

Graham & Doddsville

FALL 2021

An investment newsletter from the students of Columbia Business School

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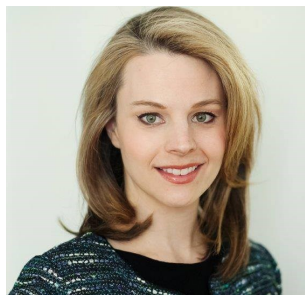
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Welcome to Graham & Doddsville



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.

We are pleased to bring you the 44th edition of Graham & Doddsville. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA). In this issue, we were lucky to be joined by three investors who have plied their craft across geographies, asset classes, and market cycles.



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 first interviewed **Gavin Baker**, founder of Atreides Management. We discussed Mr. Baker's path to investing, key mentors, and how a lifelong interest in science fiction has helped cultivate his interest in investing and the future. We also discuss changes in big tech, how retail will evolve post-COVID, and retail investors' impact on the investing meta-game.

Next, we interviewed **Rudi van Niekerk**, founder of Desert Lion Capital. Mr. Van Niekerk discusses his focus on South African public markets investing, and his path to investing. We talk through his experience launching a fund, the nuances inherent in investing in South Africa, and common misconceptions about his home market.

Lastly, we interviewed **Ben Preston**, a director and portfolio manager of Orbis's Global Equity Strategy. We talk through Ben's path to investing and experience beginning his investing career during the dotcom bubble. We also discuss how funding and investment drives capital cycles and how to invest over the full cycle.

We continue to bring you stock pitches from current CBS students. In this issue, we feature the winners of the 2021 CSIMA stock pitch competition, Ian Gorman ('23), Joye He ('23) and Raghav Mittal ('23) for their long thesis on CoStar (NASDAQ: CSGP). We also feature participants in this year's Women In Investing pitch competition Richita Jain ('23), Angela Pan ('23), Courtney Owens ('22), and Impana Srikanthappa ('23) for their long thesis on AptarGroup (NYSE: ATR).

You can find more in-depth interviews on the *Value Investing with Legends* podcast, hosted by Tano Santos and Michael Mabuoussin, Head of Consilient Research on Counterpoint Global at Morgan Stanley Investment Management and adjunct faculty member at Columbia Business School. Recent inter-

viewees include Lauren Taylor Wolf, Mason Morfit, and Thomas Russo.

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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SAVE THE DATE

The Heilbrunn Center for Graham & Dodd Investing at
Columbia Business School presents

THE 25th ANNUAL *CSIMA Conference*

Date: February 3-4, 2022
Setting: Virtual

Thursday, February 3rd

Fireside Chat with **David Abrams**, Abrams Capital and **Tano Santos**, David L. and Elsie M. Dodd Professor of Finance and the faculty Director of the Heilbrunn Center for Graham & Dodd Investing

Fireside Chat with **Dawn Fitzpatrick**, Soros Fund Management and **Tano Santos**, David L. and Elsie M. Dodd Professor of Finance and the faculty Director of the Heilbrunn Center for Graham & Dodd Investing

Investing in Tech panel

Fireside Chat with **Neil Blumenthal**, Warby Parker and **Alexandra Cowie '17**, Good Friends

Friday, February 4th

Best Ideas panel

Fireside Chat with **Howard Marks**, Oaktree Capital and **Tano Santos**, David L. and Elsie M. Dodd Professor of Finance and the faculty Director of the Heilbrunn Center for Graham & Dodd Investing

Fireside Chat with **Mellody Hobson**, Ariel Investments, and **Tom Russo**, Gardner, Russo, Quinn



Pictured: Professor Tano Santos interviews Kim Lew, President and CEO, Columbia Investment Management Company, at this year's Graham and Dodd Breakfast

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

Gavin Baker, Atreides Management



**Gavin Baker,
Atreides
Management**

Gavin Baker is the Managing Partner and Chief Investment Officer of Atreides Management, LP. Prior to founding Atreides in 2019, Gavin was at Fidelity Investments from 1999 – 2017, most recently as the portfolio manager of the Fidelity OTC Fund from 2009 – 2017. The \$17 billion Fidelity OTC Fund outperformed 100% of its Morningstar peers and won 6 Lipper awards over Gavin's 8-year tenure as portfolio manager. Gavin was the Boston Globe's Fund Manager of the Year in 2014 and his performance was recognized by articles in Barron's, the New York Times, Investors Business Daily and the Wall Street Journal. He helped spearhead Fidelity's venture capital investing and was a board observer at Nutanix, 23andME, Jet.com, AppNexus, Dataminr and Roku, among others. Gavin earned an AB in economics and history from Dartmouth College.

Editor's Note: This interview took place on October 25th, 2021.

Graham & Doddsville (G&D):

Gavin, thanks so much for taking the time to meet with us. Was hoping you could start by walking us through your background and how you got into

investing. And in terms of specialization, were you always drawn to consumer and technology businesses?

Gavin Baker (GB):

Sure. Investing and specialization were both products of my very early childhood interests. Some of my most vivid childhood memories are reading books about history and my parents telling me stories from history. I became interested in current events when I was a freshman or sophomore in high school. I started reading all the magazines and newspapers because that was kind of like history happening. And I've always had an interest in science fiction, but we'll come to that later.

In college, I loved games of skill and chance like chess and poker, although I wasn't very good at them. But I had no real interest in investing and my plan in college was to be a rock climber and a skier. I became a ski bum, working as a housekeeper at the Goldminer's Daughter in Alta, Utah. And my parents said, "Hey, this is an amazing plan. We totally support you being a river rafting guide in the summer, a housekeeper in the winter, climbing full time in the shoulder season, trying to write a novel and being a wildlife photographer on the side, and living out of the back of a pickup

truck. But would you please just do one professional internship?" I was lucky that my parents paid for my college, so I said sure. The only professional internship I could get was in the stock market here in Boston. And it was instantly the most interesting thing I had ever been exposed to because it kind of combined everything that I was interested in. To me, investing success comes from having the most knowledge possible about history and intersecting it with a really accurate understanding of the present state to form a differential understanding of the odds of something happening in the future. That was so fascinating and addicting to me, and I never looked back. I went back to Dartmouth, switched my major from History and English to History and Economics, and did a bunch of different internships and ended up at Fidelity.

Why specialize in technology? Well, I've always been interested in science fiction and the future from a very early age. Technology is fundamentally about the future, so I guess that's why I was drawn to it. And I think a lot of the success I've had since then is due to a super lucky decision I made as a very, very young man. And that decision was to not walk away from tech. That may sound like a strange thing to say today, but in 2002,

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all the great investing minds of my generation walked away from tech because they were listening to Buffett. He was on CNBC once a month doing an interview with Becky Quick, where he took a victory lap for avoiding the tech bubble, basically implying that tech was not investible. And almost everyone listened to Buffett and everyone for sure looks up to Buffett. For any sector other than tech, there are hundreds of people who've been doing it at a high level for twenty plus years. But in tech, there are very, very few of us. And it's a big advantage because investing is a game of cumulative knowledge and compounding advantage. And the only reason I didn't listen to Buffett was because of my personal interest in science fiction. That was lucky.

And then why consumer? Well, consumer and tech have fully merged. How can you look at Airbnb without doing Marriott? Netflix without Disney? Amazon without Walmart? Today, you really need to look at them together.

G&D:

Buffett would usually say, during those CNBC interviews, that tech is just too hard or complicated. Was there anything specific that made you feel like, "Hey, as long as I dive into this, I can understand

this well enough to be in that top group of people that have the potential to invest well in this sector?"

GB:

Even back in 2000, the history of tech suggested that this was true. A lot of people are attracted to these companies that you can own for 50 to 100 years, and there are very few of those. Vanishingly few. So, you have to accept the fact that there is some chance this isn't going to be a company in 50 to 100 years but the reality is that tech rarely goes away; instead it accretes over time in layers, i.e. IBM is still selling mainframes today just a lot less of them than during the 1980s. Regardless there do tend to be these very durable 10-to-20-year cycles in tech.

"And then why consumer? Well, consumer and tech have fully merged. How can you look at Airbnb without doing Marriott? Netflix without Disney? Amazon without Walmart? Today, you really need to look at them together."

And the whole '90s was one of these long duration tech cycles as the client server model replaced the mainframe and minicomputer. And because of this one powerful trend that you could just look at and be like, "Wow, here's the percentage of compute that is done on the old, inefficient model. Here's the percentage, tiny percentage, on client server and it's better, it's faster, and it's cheaper." And then you could develop these profound competitive advantages in tech around scale and network effects. You had this group of stocks that had compounded at 40% a year for a decade – Dell, Oracle, all those client server companies. Then you had the internet, which took nearly 10 years to really affect core tech, and that was through cloud computing. But I actually felt like if you were willing to dive in, roll up your sleeves, and really understand it, tech was well suited to the deep analysis that I enjoy. And by the way, how the world has changed. Buffett was a pre-IPO investor at Snowflake and Apple is his largest position.

G&D:

Who were the people that were most impactful on your development? Curious as to whether they were investors, historians, or even folks on the science-fiction side.

Gavin Baker, Atreides Management

GB:

Yeah, so many. Buffett, of course. If you're an investor, you must be steeped in Buffett. Peter Lynch. To this day, the Peter Lynch process where if you like the product, you're going to like the stock – that is powerful. I also had a lot of great mentors at Fidelity. Jennifer Uhrig is someone who I believe has run more money than any other woman and had great long-term numbers. She really taught me the value of being skeptical and always being conscious of risk. One of her signature phrases was "You have to either panic early or double down late," which has stuck with me. Will Danoff taught me the value of being optimistic and open-minded while also playing in the present. The ability to balance conviction and flexibility is hard. It's one of the things that makes investing an art. And it is the reason why you must find a philosophy that suits your temperament so that you can find the right balance between the two. Too much of either and you are not going to succeed. But Will can be in a meeting, love the story, and then, if the facts change, a few weeks later, he's selling the stock. Just total dispassion combined with a lot of curiosity and optimism. And then Steve Wymer, who runs a growth fund at Fidelity, taught me the value of hard work and knowing your companies better than almost anyone. As an analyst covering a

group of only 20 to 30 stocks and focusing intensely on only those stocks, it was really hard to tell Steve something about one of those companies that he didn't already know if it was in his fund, which speaks to both his work ethic and the value of compounded knowledge.

Science fiction, I don't know where to start. The Culture Series by Iain Banks, Hyperion by Dan Simmons, Dune by Frank Herbert, Foundation by Isaac Asimov. Maybe less known would be A Deepness in the Sky and then A Fire Upon the Deep by Vernor Vinge, who actually coined the term "The Singularity" where AI and human conscious merge.

"The ability to balance conviction and flexibility is hard. It's one of the things that makes investing an art. And it is the reason why you must find a philosophy that suits your temperament so that you can find the right balance between the two. Too much of either and you are not going to succeed."

Science fiction is powerful because it opens your mind to the fact that the future can look really different. And even though the last 250 years of history have seen crazy change – from the locomotive, airplane, moon landing, computers, to nuclear power – human beings are still linear thinkers. I think that training your mind for the potential of non-linear futures is helpful.

G&D:

So, switching gears, it seems like you have a large investible universe. A lot of the companies that you own don't necessarily fit in one thematic box. How do you think about narrowing that universe to the businesses that warrant deeper dives?

GB:

Everybody looks up to Warren Buffett, but almost no one does what he says he does. Warren Buffett has said he doesn't do due diligence. This was a statement about Precision Castparts which is one of his largest acquisitions ever. And everybody just ignored that comment, but it was a profound comment. And what he meant by it was that he didn't need to do due diligence. He had been reading every 10-K published by Precision Castparts for decades. He didn't sit down and do some 60-day deep dive. He didn't need to because he had been

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doing due diligence on Precision Castparts for decades.

That idea is similar to my philosophy. If I need to do a deep dive, we are not going to invest. You can think of my investible universe as the companies where I don't need to do deep dives because I have been doing due diligence on them for many years or even several decades. The goal is to grow that universe, steadily and incrementally year by year, with the understanding that I'm not going to do six months of work on a company and then suddenly it is going to be in the investible universe.

And by the way, just so you know, this idea that I only invest when I really know the company, it does not improve my batting average. It doesn't improve the initial decision making at all. But it does help me make better decisions when I am wrong and this is a big part of investing.

Everybody always asks about idea generation. If I were to boil down idea generation, a lot of it would be Peter Lynch and then the other part would come from Matt Cohler, who is a venture capitalist at Benchmark. Whether they're the greatest or one of the three greatest series A investors is open to debate, but there is no more debate beyond that. Matt Cohler has

said, "My job is not to predict the future. It is just to notice the present first." That is such a powerful and profound statement.

"If I need to do a deep dive, we are not going to invest. You can think of my investible universe as the companies where I don't need to do deep dives because I have been doing due diligence on them for many years or even several decades. The goal is to grow that universe, steadily and incrementally year by year..."

I am not a believer in having an investment thesis. A thesis is a belief statement, definitionally. In your sophomore year of high school, you are taught to make the thesis the last sentence of your first paragraph. You state what you believe and then you attempt to prove it. That is the wrong way to approach investing because what you really want to do is search for disconfirming information, not confirm what you already believe.

I believe in investment hypotheses. A hypothesis is a falsifiable

statement and is used by the scientific community. If you have a falsifiable statement, you look to falsify it. And if you can't do so, then the hypothesis is intact. My baseline assumption is that I'm wrong, which makes it easier to change my mind. This goes back to things like pre-mortems and having a designated skeptic on every position. And that is a little bit of what I try to do when I have an idea – let me try to prove to myself that I am wrong rather than that I am right.

G&D:

I want to ask about the private side of investing as well. Are there any examples you could share of things that you've learned on the private side, and how they've impacted the way you think about a position on the public side or vice versa, and just how that crossover approach is helpful.

GB:

It's critically important to pay attention to new issues. Crossover investing is valuable because you can see these disruptors years before they go public, which is valuable even if you're not going to monetize that information today. There's this self-fulfilling thing where VCs, knowing that startups have no legacy tech stack and want to use the best tech, are always asking their portfolio

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companies, "What's a cool new tool that you're using?" That is where a lot of venture funding and future disruption to public companies comes from. I think public market investing makes you a better late-stage growth equity investor, and vice versa.

"I believe in investment hypotheses. A hypothesis is a falsifiable statement and is used by the scientific community. If you have a falsifiable statement, you look to falsify it. And if you can't do so, then the hypothesis is intact."

