# Graham & Doddsville

Fall 2024

An investment newsletter from the students of Columbia Business School

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# Welcome to Graham & Doddsville

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

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

Columbia Business School
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The Heilbrunn Center for Graham & Dodd Investing

CSIMA | Columbia Student Investment Management Association

We are pleased to bring you the 50th 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 five investors who have honed their expertise across geographies, asset classes, and market cycles.

We first interviewed **Nadim Rizk**, founder of PineStone Asset Management. We discussed his path to investing and launching PineStone and his process of identifying long ideas. We also went over PineStone's positions in Novo Nordisk (NVO), Taiwan Semiconductor Mfg. Co. (TSMC), and Moody's (MCO).

Next, we interviewed **Kevin Tanner**, founder of Saratoga Research & Investment Management. We discussed his early career influences and how his investment philosophy was shaped by running his own small investing business, which grew into what is Saratoga Research & Investment Management today.

Then, we interviewed **Chris Waller '18**, founder of Plural Investing and author of the Hidden Gems Investing Substack. We discussed his background, his approach to running a concentrated portfolio of 7-8 stocks, and his long positions in Watches of Switzerland (WOSG) and Seaport Entertainment Group (SEG).

Next we interviewed **Elie Mishaan**, founder of Bryant Street Capital Management. We discussed his decision to launch his own fund after 15 years at Corsair Capital Management and his focus on concentration, duration and management engagement. We also discussed his long position in Limbach Holdings (LMB) and Vertiv (VRT).

Finally, we interviewed **David Baron '09**, Co-President of Baron Capital. We discussed his influences, his firm's investment philosophy and his diligence process. We also discussed his long positions in SpaceX, Spotify (SPOT) and On Holding (ONON)

We continue to bring you stock pitches from current CBS students.

In this issue, we feature the winners of the 2024 Pershing Square Challenge, Jared Duda ('25), Joe Ferguson ('25), and Garret Wallis ('25) for their long thesis on Valvoline, Inc. (VVV).

We also feature the second place finishers of the 2024 Darden at Virginia Investing Challenge, Erik Listoe ('26), Daniel Sohn ('26) and Yifan Wang ('26) and their long thesis on BlueBird Corporation (BLBD).

You can find more in-depth interviews on the *Value Investing with Legends* podcast, hosted by Tano Santos and Michael Mauboussin, Head of Consilient Research on Counterpoint Global at Morgan Stanley Investment Management and adjunct faculty member at Columbia Business School. Recent interviewees include Kim Lew, John Armitage, Nicolai Tangen, and John Rodgers.

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

***G&D Editors***

## 34th Annual Graham & Dodd Breakfast - October 10th

Panel featuring Mala Gaonkar (SurgoCap) and Michael Mauboussin (Counterpoint Global, Morgan Stanley)

Tano Santos (CBS), Meredith Trivedi (CBS), Mala Gaonkar (SurgoCap), and Michael Mauboussin (Counterpoint Global, Morgan Stanley)

## 15th Annual "From Graham to Buffett and Beyond" Omaha Dinner - May 3rd 2024

Panel featuring Tano Santos (CBS), Mario Gabelli '67 (GAMCO Investors), Thomas Russo (Gardner Russo & Quinn), Elizabeth Lilly (The Pohlad Companies), Paul Hilal '92 (Mantle Ridge), David Samra '93 (Artisan Partners)

Elizabeth Lilly (The Pohlad Companies), Ave Green, Jennifer Wallace '94 (Summit Street Capital Management)

The Heilbrunn Center
for Graham & Dodd Investing

# SAVE THE DATE

## *The 28th Annual CSIMA Conference*

## Friday, February 7th, 2025

9:00 a.m. to 5:00 p.m. EST
2920 Broadway (at 115th Street)
Alfred Lerner Hall, Columbia University
New York, NY 10027

**Featuring:**

**Liz Campbell**, FS Investments

**Ryan Israel**, Pershing Square Capital Management, L.P., moderated by **Michael Mauboussin**, Counterpoint Global, Morgan Stanley

**Carl Kawaja '91**, Capital Group, moderated by **Michael Mauboussin**, Counterpoint Global, Morgan Stanley

**Jennifer Wallace '94**, Summit Street Capital Management, moderated by **Tano Santos**, Columbia Business School

**Best Ideas Panel**

**Emerging Managers Panel**

Ticket price:
Early Bird Pricing until 12/15/2024 - $500
Regular Conference Fee - $600

***Discounted tickets are available for Columbia Business School alumni and current students***

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

# Pine Stone Asset Management

**Nadim Rizk**

**Nadim Rizk founded PineStone Asset Management in 2021 to realize his career-long dream of having an employee-owned, laser-focused, and client-centric investment boutique. Nadim was born and raised in Beirut, Lebanon.**

**Nadim earned his Bachelor of Commerce in Finance from the American University of Beirut. He moved to Canada to pursue his Master of Business Administration at McGill University and has earned the right to use the Chartered Financial Analyst designation. Nadim serves on the board of the Cedars Cancer Foundation, The McGill University Hospital Center Investment Committee, and is an active participant as a global expert for the Honors in Investment Management program at McGill University. He lives in Montreal with his wife and their three children.**

***Editor's Note: This interview took place on November 15th, 2024.***

**Graham & Doddsville (G&D):**

Hi, Nadim. Thank you so much for taking the time to sit down and talk to us today. To kick things off, could you walk us through your background and how you first got into the investment world?

