomy of your role at Saber, how do you structure your days and your process?

JH: I'm a process-oriented person. My process is very methodical and replicable. The foundation of my day is what I call a daily deep dive session. That's a very focused, intense time for work without interruption. This is like a two or three-hour block of time – it can't go much longer than that, because your mind needs a break after an intense period of focus. I

think of it like a workout and I track my deep dives on a spreadsheet.

“I think it's great to be passionate about things. But I think passion is actually overrated. My advice on that would be to pick a general field that you think you'll enjoy, and then don't worry too much about the specific position you start in and don't focus initially on ‘following your passion’. Instead, focus on becoming great at whatever you find yourself doing.”

I list what I did each day, and I categorize the sessions. They're either company specific work, general education, or writing. Most of the deep work sessions that I do are company specific work, but writing has always been a very important part of my process. There are basically four ways to learn; reading, writing, speaking and listening. I think it's important to use all of those to fully understand challenging subjects.

Writing for me has

always been a way to clarify my own ideas, it helps you solidify things you understand, it helps identify weak points and areas that you don't quite fully grasp, and it helps sharpen your focus. I have no doubt that it makes me a better investor. So that's a central part of my process. Then the rest of my day is what I call flex time.

I spend a lot of time talking to people when I'm researching a business, sending messages, emails, phone calls. Flex time is when I read the news, catch up on blogs that I follow, or catch up on earning reports – I call that “maintenance CapEx”. It might also involve listening to a podcast or maybe even going for a walk and thinking. It's a less structured time... My daily workflow is like an interplay between very focused, very deliberate work with a larger amount of unstructured time for more thinking and more serendipity. You need to have both of these categories working in concert with one another to produce the quality insights that you need to make great investments. The underlying goal of all of this is to slowly build up a web of knowledge and understanding about great companies that I might want to invest in one day.

G&D: What advice would you give to MBA students interested in

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pursuing investing as a career?

JH: I think it's great to be passionate about things. But I think passion is actually overrated. My advice on that would be to pick a general field that you think you'll enjoy, and then don't worry too much about the specific position you start in and don't focus initially on "following your passion". Instead, focus on becoming great at whatever you find yourself doing.

The common denominator that we're all looking for in a career is satisfaction. For me, the best way to achieve satisfaction is to focus on continual improvement. That's what drives me, that's what gets me out of bed in the morning. My ultimate goal is become a great investor, but the motivation to get better at my craft is what I find most fulfilling. The nice thing is, you can do that in any position you're in, any job that you have right out of school, you can start trying to become great at whatever it is you do.

I think if you approach work that way, you'll find yourself in a much more fulfilling career, whatever it is you find. My general advice is don't worry too much about getting the perfect job or pursuing your passion, but instead focus on self-improvement. If you become great at whatever you're doing,

you're going to really enjoy it.

G&D: How do you spend your time outside of work?

JH: My hobbies are somewhat related to work in the sense that when I have my own free time, I spend a lot of time reading. But we have five-year-old twins, so outside of work, I'm quite busy with family. I also spend time volunteering at my church and I'm a board member of a local charity we like to support.

I also love sports in general, and I'm an active runner. I run 50 or 60 miles a week. That's another area of my life that I get a lot of satisfaction from trying to improve, although running becomes harder and harder the older I get!

Running is also a great way to take a break, detach from the office and spend time thinking about ideas and challenging problems I'm working on. When I come back, I'm refreshed and ready to get back to work.

G&D: Thanks very much for speaking with us.

Wilmot Kidd and John Hill, Central Securities

CENTRAL SECURITIES

Wilmot Kidd and John Hill, Central Securities

Central Securities Corporation has since **October 1, 1929**, operated as a closed-end investment company with the primary objective of growth of capital. As of December 31, 2020, the firm managed \$1B. Central's common stock is traded on the NYSE American under the symbol CET.

Wilmot Kidd is CEO and Chairman of Central Securities. Mr. Kidd has been a director of the Corporation since 1972 and served as President from 1973 to 2018, when he was named Chief Executive Officer. Mr. Kidd is primarily responsible for the Corporation's investments and research.

John Hill is President of Central Securities. He joined Central Securities in 2016 as a Vice President. Prior to joining Central, he served as an Investment Analyst with Davis Selected Advisors LP for seven years. Previously, he was a Vice President at Quadrangle Group LLC and an analyst and investment banker at Soundview Technology Group. Mr. Hill graduated from Princeton University in 1996 with an A.B. in Politics.

Editor's Note: This interview took place on January 20, 2021.

Graham & Doddsville (G&D): How did you get into investing? What attracted you to it?