A couple of examples. Everything about SpaceX is very public, but really understanding and paying attention to Starlink – which is going to be very disruptive to a lot of companies with a lot of leverage all over the world – that was very helpful. Between various Twitter accounts and the SpaceX subreddit, you have everything you need to know about SpaceX. In 2019 and 2020, there were a lot of machine learning and AI accelerator startups. There was a huge amount of worry in the public markets about

what that meant for some of the incumbent GPU providers. And being able to talk to all of them and understand how far away they were from actually disrupting GPUs, things like that can be conviction building.

G&D:

It seems like 5G rollout will be one of the big technological themes over the next couple of years. Could you talk a little bit about how you think 5G changes things, either from a consumer or an individual company perspective?

GB:

The short answer is 5G changes nothing at all. If you are an incumbent, you are going to have to spend a lot of money just to stay in place. 3G was profoundly important because it enabled the mobile internet and allowed you to have applications. 4G was also foundational because it let you stream media. Without 4G, there would be no Spotify or Netflix as we know them. 5G doesn't enable anything new. Maybe it allows some of this IoT stuff. Maybe. And I do think it does make it more feasible for some of these mobile operators, on the margin, to compete with the fixed line providers.

G&D:

I saw Dish in the Atreides 13F and was curious, what is interesting to you about the company?

GB:

Telecom pricing is not well understood. Telecom is one of the few industries where pricing broadly does not follow the Herfindahl-Hirschman Index (HHI). And the reason is that the distribution of market share is what really matters because what drives pricing in telecom is the cost of repricing your installed base. And what that means is in a market where one company has a 70% share, and one with 20% share and one with 10% share – that market is way less stable than one where it's 40%, 30%, 30%. The math that everyone does is if I cut price and I reprice my own base, can I gain enough share to do that and grow my revenue? So, you really have to look at the distribution of market share to understand where pricing is going to go and how open a market is to a new entrant.

In telecom, definitionally, the newest network is always the best network because it is empty. A large part of what drives network quality is the load on the network. When we turn on a new network, it is always the best network. And not only because it's empty, but because it's built with the latest and greatest stuff. You can look and you can see where there has been a fourth entrant in a lot of theretofore 3 player markets, and it's very predictable how much share they will take

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because the incumbents can't respond on price given the cost of repricing their installed bases. And lastly, as a venture investor, I have spent a lot of time with ORAN and I'm very convinced that as a technology, it is powerful.

G&D:

One of the interesting things that's happened in tech recently is Apple and its IDFA change. What do you think the long-term implications of that are and how might competitors need to evolve and respond?

GB:

First, it's good to own a platform.

I think it's hard to argue that it's pro-consumer and pro-privacy when Apple is really advantaging their own advertising services. Apple will probably have a permanently bigger advertising business. But I also think that the ecosystem will respond and adjust in 12 to 18 months. You can do a lot with probabilistic attribution. And there's a lot of cool stuff you can do deterministically. A lot of IDFA is not about targeting, but measurement and attribution. If you listen to ten years of calls from internet advertising companies, they are generally talking about measurement and attribution. And it's so funny because investors always talking about targeting.

The irony is I do think some of the rhetoric about IDFA from some of the impacted companies looks like is going to be true. The companies most impacted are small businesses. So, if you're a big, sophisticated advertiser, you have been working hard on this for a long time. But you're running a candle store, your return on your ad spending changed and your business got really hurt.

G&D:

You have tweeted recently about how advertising platforms need to get closer to transactions. Is that idea part of a natural progression that has always been there? How do you think about that?

GB:

One of the most profound things I have read was this essay by Eugene Wei called Status as a Service explaining what social networks are really providing. And he basically compared social networks to blockchains. Initially, it was cheap to mine them, but then they got ossified. In other words, new social networks start up and there are all these people who were not influencers on any of the existing networks that get hundreds of thousands of followers just because they were first to switch. This is why every generation wants a new social network. Status becomes ossified on these big social networks. And there's

constant disruption because of that. It's endemic to being a social network.

"Status becomes ossified on these big social networks. And there's constant disruption because of that. It's endemic to being a social network."

It's hard to get around that, but the way you can do it is if you build in utility. And what's utility? It's payments. It's features that make you open the app and do something other than look at user generated content. You have seen a lot of this in Asia and very little here in America. And I think that is largely because advertising was a hell of a drug for these companies for so long. That is why all these big internet advertising platforms were slow to become marketplaces, because it would have a temporary negative financial impact. And the reason for that is advertisers, even sophisticated advertisers, systematically overrate the likelihood that a customer acquired through an ad comes back to them organically. Their LTV calculation is too optimistic, and they

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spend more on ads than they should. You lose that when you become a marketplace because nobody is confused about their chances of reacquiring that customer organically. And so, you spend less money on ads. But by becoming a marketplace and building in more utility, you build in a lot more durability and defensibility into your business. There are still going to be new social networks because of the Eugene Wei theory about how every generation wants its chance to be a star because status gets ossified, but you will have durability outside of just time spent and dominating a couple of social mechanics.

G&D:

You've made some interesting observations about omni-channel retail. Everyone is talking about using stores as mini distribution centers. But in my research, it seemed difficult to understand when it became more cost effective to pursue that strategy. Is there anything that you can expand on there? And what types of retailers are best positioned as the omni-channel evolution continues?

GB:

Pre-COVID, no retailer was truly omni-channel. They each had an e-commerce business and a store business. They never embraced "buy online pickup in store." And the reason was

cultural.

The merchants at these retailers had huge amounts of power. In a retail box, you only have so many items. And a lot of what makes a great retailer comes down to putting those boxes in the right locations at scale and then, most importantly, keeping them well stocked with the right inventory at the right prices.

"COVID forced these companies to truly become omni-channel and unify brick-and-mortar infrastructure with e-commerce infrastructure through buy online pick up in store."

Generally, the head of real estate and the head merchant – not the e-commerce people – were the big power centers at these traditional retailers. A merchant would go to some trade show, find some random little product, and order a million of them. If it turned out to be an amazing success, it was all due to their gut feeling. For ego reasons, the merchant wanted people to walk around to see the end caps, to see their merchandising and the stuff that they put at eye level. It's a bummer for a merchant if

somebody parks, comes into your store, picks up something up, and just walks away. What's even worse is if someone drives up, lowers the window, pops the trunk, and then drives away. Definitionally, that will always be the cheapest form of same day delivery because the consumer is paying for it.

COVID forced these companies to truly become omni-channel and unify brick-and-mortar infrastructure with e-commerce infrastructure through buy online pick up in store. It's going to advantage the retailers who have stores that are easily accessible on weekends and on drives to and from work.

The strong are going to get stronger because the only retailers who had that capability were high quality, best in breed retailers that had invested a lot in IT. In the same way you can think of a telecom network, it's just a big, fixed cost. You want to layer more and more services on it, so cable TV, then it was internet, then it was phone. You're just layering more and more revenue streams. And that's kind of like with these retailers, you have these stores with fixed costs and you're using them for more and more services. And I think, finally, retailers have sophisticated enough IT systems to price things.

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We can get that to you in two days out of our distribution center, here's the price. Oh, you want to come and pick it up in the store? Here's the price. Oh, you want it delivered to you by DoorDash? Here's the price. In doing that, you're optimizing this fixed cost infrastructure of stores and distribution centers in a way you couldn't before. And we're just so early in the process of doing that. I think there's years of upside to come. And by the way, everybody agrees that stores have value in an online world. Even if you make no money in a store, it lowers your online cost of acquisition. This is the reason all these DTC brands are opening stores. Stores have value.

G&D:

It almost sounds like pre-COVID, there was this idea that traditional brick-and-mortar retailers were going to be crushed. But post-COVID, there is now a bifurcation between the mall-based retailers that are inconvenient for pickup and the bigger branded retailers that are easy to access. Is that fair to say?

GB:

Even in malls, if you're in a class-A mall there's a lot of experimental outdoor stuff happening. There are a lot of great malls, particularly if they find a way to integrate the outdoors. I also think you'll see stuff like drive up aggregated

pickup points. There'd be a whole area of the mall where you could pick up orders from three or four retailers all at once. And that is something that the big mall companies should lean into like, "Okay, you're on the inside of the mall. Here's how we're going to make your life easier." You can plug into that. But no matter how you cut it, it's always better to be on the outside of the mall.

G&D:

Another one of the themes coming out of the pandemic is increased participation from retail investors. Curious if you think that's an overall net positive for the market? And has this at all changed the way you think about what could happen with a given investment on your end?

GB:

Yeah, so the meta, or the game within the game, is always changing in investing. 20 years ago in the NBA, three pointers were undervalued, statistically. Going for it on fourth down was undervalued in the NFL. And I would say that 20 years ago, understanding ROIC was undervalued in the market. It was so revolutionary when Michael Mauboussin started talking about ROIC and now everyone understands ROIC. It used to be that you could get a big advantage by really understanding the unit

economics for public companies. All these silly people used to look at an e-commerce company and say, "Oh, it's an unprofitable business." But on a unit economic level, it was very profitable. I would say that unit

economics are probably well understood now in terms of marketing efficiencies and trade offs between growth and profitability.

The meta of investing is always changing. But there are some things that are timeless, like if your return on an invested capital goes up, you are going to become more valuable. If you compound your free cash flow per share, you are going to become more valuable. There are these immutable things and a lot of those things have been written about by Buffett.

“20 years ago in the NBA, three pointers were undervalued, statistically. Going for it on fourth down was undervalued in the NFL. And I would say that 20 years ago, understanding ROIC was undervalued in the market.”

Anyone who's reading this, you're not going to

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have the luxury of not worrying about the meta. You sit in an ivory tower and think, "Oh, all I care about are returns over 5 to 10 years and I don't care about the path to get there. I don't care about volatility." That is true in an idealistic sense – the most important risk is always going to be permanent loss of capital. But your clients care about volatility. If you're running a retail mutual fund, you have hundreds of thousands of clients. You have no idea when your client may need to take money out to buy a house or to send their kids to college. So, for them, volatility does matter. I've seen a lot of idealists come and go, and they say, "Oh, I'm having a terrible year, but I don't care. I'm just focused on 5 years out. And there's a lot of pent-up performance. I feel great about it." Well, that's great that you feel good. But you may get taken out of the game before that pent up performance materializes. You can get taken out of the game by your clients or by the management of your firm. So, volatility and the path of returns matter if you're going to be a professional investor. If you're an individual investor, none of that matters because you know when you're going to buy a house. And maybe you do something different in your portfolio and raise a little cash the year leading up to it, whatever it is. If you're an individual investor, go

to the ivory tower, live at the top of it and preach about 5-to-10-year returns with a lot of volatility. But anybody who's reading this and is going to be a professional investor, that is a luxury you will not have.

"If you're running a retail mutual fund, you have hundreds of thousands of clients. You have no idea when your client may need to take money out to buy a house or to send their kids to college. So, for them, volatility does matter."

And that means you must pay attention to the meta. And the meta changed for a long time due to COVID and retail participation. The way you thought about short interest and crowding as factors, it simply changed. Whether that's good or bad, I don't know. I think having retail participation in the stock market is good, but I think the gamification of it is extremely unhealthy.

All the research that's been done by internet advertising companies –

the most brilliant minds went into making people slightly more likely to click and getting better at measuring the incrementality of that click. That's kind of sad for the world. Most people who are hanging 30 IQ points on me, that's what they've been working on – getting people more likely to click here or there. Gamification can be powerful. If you gamify mechanics that make people eat healthier, or exercise more, or save more. These are things that we know are positive for individuals. But if you gamify that which is most profitable for you, and, in a lot of cases, least profitable for the consumer, and you do it under the guise of like, "Oh, we're this champion of the retail investor," I think that is actively unethical. And I hope that there is a resolution, whether it's market-based or otherwise. Broadly, I personally think retail participation is good. But whether it's truly good or it's bad, it just is.

A thought pattern of bad investors goes like, "Oh, the market is wrong. The market is dumb. The market is being irrational." Don't say that. The market just is, and your job is to outperform the market. A big mentor of mine, Steve Wymer, said there are only two things in investing: numbers and excuses. And if you don't have the first, nobody cares about the second. And that's a very

(Continued on page 13)

Gavin Baker, Atreides Management

powerful attitude to have.

But anyway, I do think retail participation in the market is a permanent change. It's something you have to adapt to if you're a professional investor. Understanding the meta is part of your job and integrating that with these timeless principles from Buffett is important.

You want to maximize your Sharpe and your Sortino ratios because that is your job as a professional investor. As an individual investor, you should not care at all about those ratios. Maybe a couple of people on this planet have client bases that are aligned with a high volatility, 5-to-10-year return stream that might see several 30% drawdowns on the way to a superb 10 year record. To get a client base to sign up for that is one reason why, if you ever want to run your own show, you have got to be a good communicator. And this is one reason why private equity is so popular.

So, you have portfolio level volatility and need to manage it. But in terms of the volatility on an individual equity, that is opportunity. I love volatility because it definitionally leads to mispricing. Everyone is always saying, "Oh, the game is getting harder." I don't think it's any harder. It's always been hard. You've always had tens or hundreds of

thousands of brilliant people all over the world competing. In private equity and venture capital, you must be invited to compete. Public market investing is so exciting to me because it's the most meritocratic competition in the world. Anybody can compete, so definitionally it is the most competitive.

“...I do think retail participation in the market is a permanent change. It's something you have to adapt to if you're a professional investor. Understanding the meta is part of your job and integrating that with these timeless principles from Buffett is important.”

Everybody thinks that fund flows are going to be everything because these index funds and ETFs are passive, they're blindly going to pump money in, and that makes active investing harder. This is not true. It is always important to think from first principles. A lot of these ETFs are being managed actively. A lot of them are multi-billion-dollar smart beta ETFs around

momentum and value, or certain industries and themes. So, I don't think the percentage of the market that is actively managed is changing as much as people think. It's just a slightly different competitive set. It's incumbent upon me to change. And no, that doesn't mean you have to embrace the meta, you just need to adapt and be aware of the meta while integrating it with the timeless principles that underpin your own investment approach.

G&D:

If you were speaking to students and younger folks who want to move into the investment management business, would you have any advice as to what they should be doing today?

GB:

Expose yourself to as many different philosophies and processes as possible because you have got to find one that fits your own emotional make up and that helps you be rational when you're wrong. And do not be a philosopher. Do not be a high priest of investment religion. Be a practitioner. Every year, there's this crop of kids who start working at investment managers and think, because they've read Warren Buffett and Michael Mauboussin and Peter Lynch, that they are special. They're not. Everyone understands all

(Continued on page 14)

Gavin Baker, Atreides Management

that stuff. Don't think because you're steeped and versed in Buffett that you're special. Everyone is. Everyone.

So, one, recognize that. And then two, just be a practitioner. Almost everyone starts as a value investor. It's funny, that's where Buffett started. And then Buffett in the early '90s became a growth investor. And so just be open-minded. People your age are coming out of business school and won't look at or do any work on anything trading at over 20 times earnings. Don't be that person. Do work on everything that you're assigned and have an open mind.