**Nadim Rizk (NR):** I was born and raised in Lebanon. I lived in Lebanon for 20 years, and for all 20 of them, the country was in a civil war. It made for an interesting childhood, but I say that it got me prepared for equity markets as whatever happens in markets doesn't scare me anymore.

I too applied for an MBA. I only had one year of experience, but back then (almost 30 years ago), most incoming students didn't have as much work experience as they do today. I was still one of the youngest students. Coming from Lebanon, it was like doing a master's for me. The concept of working for several years before going back to business school was not as common. In Europe, master's in finance were more common, but doing an MBA was a way for me to move to Canada.

I was already a stock rat at that time. I discovered investing when I was about 15 years old and fell in love with it. I knew exactly what I wanted to do, which is lucky because most kids have no idea. I was not a good student at all until 12th grade. I was close to the bottom of my class and gave my parents a tough time. In French, we call that un cancre (a dunce). But I really had a strong interest in investing. I started reading about investments, including the Peter Lynch book when I was 16.

When applying to MBA programs, I was admitted to Wharton, which was my number one choice, but my parents could not afford it because tuition was expensive. Luckily, I had also applied to one of the best schools in Canada, McGill, which was much less expensive so I ended up attending McGill.

I still had to work part-time to pay for my tuition. I was admitted to McGill and Wharton because I had crushed the GMAT and had a pretty good GPA in college. I went from the bottom of my class in school to graduating with high honors when I went to university because I was studying finance and it was something that I liked.

At school, I was already a stock rat — I was part of the investment club and I did a program at McGill called Applied Investments, which is now called HIM (Honors in Investment Management). I sit on the board of HIM now, but HIM is a group of students that manage actual money that was donated from alums and other companies. It's an interesting investment experience, and we hire from that program because we get to know the students involved in it.

I graduated top of my class at McGill, and like everybody that graduates with a top GPA, you get a job in investment banking. I personally had no interest in working in investment banking as I

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## Pine Stone Asset Management

had done an internship and I didn't like it. I had read a book called Monkey Business, which if you work in investment banking, you should read as it is quite funny. I actually wanted to work on the buy side, but the buy side wasn't as organized as it may be today. The IB programs hired students to be analysts and associates in an organized program. In comparison, the buyside was a disorganized industry, with the exception of Fidelity and a few other large firms. Most firms were like us, PineStone, with 40-80 employees and hiring on an ad hoc basis. However, I met a McGill alumnus, who ran a private pension fund. He presented to our investment club, and I was inspired by what he spoke about, including his Buffett-like investing philosophy, being highly concentrated and extremely long-term. That's why I applied to CN Rail Pension and I was persistent enough that eventually they had no choice but to hire me.

My first job there paid me a little less than half of what the investment banking job paid, so my first lesson is don't go for the job just because it pays you the most money. Go for the job that you really are very passionate about. It was tough because, like I told you, I was completely bankrupt and had borrowed money to finish my studies despite working part time. While it was a tough decision, I'm still happy I made it. I was lucky because I knew I wanted to do investing. If I didn't know all that, I would have taken the job that pays more.

I have only worked in long-only research my entire career. I never had any interest in long/short or trading. I don't have anything bad to say about it - it's a question of what sort of makes you tick. Do you like more action? Do you like less action? When we hire people here, they tend to spend most of their time reading SEC filings behind their computers and there's not much activity.

> ***"That's my second lesson in life: don't only go for a brand name, work for someone who is actually good and who likes you. That person has a much bigger impact on your career than any brand of any firm."***

So if you watched Gordon Gekko or other Wall Street movies, and you expect that out of PineStone, you'd be very disappointed. There's none of that. However, the buy side is a vast industry that is very different from place to place. My interest was in long-term investing and when I moved to the buy side, I went to a place where what I was interested in really fit with what they were doing. That's my second lesson in life: don't only go for a brand name, work for someone who is actually good and who likes you. That person has a much bigger impact on your future and your career, than the brand of any firm.

**G&D:** You mentioned you're a fan of Warren Buffett and Peter Lynch, did you have any mentors or other investors that impacted your investment philosophy?

**NR:** Yes, I had a great mentor — my father. My father is the one who got me into investing and I'm still very close to him to this day, but he was not very good at investing. I had invested with him when I was young, and we were looking for little penny stocks where we could buy a lot of shares. He wanted to buy 10,000 shares of something worth $0.50, and if the stock goes to $100, we're going to make a million dollars. This did not work, so when I began investing, I decided that I wanted to do the complete opposite. So in a way, he was my mentor because he pushed me to decide, this is not working, which is how I discovered Buffett and started reading investment books.

When I started reading investment books, I realized that what attracted me was investing in high-quality compounders and being

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## Pine Stone Asset Management

extremely patient. That was my nature. Remember, this is in the late 80s, early 90s, so there was no Google, and the access to information was very limited. I didn't even have any idea that you could make so much money making investments — I just did it because I thought it was fascinating.