Wilmot Kidd (WK): I got attracted to investing because it's the area where all of commerce comes together. The markets have a future orientation, and I think they offer opportunity for young people to build capital and do well. Investing also provides a lot of flexibility.

“Investing [is] the area where all of commerce comes together. The markets have a future orientation, and I think they offer opportunity for young people to build capital and do well.”

I came to New York in January of 1966 and started interviewing with Wall Street investment firms. It's interesting how you remember those early interviews. I wanted to get into investment banking, and I was interested in, as we called it then, the Buying Department. So, I interviewed with a great number of firms, many of which don't exist anymore. Eventually, I ended up at Hayden Stone, an old-line brokerage and investment banking firm. A college classmate of mine that had worked in

the syndicate department said to me, "Well, you should call Don Stroben, who runs our corporate finance department." So, I put in a call and eventually got hired.

John Hill (JH): Wil, you were involved in corporate finance and investment banking at a fascinating time. Could you comment a bit about your experience working with the semiconductor industry?

WK: Hayden Stone's CEO, Bud Coyle and Arthur Rock had done the original Fairchild Semiconductor deal in the late fifties. So, Hayden Stone was there at the very beginning. Fairchild's management were the guys that spun out from Bell Labs and moved to California with William Shockley, which was really the beginning of the semiconductor industry. Arthur Rock had moved to San Francisco and started a partnership called Davis & Rock, which raised the original funding for Intel. Hayden Stone participated in that round of financing and I was involved as the "numbers guy", the youngest person on the team.

I felt at the time that you had to work on IPO's or public offerings to really understand the company. You'd sit around a table with lawyers and company executives and write a prospectus. And it was a situation where the company management

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was telling the truth because their lawyers were there telling them they had a lot of liability if they didn't. It was a great experience. Gordon Moore told me one day, "Oh, make a computer? Of course, we can do that." I think they were making memory chips at the time. It was about then that he pointed out that the integrated circuit was going to be the basis for many new businesses. It's only in retrospect that you can see how this really provided the basis for the personal computer, the iPhone, and then the internet, and now e-commerce, social networking, et cetera. It has been absolutely fascinating to observe the revolution that has occurred, the wave of which we're still on, if we're careful about it.

G&D: What an amazing story. Being able to quote a personal commentary from Gordon Moore is pretty remarkable. John, it would be helpful to hear from you as well about how you got into investing.

JH: It really was an accident for me. I had considered a lot of different careers coming out of college, but investing was not one of them. I studied politics and economics in college and had written a thesis about Japanese politics that eventually led to a job with what is now called Jones Lang LaSalle. The job was working in the New York offices of Dai-Ichi Mutual

Life Insurance company, cleaning up a portfolio of real estate investments that they had made in the late-80's. They had, on a mark-to-market basis, lost in excess of a billion dollars unlevered in the real-estate crash of the early nineties. They responded by buying 20% of LaSalle and getting a team of people into their office to make the most of the situation. It was a great experience. One lesson was that you can overpay for literally anything, because a lot of these buildings were among the very best in North America. Another was that you should always focus on cash flow. I can't recall a time when we ever looked at the GAAP financials. We focused solely on cash flow. And that became a big part of my investment process.

A third takeaway was, speaking of Graham and Doddsville, Wil's daughter, whom I knew in college, had given me a copy of the 1937 edition of Graham and Dodd when I was working at LaSalle. It seemed to be just a running list of mistakes, and, unfortunately, Dai-Ichi had made most of them. One of the things that stood out at the time was that Graham and Dodd said that the form of security doesn't matter if the person on the other side doesn't have the ability to pay you. That was a very poignant lesson given some of the situations that we were in, mostly with American real estate developers.

By 2000, Dai-Ichi began to recover most of the value that they had lost. They began to liquidate the portfolio, and I thought that investing was something that I would want to do longer term. Like, Wil, I took a turn through investment banking as well afterward, but eventually I ended up on the buy side too.

G&D: You both mentioned some really interesting experiences that have stayed with you throughout your career, do you have any other experiences that stayed with you and shaped your investing philosophy?

WK: I think the philosophy gets developed over time, but I guess looking at the history of Central Securities and cross-referencing, understanding the long-term nature of integrated circuit development led me to see that thinking long-term forced you to make the best investment decisions possible. Otherwise, it was more or less playing the game of musical chairs, trying to buy something you think you can unload to somebody else for a slightly higher price in a short period of time, which doesn't provide a sensible way to invest. So, thinking long-term is the most important thing.