The necessary conditions for investment excellence are having a high knowledge level, being up to date on the present state of the world, using a Bayesian process on every new piece of data, and accurately framing the four or five analytically bullish and bearish prisms through which we can look at the stock. So just laying out the different analytical debates. For most companies, people have probably thought of all the bull and bear cases, so you should just lay out the best of each. If you do all of that for a portfolio manager, and then at the end, you say, "Hey, this is where I come out," they will love you whether you get the stock right or wrong.

It takes a long time to develop investment judgment, which is applying those necessary conditions into a buy or sell decision. John Hempton, a deep value guy, has written about how valuation should be the last step. Nobody wants to hear about your logic for why the WACC is this level or that level. Spare the world. And finally, you translate investment judgment into performance via sizing, execution and portfolio construction, which is a whole different discipline than being an analyst. Being a portfolio manager is very different than being an analyst. So that's my recommendation. Be a practitioner, not a philosopher. Don't be a high priest.

G&D:

Makes sense. Last question is what do you like to do outside of work for fun and to stay mentally sharp?

GB:

Well, I'm a big reader. I like to ski. I'm no longer fit enough to rock climb. I have not been able to fit into my rock-climbing harness for 12 years. I'm not going to climb again until I can fit into that harness.

I find things that put me into a flow state are powerful. A great ski run will do that, as will video gaming. I think in a lot of ways, it's a form of helping your mind rest when you're awake.

Almost anything I'm doing when I'm awake, I'll have the thought, "Oh, there's a stock. I need to do this." If I'm on a steep run, I never have a stock idea. If I'm in an intense PVP match in a video game, I never have a stock idea. My mind is in a flow state, and I think that's important. And then I do have ideas when I come out of that flow state.

"The necessary conditions for investment excellence are having a high knowledge level, being up to date on the present state of the world, using a Bayesian process on every new piece of data, and accurately framing the four or five analytically bullish and bearish prisms through which we can look at the stock."

I'm also a big walker and like to walk to and from the office. Being outdoors, seeing green, is important to me. And I like to see green every day. So those are all kind of things I do. And then, of course, I love to spend time with friends and with family.

(Continued on page 15)

Gavin Baker, Atreides Management

G&D:

Perfect. Well, thanks so much, Gavin. Really appreciate all your time.

GB:

Thanks guys. Take care.

All opinions expressed by Gavin Baker in this interview (the "Interview") are solely his own opinions and do not necessarily reflect the opinion of Atreides Management, LP ("Atreides"). This Interview is for informational purposes only and should not be relied upon as a basis for investment decisions. Clients of Atreides may maintain positions in the securities discussed in this Interview. This is not an offer to sell, nor a solicitation of an offer to buy, any security in any fund managed by Atreides. The statements and opinions contained herein may change at any time, based on market or other conditions. This Interview includes forward looking statements, including projections of future economic conditions, and information that is provided for illustrative purposes. Atreides does not make any representation, warranty, guarantee, or other assurance whatsoever that any of such forward looking statements will prove to be accurate.

CoStar Group (NASDAQ: CSGP) - Long 2021 CSIMA Stock Pitch Challenge (1st Place)



Ian Gorman '23

Ian is a first-year MBA student at CBS. He started his career on Barclays' Equity Research team with a focus on Energy before moving to Scotiabank and working in a similar role. Ian is an AVP for the Columbia Graham and Doddsville investment newsletter and graduated from Villanova University with majors in Finance and Accounting.



Joy He '23

Joy is a first-year MBA student at CBS. Prior to CBS, She worked as an Equity Analyst at a L/S hedge fund in Guotai Jun'an HK Asset Management, covering China Internet sector. She began her career with China Life Franklin AMC in the sales & product team. Joy graduated from Hong Kong Polytechnic University with a B.S. (First Class Honors) in Geomatics.



Raghav Mittal '23

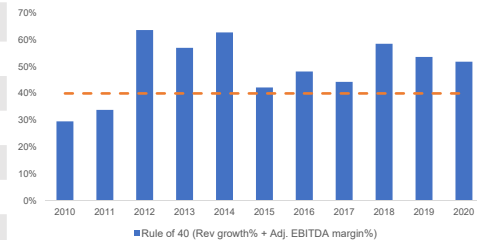
Raghav is a first-year MBA student at CBS and a Columbia Fellow. Prior to CBS, he worked as a generalist at Paris-based long-only Amiral Gestion in their global equities team, and at India focused long-only Locus Investments as a consumer specialist. He started his career at JP Morgan with the sales and structuring team. Raghav graduated from the Indian Institute of Technology (IIT) and majored in Mathematics, Computer Science and Financial Engineering.

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FY20 (US\$)		Current Price	\$82.86
Revenue	\$1.66B	Market Cap	\$32.7B
Gross Margin	81.4%	Net Cash	\$2.7B
Adj. EBITDA	\$0.55B	EV	\$30.0B
Adj. EBITDA Margin	33.3%	Short Interest	3.6
FCF	\$0.44B	NTM EV/Sales	13.0x
Adj. EPS	\$0.99	NTM EV/EBITDA	38.6x



Recommendation:

Long CSGP with a 4-year price target of \$165, representing 99% upside and an IRR of ~18%.

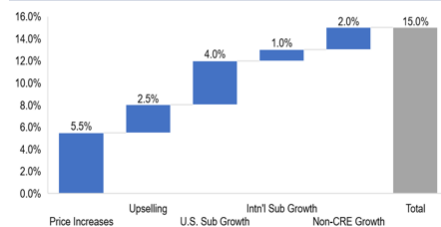
Business Summary: CSGP started as the Bloomberg of commercial real estate (CRE) and has since catapulted itself to the #1 position in nearly every segment of digital real estate services. In 2020, CSGP's revenue mix was 40% from CoStar Suite, 36% from Multifamily, 16% from Commercial Property and Land, and 8% from Information Services. We believe that CSGP is in the early innings of transformational new opportunities and will see double-digit earnings and FCF growth for the years to come.

Investment Thesis:

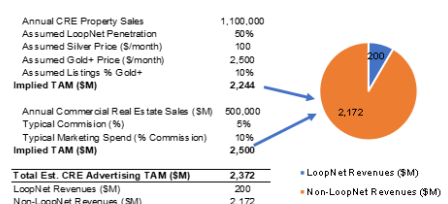
I. CRE business is a stalwart set to beat expectations:

- CoStar Suite, CSGP's core data/analytics offering, is the "Bloomberg of CRE" w/ a 50% penetration advantage vs. all competing platforms
- LoopNet, CSGP's online CRE marketplace, has >5x more traffic than all competing platforms
- Expect '22/'23 average Suite revenue growth of +15% vs. +12% for Street (banking product release, international expansion, etc to drive higher new user growth than ~4% embedded in consensus)
- LoopNet current \$200M revenue run-rate only ~10% of TAM, Australia's #1 CRE player currently delivers equivalent of \$1.4B of U.S. revenues

Path to 15% Suite Growth



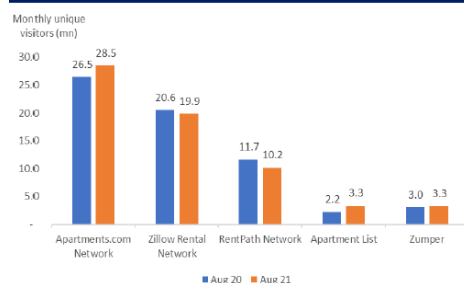
Plenty of TAM Running Room



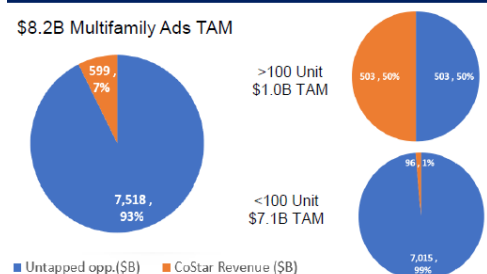
II. Multifamily (Apartments.com Network) has years of 20+% growth ahead...

- Apartments.com has the pole position in rental with traffic level significantly above competitors
- Only 7% penetration of the \$8.1B multifamily ads TAM indicates plenty of growth runway in the long run, opportunities including the largely untapped lower-end (<100 unit buildings, accounting for ~85% of the U.S. apartment market where CSGP's penetration is merely 1%) and price growth
- Near-term industry headwind due to lowest vacancy rate in decades is temporary, and expect trend to normalize in 3Q22

CoStar's Leading Position is Widening



>85% of the Market Largely Untapped



CoStar Group (NASDAQ: CSGP) - Long

...while Residential (70% bigger TAM) is off to a good start:

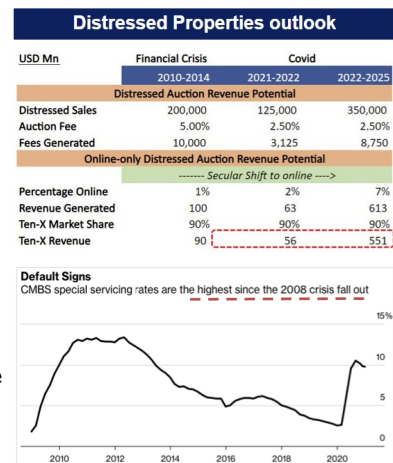
- The monetization potential of Homesnap, an agent workflow & marketing platform supported by MLSs, is currently overlooked by the market (75% of 1.2M resi agents are registered users w/ only 9% paying ratio)
- CSGP's differentiated marketplace strategy focuses on building agent ecosystem before scaling consumers, and its partnership approach ('my listing, my lead' philosophy) could win more industry supports
- CSGP has a solid track record of transforming marketplaces, and the residential buildout is following a similar playbook

Previous Experience Is Applicable

homesnap + homes.com		LoopNet Apartments.com
Repurposed 60 salespeople from Homes.com to Homesnap	Salesforce	Apartments.com: incented salesforce -> 100k+ client meetings in 2016
Winding down legacy Homes.com products	Product	Apartments.com: Added features like credit application & background check
Optimizing pricing strategy and contract terms	Monetization	LoopNet: developed price tiers to target different advertisers

III. Free Optionality on Ten-X with a long, counter-cyclical runway for growth:

- Acquired Ten-X, largest online auction platform with 90% market share (US) in Jun'20
- TenX provides 3x higher sell-through rate (60-70% vs. ~25%), 3x faster deal closing (90 vs. 250 days) and lower transaction costs (2.5% v/s 5-10%) v/s offline auctions
- Creates an industry-best flywheel of LoopNet (most visible CRE advertisement platform), CoStar Suite (captive customer-base + sales comps data) and Ten-X (monetization platform), accelerating online auction adoption and unlocking revenue opportunity larger than CoStar's entire business.
- ~\$500B of annual CRE transactions in the US, but just 1% online share. Post covid, estimate the online penetration going up to high-single digits by 2025 (v/s 20-30% in Australia/NZ as of today), with Ten-X being the biggest beneficiary
- Over the next 4 years, estimate \$550M of distressed and \$250M of non-distressed sale revenues for Ten-X, with an additional pricing lever in hand



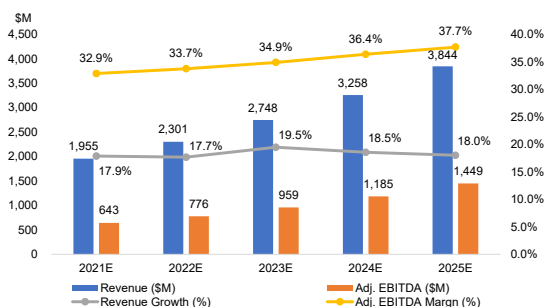
Valuation:

- Exit multiple of 36x EV/2026E EBITDA.
- Backstopped by DCF that conservatively assumes 12% revenue growth from '26-'30; 3% terminal growth post-2030 @ 6% WACC
- Base EBITDA margin of ~38% poses upside risk as it conservatively assumes minimal expansion vs. history
- Below >60x median multiple for "rule of 40" SAAS comps w/ >\$1B ARR
- Organic FCF & EBITDA growth >20% from 2020-25, ~12-15% from 2025-2030. No M&A modelled despite long-history of successful, accretive transactions.
- Bull/Bear cases suggest favorable >7x risk/reward skew; 20x multiple in bear case well below slow-growing, worse-positioned Factset's valuation of ~26x.

	Base	Bear	Bull
2026E Revenue	4,306	3,333	4,905
'21-'26 CAGR	17.1%	11.4%	20.2%
2026E Adj. EBITDA	4,306	1,126	1,959
2026E Adj. EBITDA Margin	37.9%	33.8%	39.9%
Target NTM EV/EBITDA Multiple	36.0x	20.0x	45.0x
Price Target	165	71	240
Upside (Downside)	99%	-14%	190%
4-year % IRR	18%	(4%)	29%

Risks and mitigants:

- Cyclicality of RE business:** Mix of 75+% annual subscription revenues has been historically resilient. Several business lines have countercyclical traits (eg: advertising demand goes up w/ vacancy rates)
- Structural negatives for office CRE from WFH:** Possible, but there would be value transfer toward housing and office only accounts for ~35% of the U.S. CRE market.
- Suite growth slows structurally:** Core U.S. CRE TAM still ~45% unpenetrated and initial non-CRE efforts such as banking and international offer significant long-term running room.
- Vacancy in multifamily remains low:** This would give CoStar more room to increase ad pricing, blunting the near-term impact and potentially benefiting long-run profitability.
- Building out resi proves difficult:** Profitable core business gives plenty of firepower to ramp up marketing and fight incumbents. Differentiated strategy of "partnering with the agents" helps build brand loyalty.
- Key man risk:** Our primary research suggests the leaders of CSGP's various verticals are experienced and mission-driven, following a well-defined playbook.





Richita Jain '23

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Richita is a 1st year MBA student at CBS. She started her career at Deutsche Bank as an investment banking analyst in the Financial Investments Group, before launching an enterprise technology focused VC fund for a software services firm in Singapore.

Angela is a 1st year MBA student at CBS.



Angela Pan '23

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Prior to joining CBS, she worked in Morgan Stanley's hedge fund investor services division, covering the two largest hedge fund clients of the division. Subsequently, she then moved to Nasdaq's Capital Markets Advisory team covering the healthcare sector.



Courtney Owens '22

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Courtney is a 2nd year MBA student at CBS and is a part of the value investing program. Prior to CBS, she worked at William Blair in sell-side equity research, covering healthcare services. Before William Blair, she worked at GCM Grosvenor as a manager research analyst covering the firm's global equities allocation.