The reason I mentioned Peter Lynch's book is that I find it's the easiest book to read when starting your investing journey. I read The Intelligent Investor first when I was a teenager and it made no sense to me, but One Up on Wall Street is a book that even if you just finished high school you can understand. I read it again when I finished my undergrad and it made more sense, and then read it a further time when I finished my MBA. During my MBA, since I had taken part in the investment club and had attended all these applied investment classes, it started to make much more sense to me.

The person at CN Pension who I worked for was also a mentor. While I didn't report to him directly, he ran things in a very tight investment style. After those experiences, I built my process myself piece by piece. Finally, Buffett was a mentor indirectly as I was absorbing his work, so I highly recommend making the trek to Omaha.

**G&D:** You spent over a decade at Fiera before deciding to launch your own fund, PineStone, in 2021. Can you give us a brief overview of PineStone and what inspired you to start your own fund?

**NR:** I was lucky that I became a PM when I was only 28 years old, which is very young. I had an idea of what I wanted to do. I had a vision but I was very nervous. I was taking over funds that didn't look anything like what we do today as they had been run by different PMs before. The first thing I did, is I put a playbook in place. We didn't know it back then, but this was the beginning of setting up PineStone because the first thing you have to do to have a successful investment firm is to establish the framework under which you want to operate. If you want to have a specialty firm like PineStone, step one is to establish the investment framework. How do you operate? How do you manage money? How do you hire analysts? How do you train them? How do you grow them? How do you teach them? This takes multiple years to establish.

After establishing a framework, my first hire was Andrew, who is my Head of Research today. We have worked together for over 20 years now. We started hiring people from business school, from engineering school, and teaching them our process. We were at Fiera for almost 15 years. We built the business from zero, and when we left, we had approximately $50 billion in assets, which is quite something.

PineStone is based in Montreal. It would have been easier to be based in New York City, but we're in Montreal because several members of the team went to McGill and we kind of started the business here. We created PSAM, PineStone Asset Management in 2021. As Fiera had grown and become a larger, more diversified business, we wanted to go back to our roots and focus on building an investment partnership.

*"I didn't even have any idea that you could make so much money making investments — I just did it because I thought it was fascinating."*

At PSAM, we are focused on growing client capital. We're here to execute a very simple strategy, which is quite traditional. Everything we do here is very old fashioned. Most young people I speak to want to join a hedge fund or even private equity. Nobody wants to be in a long-only, boring shop where we transact once a year, which is what we have been doing, successfully, for many years. Most of the

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## Pine Stone Asset Management

AUM that we have, we compounded. We didn't raise it. Out of the $55 - 60 billion in AUM that we have, we only raised about $15B or so, and the rest we compounded into $55-60 billion. We are focused on continuing this success in the future.

When we decided to spin off, we were quite big for Fiera. We signed an agreement to still sub-advise their funds to minimize the impact on the organization and we left on good terms. The entire team left with me and we started PSAM in 2021 with 12 employees. We're now around 45.

**G&D:** That is very impressive. In discussing your strategy, you emphasize quality compounders and holding these names for decades. Can you talk a little bit about the strategy and what you define as a quality compounder?

**NR:** Yes — the way we invest is we think of it as owning a business, not a stock. We just happen to own a piece of it. Everything we do in the investment process has this same mentality that involves not only financial analysis, but also governance work. For example, next month I'm going to meet a company in the U.S., and we're spending an entire day meeting with the board. Again, this is a private ownership mentality — we just happen to own 5% of the business instead of owning 100% of it. This mentality is very rare in the public markets. Public markets tend to be much more geared toward trading due to liquidity being available and people wanting to take advantage of that liquidity. We don't really take advantage of liquidity because we approach owning companies like private ownership.

*"This is a private ownership mentality — we just happen to own 5% of the business instead of owning 100% of it."*

We run three products, which are all iterations of the same global equities product. We have a U.S. -only product, an international-only product and a global product (which combines both). Global has always been our largest product and our flagship but there's a lot of overlap in the names across strategies.

The way we think an asset or business generates value long-term is by generating a return on capital that is above the cost of capital. The bigger the gap between your return on capital and your cost of capital, the more value you're creating. If you can grow at that high return on capital, you're going to generate a lot of value, so the businesses we're looking for are companies that have the ability to grow organically. They don't have to be growing at crazy NVIDIA-like rates, but they're growing and they have a high and consistent return on capital. While that may not sound so exciting, if you can generate a 20-35% return on capital year in, year out, and you could grow at 5% a year, you may make 10-20 times your money over the long run although performance like this is not guaranteed. Again, because public markets tend to be very active and short-term oriented, nobody has the patience to invest that way. Everybody's wired to look at estimates, consensus, beating and missing, and they are constantly transacting or switching names instead of pursuing our kind of strategy.

**G&D:** Can you talk about how you generate your investment ideas and where you typically source them?

**NR:** We have screening tools that we developed ourselves years ago, so that we have a way to quantitatively kind of screen the market. We also source through our network. We talk to companies we invest in and travel extensively. In talking to companies that we own, we might ask them who they compete against, who they respect or who they would like to emulate? It could be a client, competitor, supplier or another player in the industry — we get a lot of names in this way. Honestly, the sourcing of ideas is the easiest part

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of the job. We often have more interesting ideas than companies that we can cover or research. The difficulty is picking which ones you want to work on because there's about 8,000 listed securities in the markets that we look at and we own 30-50 names. We only own a tiny piece of the market.