But it's been interesting to see that different philosophies could produce results that

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were also very good. Another interesting part of my history of working at Hayden Stone occurred in 1970 when it was taken over by Cogan, Berlind, Weill & Levitt. Sandy Weill went on after many mergers to be CEO of what is now Citicorp. But what I remember most distinctly about Sandy was that, as opposed to taking a long-term view, his view was every day is a new day. He looked at how much money he made each day, and then the next day was going to be a new day. But there must have been more to Sandy than that because he did get involved in this Wall Street consolidation of brokerage firms that lasted for many years.

Now there are people that make investment or market decisions in seconds, days, and weeks. Maybe the most successful investor has been Renaissance Technologies. So, people have different time horizons, and I think you've really got to work with the time horizon that fits your capabilities the best.

G&D: John, anything to add on your end?

JH: I think Wil's point about taking a long-term perspective is really important. I'm not sure it can be overemphasized. We're a small firm in the context of the industry, so we don't view ourselves as being competitive on shorter term ideas. We don't believe that we're ever going to be the first

to recognize a trend or uncover a piece of information, as much as we try.

“Coming out of the tech wreck in the early 2000s and then the financial crisis, one thing that became clear, particularly in the financial crisis, is that long-term trends almost never reverse.

There are cyclical businesses that go through ups and downs, but the secular trends almost never reverse.”

The other thing about taking a long-term view, which we say in our annual letters is at least 5 years, is that it clarifies our thinking. You asked about specific experiences that informed our philosophy, and I would say that coming out of the tech wreck in the early 2000s and then the financial crisis, one thing that became clear, particularly in the financial crisis, is that long-term trends almost never reverse. There are cyclical businesses that go through ups and downs, but the secular trends almost never reverse. Before the financial crisis, there was a very

healthy debate amongst analysts following media and telecom companies about whether things like traditional newspapers or radio companies were going to have a rebound or could be good value. The financial crisis cemented the secular trend, which was that those were very challenged businesses. A few of them were going to survive, but very few of them were going to thrive in the medium to long-term. I expect in retrospect we will say the same thing about some of the effects of the pandemic.

Hopefully taking a long-term perspective about businesses can help clarify our thinking about where we really want to be positioned and help us avoid what can quickly become a value trap instead of a value investment.

Another thing we try to focus on in addition to taking a long-term view is to own good businesses that produce good returns on capital. And particularly, we tend to focus on management that is working in the interest of all the shareholders. That goes hand in hand with our time horizon, because if you're going to own a company for 10 years, then management is likely to have the opportunity over that time period to reinvest most of the market cap of the company. How they decide to allocate that capital is ultimately what's going to

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determine our outcome.

G&D: Wil, how have markets changed since you took over Central and what learnings do you have from that?

WK: The markets have gotten more efficient since I've been at Central and we can look at history too. Back in the seventies, there were really no separate, private equity businesses. The Rockefeller and Whitney families were the venture capitalists. And you could say that private equity in the 1950's and 1960's was done in the public market.

First, I would say that venture capital became institutionalized. And eventually you ended up with a few the truly successful venture capital firms, and then the followers, many of whom were quite successful too. The same thing happened in private equity, although it's easier to enter the private equity business, because it really only requires capital. The venture capital business now requires an institutional presence. For example, a lawyer from a law firm like Wilson Sonsini that would introduce the graduate students at Stanford that were starting the promising new company. And if you were Sequoia or one of the other top venture capital firms, you might get the first shot.

I also think that the institutionalization of

market specialization has been a big change. Cambridge Associates came along, and they took over control of capital allocation, and the generalist became less and less able to attract capital. That was huge. The other big change has been Jack Bogle's idea about index or passive investing. Whatever we think about that, it's had a tremendous effect on the industry.

"I would say efficiency, private equity, and passive investing are the really big trends. And a lot of this is fostered in part by the amount of money. We've basically had an inflationary environment if you look at it long-term, aside from the big Volcker period where we killed inflation for a period of time. "

I would say efficiency, private equity, and passive investing are the really big trends. And a lot of this is fostered in part by the amount of money. We've basically had an inflationary environment if you look at it long-term, aside from the big Volcker period where we killed inflation for a period of time.

G&D: Do you think the institutionalization of VC and PE has made the stock picker's job easier or harder? There are fewer companies around but perhaps the remaining public companies are better?

WK: It is harder. Today's venture capitalists have been flooded with so much money that they want to hang on until the employees demand liquidity. And so that deprives the public market of these opportunities. The venture capital and private equity business seem to be affected by Andrew Lo's adaptive markets. There's an awful lot of capital chasing startups, and the investors are not getting great deals when the founders can demand 50% of a company.

JH: The amount of money that's followed Swensen's very successful Yale model of focusing endowments on private markets has brought the same thing that happens in any market that is flooded with capital. Returns eventually go down. There are relatively few VC funds that have generated truly outsized returns.