Impana Srikanthappa '23

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Impana is a 1st year MBA student at CBS. Prior to CBS, she worked at Monitor Deloitte as a Strategy Consultant in their M&A practice. She is currently interning at a Hedge Fund, Wexfor Capital, covering Media industries.

AptarGroup, Inc. (NYSE: ATR) - Long 2021 Women in Investing Conference

Recommendation:

Buy; 2024 Target Price: \$167.42 (CAGR: 9.4%)

Company Overview

AptarGroup, Inc. (ATR) is a global diversified packaging company. The Company partners with global pharma/biotech, beauty, and consumer companies to help create, develop, and manufacture innovative packaging, containment, and dispensing solutions. Aptar was founded in 1940 and today has over 13,000 employees, services customers across the globe and has manufacturing facilities across North America, Europe, Asia, and South America. The Company operates through three reportable segments outlined below:

- Pharma (40% of revenue; 79% of EBIT): ATR is the leading provider of nasal drug delivery spray pumps and metered dose inhaler valves to the pharma and healthcare markets, globally. The Company also provides elastomeric components for injectable devices.
- Beauty & Home (45% of revenue; 12% of EBIT): In this segment, ATR primarily manufactures and sells pumps, aerosol valves and accessories to the personal care and household markets, and specialty pumps and decorative components to the fragrance and beauty market.
- Food & Beverage (15% of revenue; 9% of EBIT): ATR sells dispensing and non-dispensing closures, spray pumps and aerosol valves to food and beverage manufacturers.

Investment Thesis

Aptar is the clear market leader within several of its submarkets across the pharma, beauty and home, and food and beverage industries. Given this fact and reasons we outline below, we believe that the Company is poised for long-term, durable mid-high single digit topline growth and modest, long-term margin expansion which should translate to HSD

long term EPS growth.

Business mix is shifting towards the more profitable pharma segment: Margins across the business vary significantly, with margins in the beauty & home and food & beverage business in the low double digits and high teens, respectively. At present, pharma EBIT margins are in the high 20% range. As we see a broader recovery in the allergy rhinitis/cold and flu categories and as Aptar increases its presence in higher value packaging/services such as injectable elastomeric components, active packaging, and preclinical – commercialization services, we believe there is potential for margins to increase to the low 30% range. Currently 60% of the Company's revenues currently come from the beauty & home and food & beverage segments and approximately 80% of profitability comes from the pharma segment and as ATR further increases margins in its pharma business, we believe there is an opportunity for the consolidated margins to expand, driving eps growth, and for the total business profitability to shift even more towards pharma and thus the opportunity for the multiple on the entire business to expand.

Well – positioned to benefit from key pharma trends, with stable growth: Given ATR's capabilities, reputation, and technological expertise, it is very well positioned to grow its topline in the mid-single to high-single digit range, stably. There is an increasing prevalence of respiratory diseases across the globe and the pulmonary device market in select markets is estimated to be growing in the low double digits, given ATR's leading position in inhalation device packaging, this trend should help support longer-term topline growth. Additionally, given that ATR is often included in the FDA filing for some of these delivery devices and medicines, switching costs for pharma manufacturers can be quite high, thus ATR often will have the contract for the life of the drug. Further, ATR is making significant inroads in the injectable packaging market, specifically with elastomeric components. With the increase of biologic medicines in the global clinical pipeline, there is an increasing need for sterile packaging. Aptar is one of a few providers that has the capability to provide these elastomeric components with this heightened level of sterility and this should help to support topline growth long-term.

Innovation transfer between segments supports long-term topline synergies and enables ATR to minimize R&D spend: The combination of ATR's food & beverage, beauty & home and pharma segments is quite unique to the packaging space and creates a competitive advantage for Aptar. For example, this is evidenced by ATR's bag on value technology, which is used in pharma to dispense nasal saline, in food and beverage for cooking sprays and in beauty & home to provide higher value, prestige beauty dispensing systems. This capability often allows the Company to transfer high value technology from one segment to another to create innovative containment and dispensing products, which enable ATR to charge a premium price to their customers, thus driving topline growth and margin expansion, with minimal incremental R&D spend.

Additional Growth Options

Pharma: We estimate that the company will generate high-single digit, organic long - term growth in the pharma segment due to the reasons outlined above, but believe there are additional growth opportunities that could provide upside to our model including:

AptarGroup, Inc. (NYSE: ATR) - Long

- Drug repurposing: There are currently several drugs that are in late-stage clinical trials with the potential to change dosage forms from oral or injectable to inhalation. If these dosage form changes are approved, this provides a large long-term growth opportunity for ATR, which is currently not factored into our base case model. The end markets for these drugs, which are predominately in CNS are growing in the low double digit to mid-teens range, which would provide a long-term booster to ATR's growth.
- Biologic pipeline growth in APAC: Biologic production, particularly in China, is growing rapidly and at present biologics can only be dosed via injectable. Given ATR's increasing presence in elastomeric packaging components and its recent acquisition of an elastomeric manufacturer in China, Weihai Hengyu, ATR is well positioned to benefit from this growth long-term.

Beauty + Home/Food + Beverage: Our base case assumes the beauty + home business grows long-term organically in the mid-single digit range and the food + beverage business grows in the high-single digit range, but we also believe there are several areas where ATR is investing that could provide incremental upside to our model, including:

- Investments in Chinese color cosmetic packaging capabilities: The color cosmetics market in China is projected to grow, long-term in the mid-teens range. ATR is investing in packaging manufacturing capabilities, both organically and inorganically, which we believe positions them well to participate in that higher than industry average long-term growth. Beauty includes skincare and color cosmetics, which is projected to double the Company's sales in Asia in 5 years.
- Infant nutrition in APAC: The infant nutrition market is expected to grow in the low double digits, long-term. ATR is well positioned to capitalize on that growth, as it has packaging solutions at the low and premium end of the market.

Risks

Regulatory and Safety: Some of Aptar's products are regulated by global regulatory agencies. If there were a significant quality issue or involuntary recall of any of its products or components, it could significantly impact Aptar's reputation and hinder their profitability going forward.

Biotech Funding Slowdown: Biotech funding levels remain at record highs. However, a significant deterioration in the biotech funding environment could have a negative impact on ATR's biotech customer base, particularly in its injectables business.

Intellectual Property Risk: Aptar has over 5,000 patents, which have a weighted average amortization period of 7.2 years as of 2020-year end. Once these individual patents expire, the firm will be subject to additional competition and may need to incur incremental R&D spend, which could be a hindrance to profitability.

Raw Material Risk: As a manufacturer, ATR utilizes certain raw inputs which have come under inflationary pressure, particularly resin. While they can pass – through that cost to customers often, if they are not able to offset the rise in prices it could be a hindrance to profitability.

Valuation

Aptar currently trades at approximately 28.6x 2022 EPS, which is generally in line with its long-term average. Compared to its packaging comp group, it is trading in line with its relative long-term discount, but compared to its life sciences peers, its discount has extended. In our view, given ATR's focus and increasing penetration in higher growth and higher margin areas, which are more aligned with its life sciences' peers focus, we do not think that additional discount is warranted and believe there is potentially room for multiple expansion. Lastly, on DCF basis, we estimate the cost of capital as approximately 6% and believe that ATR can grow its earnings at approximately 4%. While these two factors imply a higher P/E multiple relative to how stock has historically traded, we do believe it signifies that there is potential upside to the current multiple. These factors, coupled with our expectation for long-term high single digit EPS growth lead us to believe that this stock is buy and place a 2024 price target on it of \$167.42 (9.4% CAGR).

Exhibit 1 – ATR Valuations Statistics

ATR - Calendar 2022					
Price	Mkt. Cap	EV/Sales	EV/EBITDA	P/E	FCF Yield
\$127.82	\$8,624	2.8x	13.6x	28.6x	1.8%
P/E Multiples	3 Year Average	5 Year Average	Current		
ATR		29.5x	27.4x	28.6x	
Packaging		30.9x	28.0x	29.8x	
Lifesciences		54.2x	50.9x	59.9x	
ATR Premium/Discount					
Packaging		-1.4x	-0.6x	-1.1x	
Lifesciences		-24.7x	-23.5x	-31.3x	

Exhibit 2 – ATR DCF using Perpetual Growth

DCF using Perpetual Growth	
2031 FCF	\$541
Terminal Growth	4.1%
WACC	5.9%
Terminal Value	\$32,002
PV of TV	\$17,798
PV of FCF	\$20,303
shares	68.1
NPV/share	\$298.20
Current price	\$127.82
% upside	133.3%
CAGR	8.6%

*assumes 5.9% WACC

Rudi van Niekerk, Desert Lion Capital



**Rudi van Niekerk,
Desert Lion Capital**

Rudi van Niekerk is the Managing Partner of Desert Lion Capital – a concentrated, unlevered, long only fund investing in South African equities, with competence in small and mid-caps. The Fund employs a fundamental, research-driven process and is willing to accept volatility and lower liquidity in pursuit of superior returns over a multi-year time horizon. South Africa is one of the statistically cheapest markets globally, with growing businesses regularly commanding single-digit earnings multiples. Mr. Van Niekerk has nearly a decade of same strategy market-beating experience investing in JSE securities – a universe that includes many sectors which are characterized by a striking lack of institutional, analyst, and capital attention. Mr. Van Niekerk is a South African citizen. He is a CFA charterholder and earned Bachelor of Commerce and MBA (cum laude) degrees from the University of Stellenbosch.

Editor's Note: This interview took place on October 26th, 2021.

Graham & Doddsville
G&D: Rudi, thank you so much for joining us. Can you talk about your background and what brought you to investing?

Rudi van Niekerk (RVN):

Thanks. I was born and raised on a farm, so I have an agricultural background, and I was not fortunate to have had exposure to the discipline of investing, or mentors who were in that field early on in my life. So, purely by virtue of not knowing what I wanted to do in my life, I got involved in grain trading. That was my introduction to financial markets. That got me interested in pricing and the concepts around pricing, so I just started reading widely. And then I stumbled across investing and fundamental value investing. And like with many other people in the field or in the industry, the concept just resonated with me immediately.

So that led to further reading and study, completing an MBA and the CFA, and then getting involved in private equity. The intersection between finance investing and agriculture brought me to a private equity fund that invested in the food and agriculture sector in Africa. I was investing my own capital since about 2004, and then in 2013 I set up a small private partnership for family and friends. That is where I started managing outside capital, which led to where I am today and what I'm doing now.

G&D:

How did grain trading in

South Africa and the commodities markets there compare to what we might be familiar with in the States? Is it structurally similar or were there big differences?

RVN:

The time I got involved in grain trading was interesting because it was when the market deregulated from a regulated single channel system to the free market system, which you are accustomed to in the U.S. Before that, prices were regulated and set by a central grain marketing board. With the transition to the free market system, price discovery was quite volatile, and we were basically interpreting the market for the participants. Spreads were quite wide, and the margins were quite good. The current South African grain market is very progressive and similar to what you have in the U.S. with regards to sophisticated financial instruments in futures and options and other derivatives. It also has a very active spot market and basis trading.

G&D:

As you were developing your investment chops and starting to move into that frame of mind, did you have early heroes or mentors that you looked up to, either personally or from afar, that were really impactful for you?

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RVN:

My mentors and the people I looked up to in the investment fields were all in books. Outside of the investing field, I would say my grandfather. My father died when I was very young so my grandfather was my father figure. He was a formidable, principled man, and taught me a lot about being rational and smart and about intelligent risk-taking. But mostly, I got to know all my mentors through books.

G&D:

Around 2013 was there anything that signaled to you that you were ready to take the plunge and start a fund yourself?

RVN:

The early predecessor funds had the same strategy as Desert Lion. Desert Lion was officially launched in 2019 and we can get to the firm infrastructure and the "why" a bit later. In terms of what I was seeing, I was in private equity since 2009, and recognized that there was a lot of capital chasing a limited number of deals. The private equity industry was paying higher and higher multiples for what I would say were average companies, while, in the South African listed markets, I was noticing, especially in the small-cap and mid-cap spaces, above-average companies trading at dirt cheap or below-average prices. For me, that dichotomy was simply not rational

and it represented an opportunity. So, I started investing my own capital, and learning through experience to the point where I built up conviction and developed a sufficient circle of competence, albeit a limited one, to take the plunge and invite friends and family to participate in extracting alpha from this opportunity set.

"The private equity industry was paying higher and higher multiples for what I would say were average companies, while, in the South African listed markets, I was noticing, especially in the small-cap and mid-cap spaces, above-average companies trading at dirt cheap or below-average prices. "

For me, the catalyst was basically watching this huge disparity. Traditionally, I was educated to believe that due to the lack of liquidity, participation, and information, private equity multiples should be lower than public equity multiples. Here, we had the opposite, so that was the catalyst to take the plunge and get

involved. This contextual framework led me to have a private equity approach to public markets. To this very day, I still employ a private equity overlay when we're evaluating our companies in the public markets.

G&D:

What do you think drives that discrepancy between private market valuations and public market valuations, even in small to mid-cap public equities, which seems to avail what would be mouthwatering targets if they were here in the US? Is it the amount of capital that the private equity funds have at their disposal? Perhaps it's not possible for the investor base in the private markets to capitalize on those opportunities?

RVN:

I can maybe relate what we experienced with our specific situation and then hypothesize about what's happening in other situations. The fund I was involved with in Africa was very much in vogue at that stage. Everyone bought into the narrative that Africa would be a food basket and that population growth and a shortage of food created this massive demographic opportunity. Africa has an abundance of natural resources, so food and agri were very much in vogue and they were easy to sell. And then more of the institutions

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wanted to allocate to alternative asset classes so there were bigger allocations to private equity at that period of time.

Specifically in Africa, which is a very nuanced operating environment, you had few fund managers who had actual on-the-ground experience managing capital effectively.

What I realized there then was that the institutional imperative was leading to more and more fund managers setting up shop and raising funds. The ducks were quacking, and they were feeding them, so they were gathering capital and allocating it at increasing multiples. I think you have similar recurring themes in other sectors of the markets as well from time to time. I think it's a combination of massive liquidity and whatever is within the Overton window at that stage in the investment industry. And then the reaction by the institutional imperative for fund managers to take up shop and gather fees. I think it's a perfect storm of bad incentives, a bit of a Lollapalooza.

G&D:

This is kind of an inside baseball type question. I think some of our readers are probably curious about this, maybe in terms of their long-term plans. In terms of setting up a public equity fund and attracting an

international LP base, are there nuances associated with taking outside investment and investing in South Africa?

“We would not have been able to establish Desert Lion if it wasn't for our local partners in the U.S. Understandably so, the U.S. service providers are extremely skeptical of onboarding non-U.S. clients, especially from lesser-known jurisdictions like South Africa. So, without our local partners in the U.S., we wouldn't have been able to set up the fund to start with.”