We have, in all modesty, an incredible U.S. and global track record over 5, 10, 15, 20 years. It's very hard to outperform the S&P, but we did it without ever owning Apple, Amazon, Facebook, Tesla, Netflix or NVIDIA. We've missed most of the super exciting, sexy stocks and we still outperformed the S&P 500 over 20 years, which is almost impossible. You don't have to invest in the best performing stocks. As long as you have some very good ones, you can still do very well because the market is so large.

**G&D:** Can you talk about how you go about your research process and how names that you're considering ultimately end up in the portfolios?

**NR:** We have a very specific process. Andrew, my head of research, oversees quality control. Andrew is in charge of operations or production, and I'm in charge of overall capital deployment.

We have a standard research template we look to populate with every research process we conduct. Researching a company for us takes at least four weeks (and usually four to eight weeks) because we do very extensive work. Since we're not transacting frequently and are planning to hold that company for long periods, we need to ensure that we understand exactly what we're buying. We start with reading SEC filings and focus on talking to the company, their clients, suppliers, and competitors.

*"You don't have to invest in the best performing stocks. As long as you have some very good ones, you can still do very well because the market is so large."*

We always seek to conduct thorough and creative research. For example, when researching a company that provided accounting and tax systems, our analysts actually trial the software. This is the level of extensive research we do to get a free license and test the product. Other aspects of our research process we focus on are the structure, culture, ethics, governance, and board composition. How is the board being compensated, why do they compensate them that way, how qualified are they?

Once that work is complete, we send it to another analyst who is assigned to be the bad cop or devil's advocate. The devil's advocate is responsible for pressure testing the research and arguing the opposite side through another report. That research process is typically not as intense. They won't necessarily spend eight weeks, but they might spend a couple weeks researching points to argue against. The idea here is that we want to see and understand the complete picture. We don't want to just pitch something we all like.

Once the counter-argument work is complete, it's sent to the entire investment team of 12 people and everybody reviews it. We have a weekly investment team meeting where people pitch their ideas. We'll allot an hour to discuss the story and the research report that contains all of the sections that we like to see. We will score these businesses using a proprietary methodology. Next, the devil's advocate will present for another 20-30 minutes, pressure testing the story. After that, the entire team will spend anywhere between 2-3 hours discussing the idea or any other companies that we own that are similar or possibly compete with the business we are pitching. After our discussion, I will make a decision. This structure works well for us, and we have been using it

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for over 20 years. I could have easily decided to sit in my office, have the analysts pitch to me, and decide on my own, but I don't like that methodology. I believe in the entire team discussing and pushing each other. This process also helps me increase my conviction.

To that end, at PSAM we only have one compensation metric. We are looking at the team's collective success, so everyone will receive the same score at year-end. The figures differ, but your percentage achievement is the same. If we met 50% of our target this year, everybody receives 50% of whatever their target was. We do this to align everyone's focus on collective performance.

To give you a sense, every year we evaluate roughly 20 companies globally. For one, we're very concentrated, but also this process takes a lot of time to complete. While this process is labor intensive, we are focused on quality not quantity of ideas pitched. Even out of the 20 to 25 companies pitched a year, we're not going to buy most of them because only 1 to 3 meet our quality threshold to merit a change to the portfolio. A typical fund for us holds 20 to 30 positions, which is quite concentrated, and we typically hold positions anywhere from 10 to 20 years. While we have a few companies that we've held for 25 years, the average hold is approximately 15 years. If you flip that statistic, it means we're changing 5 to 10% of the names a year. 5 to 10% of 20 to 30 positions is 1 to 3 new positions a year and some years we buy nothing.

Finally, because our process is so thorough and unique to us, we like to hire people out of school. We have an internship program with 2 to 4 interns every summer who sit with us and perform actual research. Our goal with this internship program is to hire full-time candidates, so we focus on giving them meaningful research opportunities and teaching them our process.

**G&D:** Is there a wish list for the 20 companies a year you look at that do make it into the portfolio?

**NR:** Of the 20 that we pitch, there's usually one to three names that we put in a wish list. We put them on the wish list because we like them a lot, but we either can't buy them today because we don't have the space or as we were finishing the work, something happened with the company. That could be a change in executive leadership, the price is too expensive, or something else that made us hesitate.

We usually have about 15 to 20 names on the wish list, and we cover them as closely as the companies we own, which is why we keep the list short as it's quite demanding to cover. We don't want to have a wish list of 500 stocks. When we're pitching an idea, we look at what is in the wish list and whether it is worth it to evaluate this new company versus something from the wish list.

*"Even out of the 20 to 25 companies pitched a year, we're not going to buy most of them because only 1 to 3 meet our quality threshold to merit a change to the portfolio."*

This process is why our hiring and compensation structure is crucial. In our pitch meetings, every team member is also considering other companies on the wish list while collectively evaluating the company being discussed. Our objective, even though we're pitching XYZ company today, is to debate and decide on the best idea we can invest in today. This only happens when everybody is engaged and taking part in the conversation, which is why we compensate only on one metric — our collective performance. If we don't do well, nobody gets paid, so you must be engaged in the meetings. Once you walk out of the meeting, you are committed to whatever decision we

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take. You can't come back three months later and say, “well, I told you we should not have invested in that.” It only takes one person to be so vocal that they can change the opinion of the 12 members of the team, which is why the discussion format is so important for us.