I don't think there's any question that the markets have become significantly more efficient over the last 20 years. In general, retail stockholders invest more of their wealth via index funds and many fewer

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individual stock positions. So, the majority of trading volume in most stocks is a combination of quants, index funds, and professional investors, all of whom are smart. That's another reason why we try to focus on the long-term. In terms of uncovering information or even having a differential view over the shorter term, it's unlikely that we're going to outsmart those very talented people. We believe there is less competition over the long-term because most professional investors have to worry about short-term performance because of the threat of redemptions and compensation incentives.

“We believe there is less competition over the long-term because most professional investors have to worry about short-term performance because of the threat of redemptions and compensation incentives.”

We look for situations where things are misunderstood, or things are relatively unwanted because of specific events or the duration required or uncertainty. A good example of uncertainty would be Schwab. It's a very well-regarded business, both by the sell-side and buy-

side, but it's probably the most interest rate sensitive stock in the world. And as a result of that, one's view on interest rates, or a lack of such a view in our case, determines your level of interest. If you look at the tremendous move in the stock over the last six months, that's purely a result of Mr. Market's impression of what interest rates are likely to be in the future. When we were adding to Schwab last year, we didn't have a view on where interest rates could go. We just thought they were unlikely to go a lot lower, already being at zero; but they could go higher, and that the marginal returns from them going a lot higher would be high.

We've found that the timing of returns has compressed. So, if you wake up one morning and decide that your view on interest rates has changed because Biden won the election or the two Georgia runoffs went to the Democrats, it's too late. The market has already adjusted. You have to decide whether or not you want to be there or whether you don't. So, we tend to look for situations with asymmetry and optionality that could work in our favor, rather than situations with certainty, because that certainly would already be priced in.

G&D: Before we move on, it would be great to get a quick overview of Central because it is

very unique. And from that I wonder, what insights you have from the fund's long track record?

WK: Central was started in 1929 in Chicago by the Central Banking Trust Company of Illinois. Central was a securities affiliate of the bank and invested in public utilities, which were a popular growth industry in 1929. What's interesting is that Central started in October 1929, so they didn't lose any money in 1929 because they didn't have it. They also didn't lose any money in '30 or '31, but lost half of it in '32 and proceeded to lose more money. They started with \$15 million and reached a nadir of \$3-4 million. In 1936 the bank reorganized and Central repurchased a large block of its stock which had to be sold. So, there was a huge buyback of 20% or more of Central's capitalization. Central stabilized there, and after World War II, the company was very successful when new management came in.

Christian Johnson ran the company from 1948 until 1962. He had recognized that after World War II with the soldiers returning, the public was extraordinarily liquid because of the financial repression during the war. Much of Wall Street was bearish, feeling that we might have a depression after the war like we had after World War I. Mr. Johnson was

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very bullish and saw the opportunity for Central. Investors bought the stock at a value of about a dollar a share, and, I was told, made, over 50 times their money in the 1950s.

After he died, a successor management team ran it until 1970, and then there was a dispute about how the company should be run. The management group left feeling that they were not going to be able to get control. Central was then run by an outside bank for a few years, and assets had declined at one point to about \$35 million. I was asked to go in and look at the situation. In retrospect, it was an opportunity to do a restart. It was clear that things were at a very low valuation, so from starting there, we started taking a long-term approach and kept our expenses as low as possible. Eventually we were fortunate enough to benefit from the bull market of the '80s and then the bull market of the '90s, in large part based on the integrated circuit industry. We also had some contacts in the oil and gas business, and that was very successful in the late '70s, early '80s, maybe due to the origination of corporate activism in a big way with Boone Pickens. The big lesson from all this is permanent capital. I mean, if you don't have permanent capital, you don't get to take a big drawdown and continue investing. So here the shareholders got a chance to "stay in

the game" and it worked out. That's the biggest lesson, and I think that's sort of overlooked during the heyday of the mutual fund businesses. I think largely, it's overlooked today. But the closed-end business is not a very big business and doesn't really provide a lot of opportunity for Wall Street to make money, other than raising new ones, which these days are mostly ETFs. And it's debatable whether that's permanent capital or not. It's not really, but it's semi-permanent, so to speak.

"The big lesson from all this is permanent capital. I mean, if you don't have permanent capital, you don't get to take a big drawdown and continue investing."

G&D: What's your investing philosophy and how has it changed over the years?

WK: Well, one of the most interesting things is even after 50+ years, I find that I am still learning. I learn a lot from John and Andrew O'Neill at Central. John mentioned that he focused on cash flow. I think we always had some focus on cash flow, but John has caused me to raise that to a totally new level. I think you can understand it intellectually, but when you understand it from

participating in the markets at the same time, it's different.