RVN:

Well, I would categorically not recommend it. Not because of the risk of competition, but because of the obstacles you will encounter. It's extremely difficult. We would not have been able to establish Desert Lion if it wasn't for our local partners in the U.S. Understandably so, the U.S. service providers are extremely skeptical of onboarding non-U.S. clients, especially from lesser-known

jurisdictions like South Africa. So, without our local partners in the U.S., we wouldn't have been able to set up the fund to start with. That's point number one. Desert Lion being a U.S. fund, predominantly focused on U.S. limited partners or investors and investing exclusively in South African listed equities. That's the structure.

Secondly, to your question about attracting capital, it is tough. It's easy for us to convey what it is that we do and investors like what it is what we do and how we do it. What is difficult for most prospective investors is to clear the South African hurdle when it comes to their due diligence. There still is this perception that Desert Lion is a South African fund, which we are in the sense that we invest in South African listed equities. But there is a perception that our fortunes and expected outcomes are irrevocably tied to the political and economic whims of South Africa, which they are not. People struggle to understand those nuances, and this makes it tough to attract capital.

G&D:

To that point of not necessarily being tied to the top-down political or economic conditions of South Africa, how do you approach portfolio construction in terms of number of positions, turnover, allocation to cash, etc.?

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RVN:

I've always had a natural inclination towards concentration. I think to some extent that is still a remnant of the private equity approach of wanting to know our companies extremely well. We know our companies very well, have access to management, and keep our finger on the pulse of business while keeping our nose out of their business. I also believe that you cannot generate truly differentiated returns with a portfolio that is too diversified, especially since we are playing in a smaller universe. We don't have thousands of stocks. We've got about 320 stocks in our universe, so we construct a portfolio of 7 to 15 positions. Currently we have 11 and the top five constitutes more than 70% of the weighting. I don't sit on cash. When we do get new subscriptions for a very short period of time, I view the cash as optionality to deploy at lower prices thanks to the natural volatility in our universe. But we do not sit on cash for long periods of time and our fund is typically fully invested. Our investors are sophisticated enough that they can decide themselves how much they want to allocate to cash. They don't allocate to us to allocate to cash on their behalf. They allocate to us to allocate to the opportunities we see in our space.

“I've always had a natural inclination towards concentration. I think to some extent that is still a remnant of the private equity approach of wanting to know our companies extremely well... you cannot generate truly differentiated returns with a portfolio that is too diversified.”

G&D:

In terms of the due diligence process for you, I know that you've spent some time as an operator as well, so how do you go about that process? What are the first stages for you and how do you walk that line between being a supportive operator while remaining out of the hair of your companies?

RVN:

That's a tough one, right? I would say regarding the due diligence before we make the investments, it varies from company to company. We do spend a lot of time just trying to verify the veracity of what is being reported. Typically, in South Africa, financial reporting is very high quality and standard. Unfortunately, it was blemished by the

Steinhoff scandal a few years ago. I would still say that the bulk of the companies are pretty good, but we do spend a lot of time just trying to ascertain how much confidence we can have on the financials and accounting that we're looking at. And then we spend time on the product where we can. You can't always, but we spend time trying out the product, speaking to customers, competitors, etc.

There needs to be a real value proposition in the product. For example, we were invested in a property company, so we bought property or we rented property from them. For a bank that we were invested in, I moved my primary account to that bank and experienced the product. There are other examples as well. And then there's the people factor, which is the most important factor and the most difficult one. If anyone has a magic formula where they get it right every single time, I'm willing to pay a premium for that magic formula. We have made mistakes in the past, but generally we've been able to get it right. I think that the fact that I'm a local on the ground and understand the culture and sometimes can connect with many of the managers in Afrikaans, which may be their home language or the mother tongue, helps too.

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For us, it's about the normal things that have been identified already: the integrity, the energy, the enthusiasm, the intelligence. We really, really try to spend a lot of time on that to do a bit of a 360 on that as much as possible. Some of the managers who are most charismatic can create situations where you can easily drink the Kool-Aid, which necessitates getting alternative views on them as well. Here, we try to talk to competitors or previous employees or previous funders, previous shareholders, whomever we can find to talk to. It's quite a haphazard process, because everything is not always available to you, but we really try to probe wherever we can. We do a lot of primary research on these companies.

"I would say that, in general, the companies listed in South Africa have become more sophisticated in their capital allocation."

G&D:

Can you talk a little bit about the capital allocation in kind of broad strokes in South Africa? Europe is very pro-dividend and the United States is very pro-share repurchase. Are there any generalities that you can make about those things in regard to South Africa?

RVN:

I don't think it would be appropriate to make a generalization, because the companies are quite heterogeneous when it comes to capital allocation. Just from my experience, we are invested in companies that excel in capital allocation, and then there is another company where we've taken an active role because the management didn't follow through on their promises of proper good capital allocation. In this specific case, I'm referring to buying back shares at a discount. The best decision with the surplus cash available would have been to repurchase stock.

I can make the following broad statements though. I would say that, in general, the companies listed in South Africa have become more sophisticated in their capital allocation. There are way more instances of companies repurchasing stock, for example, when prices are trading at discounts. They have been making progress in being smart about optimal capital structuring between equity and debt, really trying to generate good returns on equity, and focusing on return enhancing capital expenditures and acquisitions. A final observation I would add is that we are also witnessing way more shareholder activism than we've seen in the past.

G&D:

For companies of similar growth, margin profiles, balance sheets, versus Europe or the United States, I understand that the South African market trades at a discount. What level of discount do you tend to see?

RVN:

It varies. We do have a few examples of companies that are very much in vogue and in favor with institutions that are not cheap. But, in general, I would say that currently I'm seeing companies trading at 40% to 50% of the valuation of the comps in developed markets for similar quality companies with similar growth prospects.

G&D:

For your portfolio companies, does that create an opportunity from a capital allocation perspective? You mentioned working with the management team to put in more buybacks when things are trading extremely cheaply. Does that tend to be an opportunity for companies that you see in the market?

RVN:

Absolutely. But there is also negative consequence to that. What is happening now is, when good quality companies are trading at deep discounts, they are essentially cannibalizing their own shares over a pretty long period of

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time. And then they are just being taken private, which shrinks our opportunity set. To give you an idea, over the past two to three years we've lost about 25% of all the listed companies on the JSE due to that.

It is a short-term opportunity in the sense that we are investing in companies who are very likely M&A or take-private candidates. When that happens, it's easy for them because their remaining float is so small and they can fund it from the balance sheet. At the depressed price they trade at, it's easy to take the company private at two or three times the price. Obviously for a fund it's great in the short run because then you have this beautiful uplift in returns, but in the long run it's not great. It's not in the interest of the market.

G&D:

When it comes to the companies that you're looking for, you're obviously a fundamental investor looking for value. Is there a common profile that you tend to look for within that value universe? Or is it a range in terms of growth, valuation, etc.? Where do you tend to sit on the spectrum for assessing value?

RVN:

I am trying to invest in what makes sense. I like to call the approach a common sense

approach. I am very weary of this growth versus value debate. I think it's a bit nonsensical. I would categorize what we are investing in as several different situations. The first bucket, I would say are the compounders. So, we are investors in compounders like Capitec and Karoo and STADIO. Then there are inflections, where for some reason something is happening. There's a change in the company and it's not recognized by the market. We also see quite a bit of orphans, especially in the small-cap space where companies are purely just forgotten. Under the radar, out of sight, they are growing, they are doing their thing, and just not recognized by the market. We have a fair number of special situations as well. For example, our positioning in Capitec we acquired through PSG. PSG spun out Capitec, so we essentially acquired that at a 40% discount through PSG. So, I would say probably four or five different buckets we can categorize our holdings in.

Regarding my overarching view on valuation and intrinsic value, essentially in all of these we are trying to pay a discount to what we deem intrinsic value to be. Secondly, we do not know how long it will take for the market to recognize if we are right and then re-rate that security to what we think intrinsic value is.

Therefore, I will only invest in businesses where time is our friend. The only way that time can be your friend is if intrinsic value does not deteriorate over time, which means that there needs to be some growth in per-share value over time.

“We do not know how long it will take for the market to recognize if we are right and then re-rate that security to what we think intrinsic value is... The only way that time can be your friend is if intrinsic value does not deteriorate over time, which means that there needs to be some growth in per-share value over time.”

G&D:

For a bucket like the orphans, where they are being overlooked by investors primarily based in South Africa and less developed countries, are there differences associated with what you can look for there in terms of counting on an eventual re-rating or renewed interest in a company? Versus maybe a fund based elsewhere would have the luxury of

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saying, "People are going to find out about this. I can be early and I can eventually count on that re-rating?"

RVN:

It happens in South Africa, but it typically takes longer. So, Ben Graham's voting machine versus weighing machine concept. I think in developed markets the weighing machine is more lubricated. The accuracy of the weighing machine prevails quicker than it does in South Africa. But it happens. I have personally been through two of these cycles already, it just takes longer and you really need patience. We don't know how long it will take, again to the point that these companies must be "time is your friend" companies. Typically it happens through either sentiment changing and the markets recognizing the opportunity in this company, or some catalyst like M&A or enhanced liquidity and retail participation in the market. Most of this cannot be determined a priori, but we know from experience that it happens.

G&D:

One of the things from an outsider's view of the market that's just fascinating is the size that Naspers accounts for at around 20% of the equity market. I'm curious, in terms of your day-to-day, what impact does that have in terms of fund flows, and maybe investability of an

index for South Africa. Do you have any kind of context for what having one company with such a huge makeup of an index means for investing in that company or country more broadly?

"I think in developed markets the weighing machine is more lubricated. The accuracy of the weighing machine prevails quicker than it does in South Africa. But it happens."

RVN:

It's actually quite a peculiar situation. For the purposes of this conversation, I'm referring to Naspers and Prosus as a combined entity. To some extent, Naspers is an active position for most of the funds in South Africa in the sense that they are underweight Naspers. Because very few funds, even closet index trackers, would not be deemed prudent to have a 20 to 25% position in a single position in their fund. Naspers is actually a contrarian bet for anyone willing to allocate market weighting or more to it. So that's a peculiar situation.

The other thing that I can say, which we

touched on before, is that we almost have this segregation within our space, within the South African listed space, where you have the top 40 stocks constituting about 80% of the total market capitalization of the whole universe, which are extremely liquid and very well researched, trading for most of the time efficiently at prices that I believe reflect underlying value, and a very, very sophisticated institutional money management industry that is very active in that top 80%. It's a very sophisticated market and a very liquid market.

And then you have almost the opposite in the small to mid-cap space, where there's very little participation, almost no coverage, and extreme illiquidity. Many of the companies that we are invested in have maybe one analyst covering them, sometimes no analysts. One company that we're invested in doesn't engage with the market at all. The CEO's report in the integrated annual report was less than half of one page. That's the amount of information they're giving. Especially pre-COVID, it was easier then, but it seems people still now are not making extra efforts. I have attended AGMs and results presentations where I was the only person attending. Or maybe one of two people attending the results presentation. That's just to give you some

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context on this extreme disparity that we have in the market. Very sophisticated and liquid on the one hand, and then on the other side we have this illiquid and uncovered space.

G&D:

Does that get you excited when you are one of either one or two folks at an investor conference for a company? What's your initial reaction when you see something underfollowed?

RVN:

Of course it makes me excited. I mean, firstly it's a public engagement, so it's a public event. I can ask just what I want to ask, and the public has been invited to that event so we are gaining a legitimate and lawful informational advantage. That is like the holy grail. Secondly, I think it's testament to the lack of participation and interest in that space. So, it supports the thesis that it's highly likely that the company is mispriced, or that it could be mispriced. If we do think that it is mispriced and we come there and we're the only one participating in the investor call, the results presentation, then it supports that thesis as to why it could be mispriced. This makes me very, very excited.

G&D:

A lot of investors in the States are probably used to daily liquidity never really being an issue and

not really waiting on bid-ask spreads to close. Do you have any stories around volatility or illiquidity in the types of companies that you tend to look at on the smaller side or any kind of flavor for what that means as a day-to-day investor and what you kind of experience either buying or holding or selling?

RVN:

I think volatility comes with smaller illiquid, and smaller cap stocks. It's likely not unique to the South African universe, but having a more concentrated portfolio does make for a more volatile experience. I honestly view that volatility as an opportunity. We have structured our fund so that it is an opportunity for us that we can capitalize on. We have extremely high-quality LPs in our fund and don't need daily liquidity. When volatility, for example, set in during the heights of the COVID pandemic, we didn't have a single investor call us and ask what's going on. The few calls I did have were people who just added capital to the fund.

There are many stories I can recall. It's not strange for us to have and we have had multiple 10% or more up and down months. On company level, I've witnessed a string of bids with zero offers on the other side. So volatility and extreme spreads are not strange at all. I am grateful that, I don't know why, but for some reason I'm

extremely equanimous and calm, and volatility doesn't influence my temperament at all.

G&D:

Shifting gears slightly, your LP base sounds mostly U.S.-based. When you're speaking with investors from abroad, do they tend to have common misperceptions about the South African market, consumers, or the continent broadly that you help educate? Or, if they come visit, do they get a sense that things are a little bit different than they previously assumed?

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RVN:

Well, Africa is huge, huge, huge, with more than 50 countries and extremely diverse ethnic

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and cultural backgrounds. And whilst South Africa is located on the continent of Africa, South Africa is not Africa or representative of Africa. But the misperceptions are understandable, I get it. I mean, you asked about the perceptions and how people view the market. There is an Africa connotation and a negative political and economic perception. That's the immediate first order response when people Google South Africa when doing some desktop research. There's media hype about Africa, and you see the negative headlines.

I think for global investors or participants wishing to participate in this market, access is the thing. It's a relatively small market. You have to go through some extra efforts to get a broker or a brokerage that's willing to trade on this market.

From a global perspective and a developed market perspective as well, it's a very small universe having 320 listed stocks versus thousands of stocks listed on the other alternatives. If you are someone who is going to dedicate effort, being a large fund or institution or whatever, the initial expected return on effort doesn't seem great. So, it seems like there's better lower hanging fruit from a return on effort perspective.

Then of course, what I alluded to earlier is the

negative narrative, which to a large extent is supported by media when it comes to the political and economic environment. Now, let me just state for the record, I am not denying or blind to the very real challenges that South Africa has politically and economically. What I am saying is that it's a one-dimensional view to simply base your opinion of South Africa by doing high-level desktop research and looking at the articles in the media. It's more nuanced than that. It's multidimensional.

“It's a relatively small market. You have to go through some extra efforts to get a broker or a brokerage that's willing to trade on this market. From a global perspective and a developed market perspective as well, it's a very small universe having 320 listed stocks versus thousands of stocks listed on the other alternatives.”