**G&D:** You mentioned that you hold companies anywhere from 10 to 20 years, but once you've had a successful investment, what is your trigger to consider selling?

**NR:** We only sell a position for two reasons. The first reason is the investment thesis on it is no longer valid. This can mean we made a mistake, which happens more often than you can imagine in our business, and we're always mentally prepared for that possibility. It can also mean we didn't make a mistake, but over time, the business changed, the competition changed or some other aspect of the landscape changed. A company might have been an amazing business 20 years ago, but that does not mean it still is today. If that happens, the thesis is no longer valid and we would sell, and sell quickly.

Parenthetically, it might be helpful to discuss our buying process. Once we decide after the equity meeting to buy something, we always buy a small position. This is an important lesson in investing: it is important to “date” a company before getting “married” to it. Get to know the business over time because occasionally, at different stages, you may realize that this is not the business you thought you had invested in. You can research a company for six months, but until you own it for a while, you don't actually know the business that well. It takes time for human beings to really understand all the facets of a business. Even after we do the work and decide to buy a company, we'll buy a small position and own it for a while. By a while, I mean one to four years. As we own it, we really see how the business operates and we can consider ourselves as experts with the conviction to hold a much larger position.

> *“If you hold an asset for 10 to 20 years, 99% of the value you’re going to create is from the capital compounding of that asset.”*

On the flip side, going back to why we sell, if we decide that there's something broken in the story, we will sell very quickly. We could sell within a week and be out of the position, even if we've owned it for 5 to 10 years. We could also sell slowly, which typically would be due to the business slowly deteriorating. Sometimes there's something concerning but not concerning enough to exit immediately. This is a combination of science, judgment and art.

The second reason we sell is that we found a more attractive use of capital. If we discover another business we like better, we will exit the investment even if the thesis isn’t broken. We like to remain concentrated so if we have more conviction in the new opportunity, we will switch one for the other.

We will not trade for any other reason other than these two. Keep in mind, because of the holding period, many other factors tend not to impact us, whether it's the economy, interest rates, etc. If we were holding investments for 12 months, it would be very different because a lot of these macro factors would play into our decisions. If you hold an asset for 10 to 20 years, 99% of the value you're going to create is from the capital compounding of that asset.

**G&D:** In your investment letters, you discuss the importance of strong management teams when evaluating a company. How do you assess management's ability to drive sustainable growth over such a long period of time and what do you look for in a management team?

**NR:** It is a combination of art and science. We have a guidebook of

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## Pine Stone Asset Management

what, from our experience managing money for now almost 30 years, makes for a quality group of executives and what to watch out for. We also have a list of red flags that we note when something is amiss but part of this is a bit of an art and gut feeling.

Evaluating management is why we do a lot of face-to-face interactions with our companies. We enjoy traveling to their offices. You understand a lot about a business by walking through their offices and getting a sense of how they operate, how they compensate, what they spend money on, and how much passion they have. I always talk about why proxy voting is so important, not only from a governance perspective but also because it gives you a sense of a company's culture.
I tell investors, if you want to understand the culture of an organization, don't read the glossy annual report. It's better to read the proxy statement, because in that proxy, you will understand who's on the board, how engaged they are, how they are compensated and what compensation is based on. If you want to predict how a person will behave, understand their compensation structure. If they're compensated on size, they're going to make acquisitions because they will make more money. If I compensate you on net return on capital, you're going to optimize capital. You're not going to necessarily make big acquisitions for your own ego. In summary, evaluating management revolves around getting to know them and trusting their ability to care about both the outside shareholders and the company itself.

*"Special businesses can be similar. I have realized over time that you're usually much better off continuing to hold them, which is why we have become even more long-term oriented as I have gotten older."*

**G&D:** Since launching PineStone, have there been any noteworthy lessons that you've learned or any topics where you've changed your mind?

**NR:** There have been many lessons and mistakes. We try to learn from our mistakes and are conscious about tracking everything. We have data going back to inception, not only on research, but on decision making. This data includes notes from all of our meetings where we discuss companies since inception. This is important in reviewing every decision and every meeting, so we can understand the reasoning behind every transaction we have done. We detail the reasoning next to every decision describing why we sold or why we bought. Was the thesis broken? Did we trim on valuation? The difficulty is many of our mistakes are different, so it's hard to pattern recognize and systematically eliminate a certain type of mistake.

The biggest lesson was one I learned from when I first became a PM. This was back in 2003 - I was really young back then. In my opinion, human beings tend to trim successful investments too quickly because we inherently believe in reversion to the mean and we tend to be emotional and valuation sensitive. When we started, we had price targets where once a company reached a certain price, we would trim. However, the reality is most special companies, which is what we are searching for, have this incredible ability to consistently create value. While, in a snapshot at a point in time, they may look fully priced, looking back they were actually attractively valued considering their continued performance. It is difficult to see this value. For example, if you bought the Lakers franchise 20 years ago, you might have paid a crazy price but it's worth 15x that today. Special businesses can be similar. I have realized over time you're usually much better off continuing to hold them, which is why we have become even more long-term oriented as I have

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## Pine Stone Asset Management

gotten older. We were always long-term focused, but we have gone from turning over 10 to 20% of the portfolio a year to 5 to 10% as we've noticed that some of these special companies need to be held for longer and longer.