The investing education that you are getting is far superior to what I got. Although one thing that sticks with me from back in the '60s is that one of my professors said you really have to go visit companies to get to know them. I think that's something that over the years has proven to be very important for me. It's more difficult these days. But I still think it's doable, and I think that your contacts, getting to know people, that all leads to getting to meet more managements and know them. I have colleagues who just wouldn't invest in a company where they didn't know the management. I would say that's very important.

G&D: Those are great principles, but how do they influence your philosophy for investing over the long-term? Do you tend to be more value focused or more growth focused?

WK: I've always said there's no investor that doesn't want a value. It's really the fact that growth is the biggest factor in the value equation. That's the way I used to say it. But it's made even more clear by that professor of yours up at Columbia who recently wrote a piece about value investing. It's really future cash flow. Buffett's also made it so

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clear. I mean, investors are much smarter now than they were, and that has been an evolution that I've gone through. I've become smarter over time.

We inherited an investment in the '70s at Central, one of the big old meat packing companies, Swift and Company. Central's management had learned it that was dramatically more valuable as a sum-of-the-parts. They were generating huge cash flows, and if management reinvested those cash flows correctly, they could make a huge gain. But it was going unrecognized by the stock market at the time, The Crown family had taken a big interest in the company to protect them from some activists from Texas. The CEO retired and the CFO moved up, and under his leadership they increased the value of the company by six or seven times by reinvesting capital and spinning off companies, and eventually, all the businesses were sold.

That was really a capital allocation cash flow reinvestment story, but not under the guise of today's looking at a unique company that is producing lots of cash flow and well-managed. So, I suppose cash flow investing has always been understood by investors. Of course, in the case of Swift, it was necessary to get management to make it work.

G&D: How do you think about businesses that generate a lot of cash flow but have seemingly run out of things to do with the cash?

WK: That's a problem because the investment business is a capital allocation business. And you must have to have opportunities to reinvest it and for years Intel did until their recent missteps. A free cash flow model that we've been very impressed with involves acquisitions. One of my colleagues over the years was involved with companies like Dover and Carlyle and Roper where they have run businesses solely for cash flow and then taken the money and reinvested it in sensible acquisitions. And that's sort of a business model that is, I would say a model for all seasons. That is one of the wonderful things about investment. You can continue to learn, and different opportunities come up at different venues.

JH: Philosophically, it's a really important question. We've found that it's really difficult to make money when there isn't at least some organic growth in the business. It's possible, but it has to be a really special management team and a really special situation. Wil mentioned Roper and Dover and Carlyle. Of those we only own Roper at present, but that's been a situation where they have a unique culture and a unique

management team that has been exceptionally good at allocating capital over a long period of time. They've recently undergone a management transition, and it remains to be seen if they can continue their amazing track record. But their model as Wil said is very specifically focused on taking cash out of businesses in the portfolio that they select specifically because of the high gross margins and the ability to take cash out of them; then, they redeploy it into acquisitions.

We have a couple of other businesses, Cogent Communications and Star Group, that cannot redeploy all of FCF back into the business. Cogent does generate organic growth over time, but they don't have the ability to deploy all the cash they generate back into the business. They have, we think, a very unique CEO who owns 10% of the company and is laser focused on getting all the capital out of the business that can't be deployed at very good returns inside the business. Star Group is a similar situation. It's a fuel oil distributor and does not have positive organic revenue growth, but it has a management team and a shareholder culture that's very focused on improving cash flow per share over time. We think these are pretty unique situations. If we look back at painful mistakes made over the years, usually it

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involves a company where there wasn't positive organic revenue growth, or the outlook for organic growth was poor.

G&D: How do you go about idea generation?

WK: I can say that's been a perennial question as long as I've been in the investing business. There is no specific model. If there is, at any moment in time it will immediately get overused. What you are as an investor is a person with intellectual capital, with experience, understanding of businesses and contacts that allow you to get in more insightful or inside views of situations, learn what's really happening in a business.

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I just learned this recently, from an investor who was explaining the theory of

TJ Maxx. I'd never really looked at TJ Maxx and I don't own it now, but his point was that the apparel producers and TJ Maxx have a symbiotic relationship. The apparel companies have got to overproduce so that they do not get stock-outs. They eventually must get rid of the remnant inventory, and TJ Maxx is the most efficient way for them to unload the stuff that they cannot sell. They need to keep TJ Maxx around because they really give up a huge opportunity if they run out of merchandise at the end of the year or at any time.