In the past, we've hosted South African investment trips for interested allocators. Most of them have never been to South Africa before. At the end of the trip their feedback was unanimous. South Africa

is way more investable than they thought it to be. The opportunities and the quality of the operators they were exposed to left a very positive impression. Most of them allocated after having visited South Africa.

G&D:

Do you have any stories or examples that might make it more tangible for readers in terms of how the market has changed? Things have really improved over time and, maybe from your early days in the markets, either as a trader to private equity to today, just anything as far as how the market or country geopolitically, economically has improved?

RVN:

There are massive shortcomings when it comes to the efficiency and delivery by the government, let's acknowledge that. Even with those massive inefficiencies and lacking delivery on their side, we still, if you compare it to where we were 10 and 20 years ago, we've made massive strides in giving people access to water, electricity, housing, health, education, and so forth. I would say the more important insight from our perspective and what we are doing is that the people within the country, especially the private sector, are extremely enterprising. With every challenge

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that is created or presented due to the inefficiency of state, private enterprise comes in and capitalizes on that opportunity.

There are many, many examples I can mention. Within education, for example, two private education companies that started in the PSG group, one in schooling is called Curro and the other one is in college and university, STADIO. They are currently able to deliver a world-class quality academic outcome for their learners at the price, which is equivalent to or even less than the education budget of the state is per learner. It delivers high quality outcomes at very competitive prices. And they are doing so at very decent returns on capital.

The most recent example has been rolling blackouts from the electricity provider Eskom. The private sector over the past two years has stepped into the wake there and established their own electricity and power generation. Government has opened the market so private operators are now allowed to do 100 megawatts without excessive requirements. Suddenly you are seeing the liberation of that market and private sector stepping into that and making good returns and, again, addressing the challenges created by an inefficient state.

I can carry on. The point is that you have this very interesting paradox or dichotomy where you

have a large, bloated, inefficient state and extremely energizing enterprising private sector that just continually innovate and capitalizes on the opportunities created within that environment.

“There are massive shortcomings when it comes to the efficiency and delivery by the government, let's acknowledge that... I would say the more important insight from our perspective and what we are doing is that the people within the country, especially the private sector, are extremely enterprising. With every challenge that is created... private enterprise comes in and capitalizes on that opportunity.”

G&D:

Taking it back to the investment process when you look at something like a STADIO, and you see that kind of immense value proposition relative to the alternatives and the solid returns on capital that they're

generating as well. Do you tend to be more focused on the qualitative and the customer value proposition first, and then the financial valuation follows? What attracts your attention generally for an opportunity and, as you evaluate, what does your process tends to look like in terms of staff?

RVN:

Look, if I'm completely honest, I'll tell you that the idea generation process is quite random. I'd love to tell you that, 'well, we have a very beautiful, written out, safe recipe about what our idea generation process is,' but the universe is small enough that we just poke. We continue poking everywhere and turning over rocks. And there can be a multitude of sources. I have found opportunities by reading an article in the newspaper. I have found opportunities by being exposed to a product, and then following the product back to the company. I've found opportunities by speaking to people within the industry at a company that I was interested in and ask them if they had a silver bullet, which competitor would they shoot with that silver bullet and then invested in the competitor.

The universe is not unassailable, if you do enough work, most of the companies you can

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quickly have a look at the annual reports, and so we just turn over rocks constantly. To your question about the value proposition and qualitatively, absolutely. Ultimately, how does a company generate sustainable profits? The company has a client or a customer and the company has to turn over a service or a product in exchange for the customer or client's money. That customer or client will only part with their money in exchange for the product or the service, if they feel that there is a value proposition there. And then I would say, when you start looking at stuff like compounders, then is it scalable, the markets in which they operate, will the flywheel accelerate, et cetera, et cetera? That qualitative overlay is very, very important.

G&D:

How do you approach position sizing? Is there a sort of a science or an art to it? Can you talk a little bit about that?

RVN:

It's not something that is modeled on an Excel sheet, but I'm going to give you an idea of the mental framework that I use when it comes to that. To some extent it's akin to the basic premise of the Kelly formula or the higher the conviction in the expected return, the higher you will size it. In my mind, I will have what I call an opportunity cost curve, and the two variables for

each company or position that go into that are what I deem to be a range of reasonable return outcomes adjusted for what I deem to be reasonable probability assigned to each of those outcomes. I also think about the tails of the distribution a lot.

Then I will have a certain expected return outcome for that position. I will have a certain level of conviction in that. The higher the combination of those two, the higher the position sizing will be in the portfolio. There are real limitations sometimes between what you would like the position to be and what you can make it. For example, sometimes you start buying a company and the market wakes up before you've established a full position. It just happens. That's one example. We are fortunately not at the point yet where liquidity is a problem for us. Being smaller is to our advantage, in that we can capitalize on all of the sizes that are available to us.

G&D:

You've mentioned the smaller investment universe in South Africa a couple of times. Out of that universe, what you and Desert Lion does the opportunity set look like within that? Are there different kind of buckets that you tend to put your types of positions in? Does it tend to be 50, a 100, a 150, or things that could potentially be a company

that you're not in at the right price? Or how do you narrow that universe further in terms of what warrants a deeper dive for you and the team?

“In my mind, I will have what I call an opportunity cost curve, and the two variables for each company or position that go into that are what I deem to be a range of reasonable return outcomes adjusted for what I deem to be reasonable probability assigned to each of those outcomes.”

RVN:

I would say the investible universe is probably like a 200 to 250 stocks. And then for us, we can consider most, if not all, of those as opportunities for us. We only have to invest in 7 to 15, which is about 5% of the investible universe that we have to select. You can imagine if we just get more than 50% of our positions right, there's a very huge variability in individual stock returns over any given period of time. It does present an opportunity for differentiated returns.

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G&D:

We've talked about the macro and the governmental aspects, and we talked about how they're improving, but do they factor into the investment process at all on a company specific basis? Are things that you watch out for in terms of how they might affect the operations of an individual company, as opposed to painting with broad brushes for the market?

RVN:

Great question. We are bottom-up investors, but I've also recognized that we are not operating in a vacuum. To some extent, it would be intellectually lazy to not at least try and establish whether the macro environment could be a headwind or a tailwind. We're not investing according to macro themes, but we do try to establish whether the macro environment might be supportive or be a headwind to our companies. One current example of that would be our investment in Sibanye-Stillwater, which is the platinum group metals company. I've written about that in the last quarterly letter, that we do believe that there is a sustained drive towards cleaner energy.

PGM's are indispensable to cleaner energy and there has been a massive lack of CapEx over the past 10 years to bring supply online. We've got a huge lag in supply responding to that. 85% of the world's

PGMs comes from South Africa, so it's a unique intersection of many interesting observations, which to us seems to be more likely to be a macro tailwind than a macro headwind for Sibanye-Stillwater, which we've selected purely on a bottom-up approach.

“We are bottom-up investors, but I've also recognized that we are not operating in a vacuum... We're not investing according to macro themes, but we do try to establish whether the macro environment might be supportive or be a headwind to our companies.”

G&D:

Similar to that point on the capital cycle within PGM, has the lack of capital availability within South Africa relative to other locations helped support some of those types of capital cycles in terms of being opportunistic? How you think about the opportunity set today versus other times in the past cycles in the market?

RVN:

Absolutely. You are spot on in what you were

alluding to in your question. It is a symptom of that. So let me touch on the PGM space and then I'll look at South Africa a bit more broadly. In the PGM space, that was as a result of two things. The first one was reckless capital allocation during the prior boom in the 2000s and up, the 2008 commodities boom. Just making poorly thought through capital expenditure decisions. So, they've been bitten by that. Also, due to the ease of accessing capital, they have had highly leveraged balance sheets. So, then it was a perfect storm of committed CapEx, highly leveraged balance sheets and decreasing commodity prices that really hurt them. What they did, the lessons that they learned was firstly, run conservative balance sheets, because liquidity can dry up and you might not be able to re-finance the excess additional capital.

The second one was, don't be reckless in bringing additional supply online. Prices might spike and then drop again sooner than you thought. That has been the result bringing us to where we are in the PGM space. In South Africa more broadly, if I look at the periods which I have experienced and witnessed, I would say currently, if you look at the South African listed universe and you look at certain markers of where valuations are, what sentiment is towards the

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Rudi van Niekerk, Desert Lion Capital

country, and what liquidity flows look like, I would say, this is very similar to the periods from 2005 to 2008 and 2012 to 2015.

In both of those periods, we came out of a prolonged period of liquidity withdrawal from the markets, lack of international capital inflows into the markets, and subdued commodity periods. Commodities assist with the trading surplus on our balance of payments for the country, so rising commodity prices are good for deficits and also for tax revenue.

If you look at the P/E of the market, those were pretty much near the low end, if not below. In 2005 the market was at a P/E multiple of 13x, which was the inception of a massive stock market run we saw. In 2012, it was also a P/E of 13x, preceding another string run in our market. Currently we're at a P/E of 12x. There are many similarities with those periods and where we are now. It will be interesting to see. History doesn't repeat, but it does rhyme. There are a lot of similarities. There's no way I can predict what's going to happen in the future, but certainly where we are currently does look promising.

G&D:

If there are investors or people who are generally curious and want to learn more about South Africa specifically, are there any books that you'd recommend or

people to follow? Anything to inject a little bit of the life of South Africa into the day-to-day?

"I would say, this is very similar to the periods from 2005 to 2008 and 2012 to 2015.

In both of those periods, we came out of a prolonged period of liquidity withdrawal from the markets, lack of international capital inflows into the markets, and subdued commodity periods... If you look at the P/E of the market, those were pretty much near the low end, if not below."

RVN:

This is another one of the peculiarities. There is no manual for investing in South Africa. There are no primers. Hence, we have compiled our own internal document of about 200 pages, which one can view as a bit of a primer on South Africa. But that is, as you would understand, valuable IP that we reserve for selected interactions. For an entertaining read, I have

one book recommendation though about how entrepreneurs and the private sector can operate and make fantastic returns within the South African environment. I would recommend a book by Jannie Mouton, called, "And Then They Fired Me." He was the founder of PSG Group. It's not the most eloquently written, but it's extremely entertaining and instructive as to what can be done within the investment universe in South Africa.

G&D:

Our readership tends to skew more towards younger investors, business school students, and people even younger. If you were in our shoes or if you had advice for students who are looking to enter investment management over the long-term, and what are the kinds of things you'd be doing now?

RVN:

Don't do it, do something more productive with your life. Maybe I am being facetious, but there's a kernel of truth in there. I think that there is a certain perception that there's a huge amount of riches and wealth to be gained from being a fund manager. That certainly is true for those who have been successful. However, we need to remember that the attrition rate is extremely high and so

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there's a massive amount of survivorship bias that we are being influenced by. Secondly, if you want to do it for the money, it's highly likely that you're not going to succeed. The most successful investors and fund managers I know are people that do it because it's a genuine passion of theirs, and the money is a natural byproduct. I would say, by all means, enter the profession if you believe it is for you, but think hard and long before you just enter the profession because you think it's an easy way to riches. I don't think that should be the overriding factor.

If you then after those considerations still believe you want to do it, I think the most important thing to do is accept it's going to be hard. Unless you come from an extremely wealthy family and are very well connected, accept that it's going to be extremely hard. Show traction. It doesn't matter how small it is, even if you do it with a limited amount of your own capital and a few of your friends and family, show traction and document your traction. If you persist and if returns are satisfactory, eventually you will succeed.

It is immensely satisfying from an intellectual perspective to do what we do. You are in complete control of how you want to structure your life. You can structure a life which is congruent with and supportive to your

personality. If you are successful in what you do, you are adding value to a lot of other people, and you can be an agent for rationality, especially if you operate in pockets of the market that is more irrational. I do believe we all, to some extent, have an obligation to contribute to society being a little bit more rational.

“Show traction. It doesn't matter how small it is, even if you do it with a limited amount of your own capital and a few of your friends and family, show traction.”

G&D:

Last question is what you like to do outside of investing?

RVN:

I have two boys, they're two years and four years old, and there's really not much time available outside of family and investing. I do structure my day to make time to exercise, to work out. That's very important to me and my interests are aligned with that. I enjoy anything with nature. Going for runs, hikes, mountain biking in nature. I love doing yoga. I love cooking with the family. I'm learning a new language, French. That's about it. My work is my passion. Running

the firm is my passion and my family is my other passion. For the rest, I just structure all of those activities and hobbies to fit in with that.

G&D:

Thanks so much, Rudi.

Ben Preston, Orbis



**Ben Preston,
Orbis**

Benjamin Preston, Master of Arts (Honours) in Mathematical Sciences (University of Oxford), Chartered Financial Analyst. Ben joined Orbis in 2000. Based in London, he leads the global sector investment team and is one of the stock pickers who directs client capital in the Orbis Global Equity Strategy. He is a Director of Orbis Holdings Limited. He previously worked at Barclays Private Investors.

Editor's Note: This interview took place on September 24th, 2021.

Graham & Doddsville (G&D):

Ben I really appreciate your time today and it's really nice to meet you as well. To start things off, it would be great to hear about your background and what brought you into the world of investing.

Ben Preston (BP):

I grew up in a fairly small town in the southwest of England. Everyone in my family is a doctor. It may actually be something of record, I'm not sure, but my sister, my mother and my grandmother are three generations consecutively of general practitioners (primary physician). And they all married general practitioners too!

When I was talking about career options with my family, they had nothing for me except, "Why don't you try medicine?" I started saying no, I think just because I wanted to do something different.

My strongest suit academically was mathematics, so that's what I studied at university and was pleased to be accepted at Oxford. At that time in the late 90s, the most prestigious roles were really investment banking and management consulting, so I applied and was given an offer at an investment bank.

But I realized quite quickly that it wasn't really for me. It was basically preparing pitch books and crunching spreadsheets at four o'clock in the morning in a way that, frankly, a monkey could have been doing just as effectively. I think I wanted to engage my brain a little bit more, so I moved over to the investment side.

I was lucky enough to stumble upon Orbis 21 years ago, and I joined as a 23 year old without much experience, just a couple of years out in the workforce but really still very fresh. That's exactly how we still love to hire people today. We have a way that we like to invest and we like to think about intrinsic value. We like to have people that can absorb that without having

already had their brain pre-programmed in a different way. I think if you're going to do something a little bit different and better than average, then it helps to start with a blank sheet of paper in terms of people's experiences. That way you can really train people up.

So I was a classic hire in that sense and I worked very closely with Allan Gray, who was the founder of Orbis, and his son, William. They taught me how to invest.

G&D:

You joined Orbis 21 years ago, so that's 2000, sort of the tail end of the dot com bubble. It'd be great to hear about your experience learning about the market in the midst of such a unique event.