**G&D:** That's a good transition to discussing a few positions in the portfolio. Could you discuss how you approach position sizing? Could you please highlight the thesis points that attracted you to Novo Nordisk?

**NR:** We always start with a small position, usually about 1%. As the story pans out and we have more conviction, we'll increase it. Some companies are capped because of risk or business sustainability but others have a higher max cap. Typically a position will be anywhere between 1% to 10%. In the past we tried to have larger positions but we usually try to stay in that 1% to 10% range, with median sizing around 4% (25 positions on average). We are not looking for mega positions in the 15-20% range and we don't want to have a lot of tiny positions that don't add anything. The largest positions are usually companies we bought 5 or more years ago.

Regarding Novo Nordisk, the Acquired podcast has a good episode discussing it. We purchased Novo Nordisk in 2009. When we first invested, it was predominantly an insulin company. To describe the diabetic cycle, the first stage is pre-diabetes. The number one solution is healthy eating and exercise, which most people fail. The second stage of defense are drugs from the metformin family. These metformin pills usually work up to a point, after which they're not effective. At that point, you must take insulin and once you take insulin, you must take it for the rest of your life. Once you start taking insulin, at some point you will have to be on dialysis.

> ***"Eventually, Novo completely disrupted the industry by creating this class of drugs called GLP-1s, which in a way hurt its own insulin business but created a much larger market opportunity."***

This has historically been the pattern and Novo was one of the biggest companies that made insulin. Now insulin was not a protected drug under any patent, as the patents had already expired, but insulin is a difficult and costly drug to make at a consistent high quality. While anybody can make insulin, very few people can make it profitably and at a very consistent level of quality. Novo is one of the few companies that can, and once you begin using insulin, patients almost never switch providers unless there is a drastic change in price. As insulin has such an impact on your health and lifestyle, customers rarely change providers. While it is unfortunate for patients, this creates an amazing and sticky business — the foundation of our thesis. Of course, we also approve of how the management team is running the business. Management is incredibly qualified and has spent heavily on R&D, which is crucial for a pharma company. Novo rarely makes any acquisitions, which is rare in U.S. pharma.

Eventually, Novo completely disrupted the industry by creating this class of drugs called GLP-1s, which in a way hurt its own insulin business but created a much larger market opportunity. GLP-1s work such that once metformin is no longer effective, patients will use GLP-1s. GLP-1s were initially branded under the name of Victoza in the U.S. but today are branded Ozempic and Wegovy. GLP-1s are much more effective than the metformin drugs and are better than taking insulin. They effectively push your need for insulin and hence push your need for dialysis. That is a massive social benefit to humanity, because if you can postpone your need for dialysis, you've massively increased your quality of life and life

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expectancy.

Novo began noticing that patients on GLP-1s were losing weight because GLP-1s suppress appetites. This is how the Ozempic and Wegovy weight loss business was created, which has since completely taken off.

The weight loss market is much larger than even the diabetic market because while there's a lot of people that are either diabetic or pre-diabetic, almost everybody in the Western world is obese or overweight. Our lifestyles today revolve around sitting in an office with almost unlimited access to food, which is not compatible with the way humans were biologically designed. Human beings were designed to eat as much as possible when they did find food and to store the excess as fat. That is why it's so hard to lose weight — your body is acting against you. In today's world, that's a very bad model because we have access to unlimited food, and the less income you have, the worse the food you consume, resulting in even higher calorie consumption. In addition to that, most people are not very active. This is why we think the GLP -1 drugs will be massively beneficial to society.

While GLP-1s have some side effects — and we will discover that they have more side effects as there's no drug free of side effects — the potential benefit is enormous. GLP-1s have significantly increased the value of Novo. When we bought the company, it was a good business but it has become an incredible business over time.

**G&D:** You've owned the business since 2009 and while the company has done very well, it's now nearing the midpoint of your traditional holding period. It's also not the only player in GLP-1. Could you tell us about the future opportunity for the business, how you think about barriers to entry, and why they should capture more value in that market than others?

**NR:** Novo operates in a relatively fast-changing industry, so we can't say for certain that we'll own it 10 or 20 years from today. I think we will but nobody knows because unlike a Moody's, Novo operates in a faster rate of change industry. Their closest competitor is a company called Eli Lilly, who has also been very successful in the GLP-1 category. Eli Lilly was previously behind but they have largely caught up to Novo. However, the market is very large so I think they can both win. Eli Lilly has had a messier track record. Eli completed a few acquisitions and the financial returns were mediocre at best. Novo, on the other hand, has consistently generated strong financial results over the past 20 years organically, which is our preference.

I think there's going to be more and more competition. The market is large so it will certainly attract competition — that's capitalism 101. Companies see the opportunity and jump in. Amgen and some others are already attempting to compete.

*"Eli completed a few acquisitions and the financial returns were mediocre at best. Novo, on the other hand, has consistently generated strong financial results over the past 20 years organically, which is our preference."*

As far as Dominic, our Healthcare specialist, can tell, the only company that we view as a competitive threat is Eli Lilly. It takes a while for companies to develop competing solutions. Perhaps in 5 years, the landscape might be different but we think Novo is going to constantly innovate and move the goalposts. Ozempic is the weight loss drug 1.0 and Wegovy is version 2.0. These drugs are injectable. Novo has been working on an oral drug, which would be very interesting, but it is quite complicated. We see Novo continuing to improve the drugs through their track record of very strong

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R&D.