So, it's getting to understand those insights into business that just aren't in the public press and often aren't in Wall Street research. But I think it's somehow getting to where you understand situations. John had mentioned Star Gas, well, we don't know that it'll work out, it's a declining business. I'm reminded of the first LBO, when the Gottwald family bought Ethyl Corporation, which had been the company that made tetraethyllead. In the fifties it was banned and then use of tetraethyllead was discontinued. So, the company was going to go out of business, and they bought it from a consortium of oil companies with borrowed money and used the cash flow to pay off the debt. Over the years, they've produced four or five different companies, including Albemarle,

which is the lithium company riding on the Tesla wave at the moment, which just goes to show that there are just so many different ways of using cash flow.

G&D: Would you say that is the biggest area you focus on at Central? What is the cash flow profile and what's the opportunity for deploying it?

JH: I think that the cash flow statement is usually a disqualifier rather than a buy signal. If there's a big discrepancy between the income statement and the cash flow statement, it's rare that the discrepancy is good news.

Uncovering ideas as Wil said, is a question everybody asks and there's never a good answer for it. A lot of it is serendipity. Wil talks a lot about trying to expand our network and expand our circles of competence over time. And those two things are related. Some of the best ideas that I've ever come across have come from talking to executives in the technology industry about how their customers use technology, and vice versa. Some of the best tech ideas I've had, have come from talking to consumer product executives about how they use software. I've been very surprised about some of their answers over the years.

Wil mentioned that good ideas always attract

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capital and one very fertile area for a long time was sort of the Joel Greenblatt book, "How to Be a Stock Market Genius", which focused on corporate action and spins and such. Spins seem to have gotten to be a somewhat less fertile area to look, although they can still at times be quite good. When Bristol Meyers spun off Mead Johnson, its infant formula business, it didn't look particularly cheap, but it was a great idea. And when HP spun off Agilent, and then Agilent spun off Keysight, Wil had the wisdom to keep Keysight. It's been a great investment for Central.

I went up to see Keysight in Santa Rosa when I started at Central and concluded that we should keep the position, but not add. Well, it's up five times since then. So, I was quite wrong. Spins historically were a fertile area, but they seem to have become less fertile than they may once have been. Meanwhile, we have found that other forms of corporate action, like M&A seem somewhat more fertile because the time horizon for most investors has gotten so short that they don't want to look past the close date to see whether or not they want to own the new company or not. When Analog Devices, which is our biggest public position, bought Linear Technology in 2016, the stock declined on the announcement. We loved Analog before the

deal was announced, and we loved it even more after announcement. We thought the valuation had declined from, 17- or 18-times free cash flow, to 14- or 15-times while improving the long-term complexion of the business. The market just thought that Analog was dead money because it would take a year to get Chinese regulatory approval to close. We added to the position.

Another similar and more recent situation is Aon, the second largest insurance brokerage company, which is buying Willis Towers Watson, the third largest. We've wanted to own insurance brokers for a long time; they're great cash flowing businesses. Aon more or less treaded water for some time after the announcement, which gave us time to do due diligence. We are hopeful that cost synergies could be significantly greater than management's initial estimate and that free cash flow per share could at least double over a four-to-six-year period.

G&D: When or how do you decide when is the right time to sell?

WK: Well, the answer is you want to own companies. Someone asked Sandy Gottesman, a director of Berkshire Hathaway, who has been with Buffett since the very start, what the right time to sell was? He said, never!

I suppose the answer is there is no answer. If a company's fundamentals start to deteriorate, I think it's probably smart to recognize that early. And we've been recently at fault in not recognizing some things early, I'm thinking particularly of Intel's stumbles, where of course it's always easy to look in hindsight. Also, when you're getting tomorrow's price today, it's probably a good idea to at least trim your holding. Which reminds me, I think that some of the more successful sales we've had is when an investment grows from say, four percent of your portfolio to seven. You might say, well, I'm just going to trim it down to five. So, trimming your winners. However, that goes totally against the theory of watering your flowers and pulling out your weeds, and I think it's very important if you're a long-term investor to try not to get out of your flowers too early.

"I think it's very important if you're a long-term investor to try not to get out of your flowers too early."

JH: Tomorrow's price today is the hardest thing to manage appropriately. The reality is that in the short-term stocks can go far past your most generate estimate of fair value.

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We eliminated a position in an insurance company called Kinsale last year. We think the founder and CEO, Mike Kehoe is among the very best executives we have met. He owns about 5% of the company and has done a magnificent job in every aspect of the business. They've used IT to achieve a much lower cost ratio than most of their competitors in the E&S insurance market.

They're likely to gain share for a very long time, but we felt that the stock was starting to price that they soon would be a bigger E&S insurance underwriter than say Markel or RLI or W. R. Berkley, all of which have been around for decades.