BP:

Being quite mathematical, I had a very analytical bias. I wanted to go deep, I enjoyed the modeling. I enjoyed understanding about return on equity and capital, how markets worked and how companies created value. I loved it. It stimulated me a great deal. But I didn't yet understand about contrarian investing.

It was at the height of the bubble that I came for the interview at Orbis. They asked me - if you had to buy a share today that you would

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hold for the next four or five years you think might double in value over that time period, what would you choose? I said Vodafone, which was the most high-flying overvalued stock in the UK at that time. It was right at the peak of the TMT bubble. I walked into Orbis and I looked at that portfolio. It was full of cement producers and food companies, and I thought, you guys, you don't get it. Well, it turns out it was me that didn't get it. Vodafone was priced at about £4 a share and 20 years later it's £1 a share!

Thankfully my interviewer was willing to look past that example. I'm grateful that it happened because it was a fantastic lesson for me. It was the first time that I really encountered what it meant to be a contrarian investor. Not just investing based on what you think the future might hold but actually looking at what you think the true value of a business might be, including all those fantastic growth prospects and take a sober appraisal of that, but then, of course, compare that to the current share price. And only buy the share if you can get it at a discount from that intrinsic value. That was the big error that I and others made at that point in liking shares that were flying high.

G&D:

I'd be great to talk more

about the contrarian investing philosophy, and some examples of businesses that Orbis has invested in that worked and that haven't worked.

BP:

You can start with the fact that we know that businesses go in cycles. That's always been the case. It might be because of something that's happened externally, like we've all had a massive cycle because of this pandemic. That's been an extreme one. But you can get smaller ones. Typically, businesses go in cycles and that's true of individual companies as well. They tend to participate in the cycle, but also cause the cycle. A typical way that that would play out would be when things are going great, managements tend to feel good and invest in the future and competitors come in.

But that new influx of capital is chasing the same pool of profits, and that depresses the return on investment that you can get, and all of a sudden things get a little bit worse and people start pulling their capital out and, of course, that is what causes the cycle to go the opposite way again. Because then you're faced with a bit of undersupply and the whole thing goes into reverse.

Now, investors, in theory, should look through that. In theory,

investors should say, "I recognize that there's a cycle. I'm going to take a little mid-cycle estimate and that's what I'm going to base my intrinsic value on." But we don't because we're human and we tend to extrapolate the past. We have recency bias and we are suckers for people who tell a good story, which is easy when business is going well. So what we actually do as investors, as a herd, is that we magnify the cycle. We tend to put a higher multiple on companies' shares when the prospects are currently very good.

If you look at share prices over long periods of time and compare them with earnings, typically when the earnings are high, the share price is super high, and when earnings are low, the share price is super low. This is the basis of contrarian investing.

“So what we actually do as investors, as a herd, is that we magnify the cycle. We tend to put a higher multiple on companies' shares when the prospects are currently very good.”

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A common misconception is that contrarian investors think we're smarter than everybody else: if everybody else is going to zig, we're going to zag. But actually, our approach isn't based on the concept that everybody else has got it wrong. It's just a reality that businesses, companies, move in cycles. Investors tend to extrapolate those cycles and so by doing your own homework carefully, doing your own research, not deliberately going against the crowd but not deliberately copying them either and just dancing to a tune, you can often find clarity and sobriety and common sense in a world that sometimes loses its collective head.

Several years ago Toyota had problems with its pedals. The car was accelerating accidentally because of a faulty accelerator pedal that would get stuck. It was a very real problem, and investors reacted by selling en masse. But while it was a real problem, it was also fixable. It was a temporary issue that wasn't really a big factor in Toyota's true intrinsic value. When investors over-react to bad news like that it can often give us an opportunity to buy. That's a single company example, but it can happen across industries and it can happen across countries.

The most pertinent example is when our Global Equity fund launched in 1990, near the peak of the late 1980s bubble in Japanese stocks. When Orbis launched, we had a weight of zero in Japan. That was seen as being absolutely suicidal because Japan was widely considered the economy of the future - it might be a bit like having zero in technology stocks today. That's how important Japan was seen to be. Japan was over 40 percent of the world index by market capitalization at that time. Of course, while the whole world thought it was very risky to be out of Japan, the truth is it was very risky to be in Japan. Our clients were protected from the implosion of that bubble.

“What it means is that there comes a time when investors are so despondent or they've just got so used to ignoring something that we're almost the only people who turn up and are willing to read note 38 on page 52 of the annual report. That gives us a tremendous advantage.”

Now, fast forward about

20 years later, we actually had 30 percent of our portfolio in Japan. By this stage it had fallen to be eight to nine percent of the world index and people thought we were crazy for the other reason. "Why are you so heavily invested in Japan? Don't you know that its demographics are terrible? It's got this massive government debt. It's got no cultural innovation."

It's amazing how Japan had gone from being absolutely flying to being in the garbage bin. But the way we invest is to look not at Japan's prospects as a country, but at individual companies and look at their prospect in the cold light of day. And you know what? If there's great value there, that's what we'll be driven by. We couldn't find much value in Japan in 1990, but we could find an awful lot later on when everybody else was overlooking it. That's where the contrarian philosophy really comes into its own.

What it means is that there comes a time when investors are so despondent or they've just got so used to ignoring something that we're almost the only people who turn up and are willing to read note 38 on page 52 of the annual report. That gives us a tremendous advantage. Whatever game you're playing, you're more likely to win

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if A, you have an edge and B, you have a smaller number of competitors.

That's why we don't spend our time trying to predict inflation and bond yields and GDP growth rates. We could try that if we wanted to, but I'll be honest, I don't think we'd have any edge whatsoever. We'd be competing against every man and his dog who's already trying to play that game.

But if we can find something that has less interest, then maybe we do have an edge and maybe we're playing against a smaller number of competitors and so we're much more likely to see success with that investing approach.

That's really what contrarian investing means to us. It means being independent. Not deliberately going where other people are not, but making sure we dance to our own tune. We have a large investment team, a resource base that allows us to cover a lot of ground, which we think gives us an ability to invest where others aren't looking.

G&D:

You're looking in so many places where other people tend to not be looking, but that's still so many companies to look through at a given time. Are there heuristics or filters that help you? Signals that maybe something is worth

digging into? How do you narrow down that huge universe into something that your team can wrap its head around?

BP:

Well, we do like to own good businesses, preferably great businesses. They often don't come as cheap as we would like them to, so we have to be patient. But we don't want to own bad businesses. We don't want to own businesses that are behaving in a way that we don't think is sustainable or that wouldn't be in line with the values that we would expect. We would typically be searching for businesses that we can analyze over long periods of time. We love long-term data and by looking over it, we can immediately get a sense of how profitable this company has been over a long period of time.

“We've historically found better value in the companies that have maybe had a long history, but they've gone through a long period of not very exciting fundamentals and perhaps have just gotten to show some signs of success again.”

Now, of course, things can change, but history provides a starting point.

So, looking for companies that have a good return on equity over a period of time and that have shown the ability to grow. That's mathematical, that's what a computer can show us and then, of course, we have to take over as analysts. What does their competitive position look like? What are their competitive advantages? We would start off with a proprietary screening methodology. We buy in our data and we can crunch that ourselves. What we're doing is starting off by looking for companies that are good and that screen as attractive, in terms of their current share price.

Typically, we're not looking for companies that have been great and suddenly their share price has declined significantly. That can often be a risk factor. We've historically found better value in the companies that have maybe had a long history, but they've gone through a long period of not very exciting fundamentals and perhaps have just gotten to show some signs of success again.

I will give you an example of a company that we currently own that might bring it to life a little bit: ING, which is a European bank. If you

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look at the history of ING, it has been a pretty successful bank. It has a reasonable return on equity over history. It has added value for its shareholders. But in the last few years, particularly since the financial crisis, it has been very tough for all European banks. The regulatory cost of doing business has been rising significantly. Interest rates have been falling, which pressures their ability to make the interest spread. Regulators have forced them to hold more and more capital, so they've had three very nasty headwinds. If you look, their share price hasn't been very exciting for the last 10 or 12 years.

“If you look at the share price of ING, you're paying a 10 or 20 percent discount from their net asset value. Most companies today are trading at a significant premium.”

Now, if you ask a lot of investors why, they would say, “Well, the prospects for European banks are terrible because the interest rates are going to continue to be low and that's going to work its

way deeper and deeper into the loan book and put more and more pressure on them. They will continue to face these same regulatory burdens.” But if you speak to management, they will say, “If interest rates fall, we have other levers that we can pull. We can increase our fees on checking accounts, on credit cards, we can cross-sell our products where we actually don't make much money at the moment compared to our competitors, so we've got a lot of leeway to add value there.”

If the worst of the bear case that people are talking about actually comes true, they're probably going to be okay compared to what expectations would be. But if it doesn't happen and interest rates don't continue to grind lower and actually might go higher, then you've got something quite exciting on your hands because that's when they can start to improve their interest margin again. Interest rates are currently at a 5,000 year low: to think that rates might rise again at some point in the future, maybe that's not so crazy after all.

If you look at the share price of ING, you're paying a 10 or 20 percent discount from their net asset value. Most companies today are trading at a significant premium. Average on the FTSE world index is five times that asset value. So here we can buy a company

which is very well capitalized and is earning decent profits and yet is on a discount to its net asset value.

G&D:

Perhaps we could talk for a moment about China, especially given NetEase is one of your fund's largest positions. To the extent that you're willing, it'd be great to hear your thoughts on the recent developments and even more of a long-term perspective on investing in China.

BP:

I will make a few comments on that while also recognizing that we are actively reviewing it. I'm not going to be too definitive because we have to make sure that we allow ourselves the room to act on our best judgment at all times. We will be responsive to developments and we will be responsive to price and in both those respects, things have been moving pretty fast in China. We are constantly reviewing our stocks there.

You can put NetEase, if you like, together with Tencent. Those two companies are both fantastic companies. They have a history of creating a lot of value for shareholders, growing their businesses by compounding a nice return on equity over time. They're both online gaming companies at their cores.

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If you compare the likes of NetEase and Tencent with some of the most successful companies globally over the last 10 or 20 years, that's to say the Googles, Microsofts and Amazons of the world, they are the equal in our view in terms of their competitive position, their ability to grow, their track record and their prospects. The two glaring differences are the country in which the companies operate, and the price that one pays for the shares of those two baskets.

We have found that, like for like, in terms of quality and growth, we've been able to buy the shares of NetEase and Tencent at a lot lower valuations than we would have been able to buy the Amazons and Microsofts, and that's very appealing. At the same time, we recognize that there are some risks that come with investing in China. Whether that's because the regulatory environment can change at the stroke of a pen, or the VIE structure through which investors have to own these shares, it's really been a question of how you weigh those two things against each other. There's no right answer to how to handicap risk. That's something that we will always have to make a judgment on—and like any judgement we take the risk that we might get it wrong.

One thing we can say for certain to our clients is,

"Look, we will do with your money what we would do with our own." We can back that up with substance because if you add up the assets that are our own employees and parties that are controlled by our employees including the foundation that owns Orbis, we are one of our own largest clients. A lot of our own money is invested alongside that of our clients. That allows us to look our clients square in the eye and say, "We are doing with your money what we do with our own, and you can be sure of that because we're invested alongside you."

The message that we give is that we will be benchmark agnostic. It really shouldn't matter to us or you what the stock market average does. We're looking to get good returns on the money invested with us. Now, it's natural and correct to compare our performance against the stock market averages because that's the only way to figure out whether we're doing a good job or not, but the returns that we're really trying to aim for are superior risk-adjusted absolute returns over the long term.

I mention that because if you look at the way the world index benchmark is currently invested, it's something like 65 percent in the US and zero in China. The US is a great country, but for investors to have 65 percent of their money invested in just one

jurisdiction is not particularly balanced, with zero in China, which is the second-largest economy in the world.

"If you compare the likes of NetEase and Tencent with some of the most successful companies globally over the last 10 or 20 years, that's to say the Googles, Microsofts and Amazons of the world, they are the equal in our view in terms of their competitive position, their ability to grow, their track record and their prospects."

We have gone out on a limb in terms of overweighting China relative to the benchmark, but in absolute terms, we've invested much more in the US than we have in China. We think the balance there is appropriate. Currently, about 10 percent of our portfolio is invested in China. We recognize that there's a rapidly changing regulatory environment, but we've owned shares in NetEase for well over 10 years and during that time it has been exceptionally rewarding.

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That really is the essence of how we invest. We like to find great businesses, own them for long periods of time and see the share price appreciate because the company is adding value without us having to trade in and trade out of shares. If you look at the long-term experience in NetEase, it has been great. It has been tarnished somewhat over the last few months by what has happened in China and the way the investors have panicked in response to that, but our task here is to keep focused on the long term.

G&D:

I wanted to follow up on one of the comments made earlier that I thought was really interesting, talking about the capital cycles that you tend to look for, as well as some of the reflexivity that goes into that, where funds follow performance. I think you can see that within individual industries, and you can see that within investment returns as well, to a certain extent, and in terms of exactly what you just said with the geographic concentration across investors and following things.

It seems like today there's more of a level of reflexivity where the funding causes more funding and more talent to flow to things. Whereas in the past you got faster mean

reversion versus today's trends are sustaining longer. Is that similar to the way that you see things and how do you think about those types of dynamics when you're thinking about investing in a cycle that should be ready to mean revert back to its historical averages?

“I think one has to, as an investor, try to figure out when share prices are running hard. Are they driven because the fundamentals are actually doing very well or is it investor over-enthusiasm? And it's often not as obvious as it looks at the time. “

BP:

I think those are very good points and I had exactly that in mind when I was talking about why we don't go for companies that have very recently fallen from grace. It's because the mean reversion process, actually, is naturally quite slow. It takes a while for a company to change its plans. Maybe they've invested in a project which will take four years to complete. If you're two years through that then you're half way through, so you're not going to want to cut it off. That's why it can take a while for

things to properly play out – on both the upside and downside.

I think the heart of your question is whether or not things take longer to play out than they would've done in the past because you've got a bit more reflexivity built in. I don't know the answer there. I think it's a fair question. But I would say, although I've described that the world moves in cycles, it doesn't only move in cycles. There are things that come along, whether that's the internet or mobile phones or whatever it might be, that are more enduring. Part of what's been the case over the last 20 years has been a genuine, extraordinary amount of value creation by companies that have carved out exceptionally strong, competitive positions in enormous markets. To that we must take our hats off and say well done.