Regardless, we will continue tracking and monitoring Novo's performance like every business in our portfolio and if we feel that the business has changed or the competitive environment has deteriorated, we will sell. In fact, we have taken significant profits over the last couple of years. Beginning in 2023 and during 2024, we have trimmed it multiple times on strong performance simply because we had such a large holding. We also felt there was perhaps excess excitement over the drugs with everyone talking about Ozempic. It has become a household name, which is funny because Ozempic wasn't a drug that was made for weight loss. It has weight loss benefits but the real weight loss drug is actually Wegovy.

We still like the company and the stock has corrected recently as some of the excitement has worn off. Did it make sense that the company was trading for 1,000 Danish krone? I don't know. There might have been a little excess excitement but I think their business is very strong and global demand will continue to be a large tailwind.

**G&D:** How do you think about keeping absolute name turnover in the portfolio low while sizing up and down positions as opportunities present themselves in other names? Do you view successful positions more as a source of cash?

**NR:** We do size positions up or down based on our view of the attractiveness of the opportunity. We don't do that for every position and we don't do it daily or even weekly. For example, we trimmed Novo approximately 10 times since last year. We have taken some profits off the table without selling the position down materially because we still like the business. In hindsight, it paid off to take profits slowly because the business has continued to perform well and the stock has continued to rise. In most cases though, we only do this when there's something interesting for us to buy.

We do have around 25-30 positions, so sometimes there are other opportunities that are incrementally more attractive and in need of capital. I don't remember a single time where we trimmed something and there was not something else that looked attractive to us. However, in the worst case, if there's nothing else that's attractive, we could keep the money in cash. We don't usually hold cash, but if we trimmed 1-3% of Novo and there was no other interesting company to buy, we could just keep it in cash.

Currently many of the consumer staples companies are behind. Nestle is down and Pepsi is down, but nobody wants to buy them because everybody's chasing NVIDIA. Therefore, by taking profits on Novo we can easily park them in any of these consumer staples companies that pay high dividends or in a financial company that has been left behind. There's always a segment of the market that has been left behind.

*"In hindsight, it paid off to take profits slowly because the business has continued to perform well and the stock has continued to rise. In most cases though, we only do this when there's something interesting for us to buy."*

**G&D:** Can you touch on TSMC — what attracted you to the company and what is the thesis there?

**NR:** Taiwan Semiconductor is similar to Novo Nordisk in that when we bought the company, it was a really good business, and over time, it has become an incredible company. We first purchased TSMC in 2006. TSMC is essentially a fab company. Historically, semi companies like Intel did everything: they did design, engineering, manufacturing, etc. However, as semi

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businesses have become more complicated and more expensive, companies have had to specialize.

Several companies decided to specialize in design and would outsource the manufacturing of their chips to fab companies, mostly in Asia, which is how TSMC started. Over time, TSMC has become more of a dominant company because it's so well run. Today, if you look at TSMC, it's by far the best fab company in the world. TSMC manufactures every single leading-edge semi chip in the world. If you look at 5nm and below, it manufactures them for all the largest companies including NVIDIA, Microsoft, Amazon, Google, and others. This makes TSMC a company that is very hard to replace. As I mentioned, over time TSMC has become an incredible business and as far as we can see, no one can compete with the company. Perhaps 10 or 20 years in the future there will be other competitors but as of today, they're in a league of their own.

**G&D:** Can you touch on Moody's — what attracted you to the company and what is the thesis there?

**NR:** We invested in Moody's in 2001 and I personally did the research on it. Moody's is the holy grail of the types of businesses we like to own. Its industry is effectively a duopoly between them and S&P. There's another company, Fitch, that also competes against them, but it's much smaller. The industry structure is similar to that of Visa, Amex, and MasterCard, where Visa and Mastercard dominate, and Amex is much smaller. Moody's and S&P are similar sizes and effectively control the market.

*"The ROI for the client is massive — they receive 20 to 50 basis points of savings on the coupon by being rated for the cost of three or four basis points at Moody's. This creates a very sticky business."*

This is a typical network business where the two winners take all. Similar to Facebook and Instagram with social media, the bigger you are, the easier it is to continue growing. This is what I call a benchmark business — as a company grows larger, the better its chances of continuing to grow. This happens because every client win pushes the next client to be your client. For example, in the ratings industry, most companies need two ratings to be admitted into any index or to sell bonds. Once a customer has been rated by S&P and Moody's, they have no interest being rated by a third agency - there's no additional benefit to the company.

Ratings typically cost between three to four basis points for bonds. In turn, rated bonds usually issue at anywhere between 20 to 50 basis points lower coupon versus unrated bonds. This dynamic creates a strong incentive for customers to be rated as they can save on their cost of issuance. The ROI for the client is massive — they receive 20 to 50 basis points of savings on the coupon by being rated for the cost of three or four basis points at Moody's. This creates a very sticky business. From Moody's point of view, these are very small fees, but they translate to a 50% margin. Businesses that create a very high ROI for the client at a low cost to the client are always attractive to own.