Furthermore, they would have to raise capital in order to support that much greater level of premiums. And so, we sold the position and the stock just kept going. It's a humbling business. Wil mentioned Intel. I think another reason to sell in addition to tomorrow's price today is just if we have a very clear sense that the competitive position of the company has changed. In the case of Intel, our research uncovered that for the customers that are able to fully optimize code to the way that AMD addresses memory and other aspects of the way their chips process instructions, AMD server chips today can do significantly more work on the same power budget. We didn't eliminate the position in

Intel because we still think it's an important company long-term, potentially with national security implications, and it's certainly inexpensive. But we felt the competitive position had changed and that we should reallocate some of the capital to positions like Alphabet, where we felt that there were some areas where the company was under-earning due to cyclical factors, like travel, and investment through the income statement, such as Waymo and Verily.

G&D: Could you walk us through one or two recent ideas? What's the high-level thesis or what do you think is misunderstood by the market?

JH: Plymouth Rock is a very important part of Central. It's about 20% of assets today. It's a private company in which Wil invested in 1982 at its inception. The founder Jim Stone, Wil had known from his time at Hayden Stone. Plymouth Rock underwrites auto and home insurance and smaller lines like umbrella in the Northeast. Plymouth Rock has an extremely entrepreneurial culture while also being quite risk averse. Wil, what would you say about Plymouth Rock and the investment thesis and its importance to Central?

WK: It's a company that's owned by the shareholders and run for the shareholders. Management firmly

believes that being a privately held company allows them to take a long-term viewpoint that they could not take if they were a public corporation. And I think that probably the reason we think highly of it right now is that they recognize where the personal lines market is going. They are working as hard as they can to take advantage of it. There is a massive shift to the online acquisition of business. When you have an investment like this, where you know the company well and are on the board, you get to see a business from the inside and you get to see what's really going on in the industry. It's a huge \$2+ trillion business, so a huge addressable market.

JH: It's a huge market, and it's also still an extremely fragmented market. There are at least 20 companies that sell car insurance in every state in which we operate. And most of them are not well known. Most of them are not terribly competitive or profitable, at least on an underwriting basis. Most of them rely on the investment income to support the underwriting operation. Investors tend to think of Progressive and Geico as really the dominant forces in the market, and to a large degree, that's true. But it ignores the fact that there are still 15 to 18 other companies from which we can gain share over the medium to long-term. That's extremely

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important.

Another aspect of Plymouth Rock that is unique is that they've been extraordinarily good capital allocators and investors over the long-term. We think of Progressive as a company that is primarily an underwriting profit-driven company. While Plymouth Rock has generated underwriting profit over time, its success has been driven primarily by very strong investment results and outstanding capital allocation. Acquisitions have played an important role in Plymouth Rock's growth, particularly of our business in New Jersey, which is a reciprocal structure. If you're not familiar with what a reciprocal is, I think Erie is the only public company that has a reciprocal structure. In a reciprocal the capital of the insurance company is owned by the policyholders, and then there is a management company that receives a fee to manage all the operations of the insurance company. We own the management company for that business, and it accounts for slightly more than half the premium of Plymouth Rock. So, the profitability of essentially half of Plymouth Rock is really determined by that fee-driven business model, and the other half is the combination of the traditional insurance companies and the holding company that holds investments.

G&D: Do you think your involvement with Plymouth has made you better investors?

WK: I think the first answer to that is that it's made us understand the insurance business better, and we should have understood it better earlier, because Progressive has been an extraordinarily good investment over the years that we should have owned more of. But, yes, it has provided insights into investing, as well.

G&D: How does Plymouth Rock think about the capital allocation piece? What are they looking for? What do you think they can do differently?

WK: Well, in public companies, many managements have low hurdle rates for acquisitions. They've simply got capital and they want to do acquisitions. And, I mean, I've seen this time and again over the years. Plymouth Rock's management are big stockholders of the company, and they have got a very high return threshold for allocating capital. Otherwise, they'll give it to the stockholders to allocate themselves. That is the primary thing I've seen. I've been involved with companies that convince themselves that they're making great acquisitions when they're barely in excess of their cost of capital. Plymouth Rock is making acquisitions where their returns have been above

the 20% area over the long-term.

I would say it's having skin in the game. And that's part of what's really important to us, which is knowing management and having management that's working in the long-term interest of stockholders. It's the agency problem, as they say in economics. It's really important to have management that is shareholder-friendly, honest, and capable.

G&D: Has there ever been a situation where you really liked a company, you thought the stock was attractive, but didn't invest because management didn't pass your sniff test or didn't own enough stock or had been selling recently?

WK: I think I can think of plenty of situations where the management didn't pass the sniff test. And I think one of the things I learned is that the sniff test doesn't always work. I mean, I think that one of my misses was not investing with Sandy Weill because I really didn't think that Sandy passed my sniff test, basically because he was so short-term. But he made a lot of people an awful lot of money.