I think one has to, as an investor, try to figure out when share prices are running hard. Are they driven because the fundamentals are actually doing very well or is it investor over-enthusiasm? And it's often not as obvious as it looks at the time. But if you look back over the last 20 years, over a long period of time, you can certainly say that the bigger part of what's driven the likes of Facebook and Google and Amazon shares over the last 10, 15, 20

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years, has mainly been the tremendous value they've created fundamentally.

However, once that growth starts to slow, because the companies become a little more mature, investors tend to be slow to see the end. One exercise I did recently was to divide a little bit of recent history into decades. In the 1970s, with inflation and not much economic growth, the thing that you really wanted to own was gold. If you'd done that, you'd have made many times your money. But if you came to that conclusion at the end of the 1970s, you would have been too late. The gold price hit a high in real terms, which has never since been exceeded.

In the 1980s, the thing that was really exciting was the Japanese miracle economy. If you'd invested in Japan in 1980 and held it to the end of the eighties, you'd have again made several times your money. But if you'd bought in 1989, when they said that the Imperial Palace was worth more than the land in California, then you'd have lost three-quarters of your money.

And then of course, in the 2000s what was really driving the world at that time was the industrialization of China after they had joined the WTO. If you'd invested in the sorts of things that China wanted, iron

ore mines and commodities generally, you would've gotten it very cheap because everybody else was still in tech and you would've done fantastically well over that decade compared to most investors. But if you'd done it at the end of the decade, you'd have caught the second half of the commodity cycle, which was the down half.

I missed out on the 1990s, which was of course a massive bull market for the NASDAQ, which culminated in the TMT bubble and my Orbis interview! The 90s were a tremendous time to invest in tech, but if you had bought it in 2000, then we all know how badly you would've done after that. These trends, which can be incredibly powerful, when they come to an end can be very dangerous for investors. And when I observe the stock market today, what we see is that investors are betting very heavily on the next decade being identical to the last one. They're betting very heavily on these global tech winners, which have just had such a fantastic last 10 years.

And perhaps, just perhaps, what's happened in China recently with the regulatory crackdown is a sign of what might happen elsewhere. China has got there first in terms of making sure people don't spend too much time online and

play too many games. Who knows whether that might spread? I don't know. That's not a prediction, my only statement here is that these trends, powerful though they might be, are not rewarding for investors that come in too late. And when everybody is expecting that the next decade will be the same as the last, that's when investment accidents happen and a contrarian mindset can be protective.

G&D:

One of my most useful investment books that I've read is *Investing Through Capital Cycles* and it talks about a leading indicator for the pricing power of an industry is if there's just not been enough capital investment spend for years leading up to that and then you have the

***“...trends, powerful though they might be, are not rewarding for investors that come in too late. And when everybody is expecting that the next decade will be the same as the last, that's when investment accidents happen and a contrarian mindset can be protective.*”**

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under supply and that leads the pricing. And getting to your point, a lot of these things seem obvious in retrospect, but in terms of catching them earlier, there are leading indicators like that for a given industry or maybe with where valuations are, investment dollar flows from one sector or one geography to another that seems like it's right for potential re-performance. Are there metrics that you tend to look at for those high-level things?

BP:

Very much so and one of them is one you've identified: CapEx. We can look at several companies in the same industry, we can aggregate to look at the overall CapEx that's going in through an industry and if you measure that over a short period of time it means nothing at all, but if you measure it over a period of years, you can see some interesting trends. If you supplement that with talking to management teams to see how they're feeling about investments, you can often build up a picture of where a company is in the cycle. Now you can't predict where it's going to go next because there's so much uncertainty in there, but you can at least know with some accuracy whether you're in the top half or the bottom half of the cycle. And that's helpful in and of itself.

Cycles can change surprisingly quickly – look at right now. These have been extraordinary times, but isn't it amazing how the world has gone from over-supply to under-supply in the blink of an eye. Last year, whether you were buying clothes or flights, or renting an apartment or a car, they couldn't give stuff away cheap enough. There was no demand and so you were the only buyer in town. Now, how quickly that's changed. If you look at the price for shipping containers or building supplies or labor. Things can change rapidly.

“That actually ends up meaning the company has a very lean cost base, which when the next cycle comes around on the positive side, it can be extraordinarily profitable because that's when resurging demand hits a very lean capital base and a very lean cost base.”

In terms of indicators, I think CapEx is a good one. I think profit margin is a good one as well, for obvious reasons. But when a company is going

through bad times, the first thing that happens is profits drop and then they cut costs. They make the hard decisions that maybe they weren't quite ready to make when times were better. Maybe they really focus on who they need to keep and who they don't need to keep. They take some tougher decisions because they have to.

That actually ends up meaning the company has a very lean cost base, which when the next cycle comes around on the positive side, it can be extraordinarily profitable because that's when resurging demand hits a very lean capital base and a very lean cost base. One of the companies that we own at the current time is Rolls Royce. They make aircraft engines for long haul travel and they get paid by the amount of flying time that each engine does because they really get their money from the servicing. And there hasn't been a lot of long haul air travel. These have been in desperate times. They've had to raise capital from their investors, their free cash flow's been negative, they've been having to sell off various assets that are non-core, and they've done what they can.

But this period of time will not last forever and travel will eventually ease and when that demand comes back, it will meet a dramatically

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lower cost base. I think to your point, that's where that capital cycle or business cycle investments can be helpful.

G&D:

Transitioning a little bit to concentration and position sizing, you tend to run more concentrated than the average fund. When you think about position sizing, what are the biggest factors, whether it's absolute upside or risk of permanent impairment, how do you balance those things as you're thinking about sizing something?

BP:

Those are exactly what we try to make sure we keep in mind, the upside that we might have compared to the risk of loss. We'll be heavily driven by the data and how we compute the data, but ultimately, we have to apply our own judgment and that means staying very close to the companies that we follow. And there's only so much bandwidth that any human being might have. So, really what constrains our portfolio size is the amount of people we have multiplied by the number of positions that each person can keep track of without dropping the quality.

In a global equity strategy, for instance, we have five key stock pickers. We have a multiple portfolio counsellor approach with

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five of us that break the world down into different regions (except me, who is global). And we each think that we can cover somewhere between 10 and 20, but closer to the lower end of that, maybe 10 to 15 companies each. And if you multiply 10 to 15 by the number of us being five, then that's how we end up with the number of core positions we have in the portfolio. Any more than that and we would start to struggle to know the companies as well as we need to.

There can be a great comfort, a false comfort in being diversified, but we don't really think that's what our clients want from us. They want us to take definitive views and to invest behind them with conviction so that we can actually make a

difference.

When we've done the analysis ourselves, we've compared the bulk of the portfolio with the longer tail of smaller positions. What we've seen is the longer tail of smaller positions doesn't really contribute much value. We get most of our value from the larger positions and so that helps us to say to ourselves we should focus on the stocks where we have the most conviction and be prepared to sell the ones that are not the top ones. And that way we can try to optimize and make every dollar count, with every dollar being well invested.

G&D:

It looks like British-American Tobacco is the largest holding. It seems like the fundamental performance has been very strong and it's been mostly about the valuation that's driven recent returns in terms of the multiple. How do you think about situations like that?

BP:

I'm not sure it's possible really to speak about tobacco without touching on ESG, so let me do that in a minute.

But first, yes, we are often asked: why would you expect a re-rating from that company? But that's not our mentality. We try to draw a hard line between investing

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and speculating. And speculating for me is when you buy something in the belief and expectation that you'll be able to sell it later on for a higher price. Investing is when you say, "I think if I held this share forever, then the amount that I would earn by being paid out the earnings and the dividends of these companies over time is it more than adequate compensation for the price I'm paying today." That's what's we do.

It doesn't commit you to holding the share forever. It just says if I were to hold the share forever, I think I'm onto a winner here. And if you get that right, then what often happens is the share price does rise and then you can find a better opportunity. You can sell the one you bought, and buy the next one. We're not saying that we buy stuff and then hold it forever, but what we are saying is that we'll buy stuff below its true fair value. And if we get that part right, then the re-rating take care of itself.

And with British-American Tobacco with a dividend yield that is 7.9 percent, then that's a pretty good return and any re-rating would be icing on the cake. But most of the return that we'd expect to get from that share would be the dividend yield, which in and of itself is pretty good.

I will just say, one of the

reasons that the share price has become so cheap is because of the ESG concerns. That is something that we pay attention to, we're committed to paying attention to. Now, we can have a debate about the ethics of the tobacco industry and I think some would say that it's better to have a well-regulated, heavily-taxed tobacco industry than let the whole thing go into the hands of criminals, which would otherwise happen.

In some sense, it's a necessary evil, but we want to go a little bit further than that and to make sure that we are behaving responsibly as owners. And so we have engaged with them extensively, including sending a message that we would rather they give up short-term profits in some cases to ensure that they're on the right side of making sure they're behaving well. Things like making sure they're marketing their new products responsibly, not encouraging underage people to take up vaping. That's I think how we would characterize the ESG aspect of British-American Tobacco where we believe the company still has work to do. We've told them that and we'll be honest about that.

But in terms of your question, we don't think we really need to see re-rating there. We are indifferent as to whether our returns for our

clients come in the form of dividends or earnings growth or re-rating. They all count the same.

G&D:

With respect to the broader ESG trends. I think 10 years from now, it seems pretty obvious it'll be bigger than it is today. But at the same time you have companies that are issuing debt and because there's an ESG component, maybe you're taking off 40 basis points or something. How do you balance the long term with some things that might not make the most sense in the present? I think it's a broader question, even beyond ESG, and tech is similar.

"We are indifferent as to whether our returns for our clients come in the form of dividends or earnings growth or re-rating. They all count the same."

BP:

I agree with your observation that it's becoming more and more important and I think part of that is how investors want to invest as your generation cares

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more about the impact it has on the world than perhaps my generation or my parents' generation ever did. So that's great to you guys because I think it's important. That's where investors want to put their money, but there's another dimension to it, which is what it actually means for the fundamentals of the companies themselves. And it's becoming increasingly important because of regulations.

There's been a lot of new regulations in Europe and the US and elsewhere, about where smoking is permitted and which kind of products you can use. But much more important are the things like climate change with net zero carbon commitments by many countries and special subsidies for renewable energy and so forth. Yes, absolutely this is more important than it has ever been and it's not a passing investor fad. It is something that will be increasingly important for the intrinsic value of the companies that we look at.

For us, we have to make sure we're doing a great job, in three respects. The first is to make sure that we are integrating these things properly when we try to figure out what an intrinsic value is for a company. We need to make sure we properly incorporate all of the ESG factors as well as other components, and integrate thoughtfully

everything that might matter from an ESG perspective. And second is to engage proactively—like we have with BAT—to make sure that we are doing what we can to help management improve their ESG footprint.

This is not entirely altruistic. We think that there's an opportunity to help make the world a better place, but also it's a win-win for clients, because companies that are leaders on ESG tend to have higher multiples than most that are laggards. And so we think there's a real opportunity to do our clients a favor as well as investing to make society richer as well.

Third, is to actually think about the companies we wouldn't want to own even at any price. For us, that doesn't mean broad-brush exclusions. We're not going out and saying "thou shalt not own fossil fuels". Because fossil fuels, yes they might be environmentally problematic, but if you cut fossil fuels entirely, well that's socially problematic because people can't afford to heat their homes. We've seen some of that whether in China or Europe these days. These issues are rarely as simple as they first appear, so we don't like these broad brush exclusions, but we do think there's a place to say: "We've had a look at this company and there's a few things we don't necessarily agree

with. We've engaged with them. The engagement hasn't gone anywhere and we don't believe that we can in good conscience participate in this company's profitability". And at that stage, we will walk away. That's really our approach to ESG in a nut shell.

"We think that there's an opportunity to help make the world a better place, but also it's a win-win for clients, because companies that are leaders on ESG tend to have higher multiples than most that are laggards."

We don't believe really in the approach of saying, we must continuously reduce our portfolio emissions. That might sound kind of contentious. After all, why would we not want to reduce our portfolio emissions?

Well, we would. But there's a good way to do it and a less good way to do it. If the companies themselves are reducing their emissions, that's great. But we're not going to sell an oil company and buy a veggie burger company just because that would reduce our portfolio emissions. That wouldn't

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make any difference to the number of veggie burgers sold or carbon emitted: it would just transfer the problem to somebody else.

We think it's much more effective to engage with companies to see if we can be part of the solution we'd like to see. That's why we've come up with this framework to make sure we're integrating thoughtfully, engaging proactively, and rejecting judiciously.

G&D:

It would be great to hear any advice you have for MBA students who are interested in pursuing a career in investing.

BP:

It's been a very rewarding career for me in terms of how it's kept me interested for so long. And full disclosure, I didn't expect that when I joined Orbis 21 years ago that I'd still be here. It's a testament to how much you can enjoy the learning experience and the changing nature of the investment markets and the world economy that they can keep you interested for a long time.

I'm not going to give advice, but I will describe my own situation because I know that for me, it had to be about something more than just being a job. In other words, it had to be about something more than just earning the money. If that had been

my driving motivation, I think inevitably, I would have gotten bored somewhere along the way, because that doesn't really keep you interested for long.

“We think it's much more effective to engage with companies to see if we can be part of the solution we'd like to see. That's why we've come up with this framework to make sure we're integrating thoughtfully, engaging proactively, and rejecting judiciously.”

Unlike many professions in life, investing is a job where one is constantly confronted with one's own mistakes and shortcomings. People that have worked in this business for a long time find themselves becoming increasingly humble, and thoughtful and very conscious of the reality that they can be wrong a lot! And so, it really favors people who can make peace with that. Investing is a career that I would highly recommend to people who can face up to the ups and downs of life, be prepared to put their ego to one side, and enjoy learning curiously and

continuously for their entire career, because you're always learning something new.

One other thing, which is that I think that as investors we serve a surprisingly important function. A lot of people don't have that much investment expertise and yet they have to be responsible for their own retirement. That's scary for people. Second to looking after people's health, looking after their ability to fund themselves in retirement, I think is a really important task.

And so, that's something I like to make sure that my team is reminded of frequently, that what we do is not just a game with charts of share prices that wiggle up and down on a page. What we're doing is important and will change people's lives and that can be kind of daunting, but also very motivating.

G&D:

What do you like to do outside of work?

BP:

Well, I like to do physical exercise, not because I'm good at it, but because it gives me mental peace and frankly it just helps me to stay happy. I do quite a lot of running and I love sport. I could chase a ball all day long if I'm playing football or rugby or something like that. I love that and I love to

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sail. I find that the peace and tranquility of being on a boat and being able to go wherever the wind might take you is an exceptionally rewarding and relaxing combination.

Independence and being in nature is just fantastic so those are my two hobbies. And I have three wonderful children who keep me busy in other ways as well.

Yeah, don't worry about my spare time, I've got many ways to occupy myself.

G&D:

Thanks so much for the time.



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