G&D: What advice would you give to MBA students interested in investing?

JH: For people who want to pursue a career in investment management, I'll give

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you the advice that Wil gave me when I was young, which is that when you're early in your career, the most important thing is to get exposure to people and to companies and industries that can raise your level of play, help you build a network and build out your circles of competence.

“When you're early in your career, the most important thing is to get exposure to people and to companies and industries that can raise your level of play, help you build a network and build out your circles of competence. Working in investment management is a lifelong exercise in learning, which is a wonderful thing.”

Working in investment management is a lifelong exercise in learning, which is a wonderful thing. The more exposure you can get to great people early in your career, the more beneficial it is.

WK: You want flexibility. You want to, if possible, be more of a generalist so you get a lot of exposure to different

industries. I think that it's really important to involve yourself with a company with high-quality people. Many years ago, I served on the University Club Board of Directors, and Rick Cuniff was on the board, too. And he liked to talk a lot about his experiences at Ruane Cuniff, and he pointed out that they had a wonderful young guy there, and the guy had come to work at Ruane Cuniff and said he wanted to work there even without a salary. He just wanted to learn. And so, I think the idea would be really look for the company where you're going to learn the most. Life gives you a long career and going for the highest initial buck is not the smartest approach. So that would be really it. It's people you want to associate with, a company that you would feel good about.

G&D: How do you spend your time outside of investing?

WK: If you find a career that is interesting to you, it's not work. And that may be the most important thing. The goal should be to have what you are doing at work be something that is so good that it's not work. I've probably spent too much time working, which, of course, I never considered work. And outside, I was pretty standard. I was fortunate enough to marry a young lady who introduced me to the ballet the philharmonic

and the opera. And Broadway shows.

“If you find a career that is interesting to you, it's not work. And that may be the most important thing.”

Being involved in sports is very important, because it's very good to stay balanced. And certainly, you really want to focus on health, finding sports that you are good at and pursuing them. I played squash for many years. I was never particularly good at it, but I got to meet a whole lot of people in that universe. And I probably got a lot of ideas and made a lot of friends and contacts just from being involved in sports.

Central has a large stockholder, The Endeavor Foundation, which my wife runs, and so I've sort of considered that my avenue for philanthropic work. That's a nice thing to be able to do. I would say maybe most importantly, some of the greatest experiences I've had are being on nonprofit boards or where you're really doing it for other people, so doing something for people outside yourself is, when you look back on it at my age, it's one of the more rewarding parts of what you spent your life doing.

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JH: Wil has showed me that when you find purpose in the work, it changes your attitude about work, your engagement, and the length of career that you'd like to have. Coming to Central and working with Wil has been really great for me in that respect. I also think that, to me, personally, there's a lot of purpose and meaning in trying to help the Endeavor Foundation make the grants that it does. They own about a third of the company. And knowing that if we do a good job, that we increase their grant potential is something that's really important to me.

Wil has also encouraged all of us at Central to, as he said, be physically active and physically fit. It helps our focus at work and it also extends the duration that you'll be able to spend working. And so that's something I've really taken to heart, as well.

G&D: Gentlemen, thank you both so much for your time.



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3022 Broadway
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Contact Us:

RDepaula21@gsb.columbia.edu
MHabig21@gsb.columbia.edu
LTien21@gsb.columbia.edu

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Rodrigo de Paula '21

Rodrigo is a second-year MBA student, a Meyer Feldberg Fellow and a member of Columbia Business School's Value Investing Program. During the summer, Rodrigo worked as an equity analyst at MFS Investment Management. Prior to Columbia, he worked at Clayton, Dubilier & Rice as a private equity associate. Rodrigo graduated from the University of Pennsylvania with a B.A. in Philosophy, Politics and Economics. He can be reached at RDepaula21@gsb.columbia.edu.



Matt Habig '21

Matt is a second-year MBA student and a Columbia Fellow. During the summer, he worked in the Restructuring Group at PJT Partners. Prior to Columbia, Matt worked for six years in the Institutional Equity Division at Morgan Stanley, most recently spending three years in their Special Situation Group. Matt graduated from Dartmouth College with majors in Economics and Engineering Sciences. He can be reached at MHabig21@gsb.columbia.edu.



Alison Tien '21

Alison is a second-year MBA student and a Columbia Fellow. During the summer, Alison worked in the Equity Investment Group at T. Rowe Price. Prior to Columbia, she worked in portfolio analytics at Capital Group in their Los Angeles office. Alison graduated from the University of California, San Diego with a concentration in Economics and a minor in Accounting. She can be reached at LTien21@gsb.columbia.edu.