That's the Moody's business, which is the holy grail of business models and why we've owned it almost since its IPO. Moody's has been one of the largest holdings in our funds since inception. It is not the most exciting company, it doesn't grow very quickly, and it's not super sexy. In years like this year where technology stocks are very strong, it doesn't look like much, but it's an incredible compounder of capital.

**G&D:** How do you think about the exposure to the cyclicality of debt issuance while taking a long-term view on the company?

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**NR:** You are right that it is a cyclical business. While it is not cyclical every year, if there's one flaw in the business, if you look at 2008, it had a very bad time. Issuance declined with the banking crisis and Moody's was sued by some entities. This is the period where we bought a significant holding because the stock was heavily shorted. There was a vocal short seller at the time and we kept buying it all the way down to the bottom, eventually building a very large position.

In 2022, when rates moved up significantly, issuance also slowed down. As a shareholder, you go through these phases where issuance slows down whether it's due to the economy slowing down, a banking crisis, or some other reason. However, the world is addicted to borrowing, so these downturns tend not to be lasting.

**G&D:** Thanks for sharing. What are some of the things you do on a regular basis to improve as an investor?

**NR:** Use your common sense. Being successful in investing is 70% temperament, 25% grit, and 5% brains. You don't need to be especially smart. Never think of yourself as highly smart because it actually acts against you. A lot of it is really temperament. You obviously have to have the ability to digest a lot of information, distill it and make a decision. You can be an amazing analyst but it doesn't mean you're going to be an amazing PM. Being an amazing analyst is a necessary but not sufficient condition because if you're a bad analyst, you're not going to be a good PM. Doing amazing research is different from deploying capital. To deploy capital, you not only need to be very good at research but you need to have this ability to synthesize a lot of information and make decisions, which a lot of people struggle with. It sounds easy, but it's not so obvious and a lot of it is temperament. You have to be calm. In French, we say posé. It's very hard not to do something because you're hardwired to react.

*"Being successful in investing is 70% temperament, 25% grit, and 5% brains. You don't need to be especially smart. Never think of yourself as highly smart because it actually acts against you."*

So, again, going back to you being in the forest 10,000 years ago, the way you survived from being attacked by a tiger is by reacting quickly, having your adrenaline kick in, forcing you to do something, whether its climbing a tree, running, or defending yourself. That's a very bad model for investing because you get bombarded by information and you have a tendency to want to react. In my opinion, these reactions usually lead to bad decisions. A lot of investing is behavioral. It's about having the ability to distill information and to think about it logically, not emotionally.

**G&D:** What advice would you give to current MBA students looking to break into the investment management industry and when you are hiring your analysts, what qualities do you look for?

**NR:** First, decide if you like being on the buyside. We're notorious for only hiring stock rats and we are notorious for not paying well because we are screening for passion. We do that on purpose because we want to weed out the applicants that are more interested in making fast money or are leveraging us for banking or private equity. You want to be passionate about investing. You want to look for someone that you think you can learn from and that you can connect with versus a brand name place. It's better to look for an investor you admire — as in, I know what Bill Ackman does, I love being an activist and I want to learn from him versus I want to work for Goldman Sachs. Finding an investor that can teach you has a lot more value and forget

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about the money. If you're passionate about something and you do a good job, money will come.

**G&D:** We always like to end on a fun note, so the last question we have for you is what do you like to do for fun outside of investing? Do you have any fun or unique hobbies? A favorite Lebanese dish?

**NR:** I cook a little bit, but not much. I played a lot of basketball as a kid. I played in high school and I played a year and a half in college. I realized that, as much as I thought I was an amazing high school basketball player and my parents were very proud, I was not good enough. My parents still have my jerseys and were very proud of me, but I was a benchwarmer in college. While I hardly played any games when I was in university, it was still an amazing experience.

I'm also lucky that I learned how to ski growing up in Lebanon. People are always shocked when I tell them I learned to ski in Lebanon. We're a family of skiers — my three kids have been skiing since they were three years old. My son is on the junior ski racing team. He's only 10 years old, but nobody can ski with him anymore, he is too good. While our kids and dog keep us busy, we love traveling as a family.

# Saratoga Research & Investment Management

**Kevin Tanner**

**Kevin Tanner founded Saratoga Research & Investment Management ("Saratoga" or "SaratogaRIM") in 1995, establishing the firm's foundational investment philosophy at that time. Since then, he has developed and implemented the firm's research and investment process, while simultaneously recruiting and developing the team of 23 members at the firm today.**

**SaratogaRIM specializes in the construction and management of equity portfolios composed of high-caliber businesses utilizing common sense investment principles.**

**The firm manages approximately $2.8 billion in separately managed accounts for high-net-worth individuals, retirement accounts, trusts, endowments and foundations across the United States. The firm also oversees investment models on model delivery platforms across the United States and Canada with roughly $2.9 billion in assets under advisement.**

***Editor's Note: This interview took place on October 31st, 2024.***

**Graham & Doddsville (G&D):** Kevin, thank you for joining us today. To start off, we would love to learn more about your background. How did you first become interested in investing, and why did you start SaratogaRIM?

**Kevin Tanner (KT):** I grew up in Saratoga, California. I went to Santa Clara University, majored in economics and minored in business. I also played football there. After my senior year of football ended in November, I decided to start interviewing with some financial firms that I was familiar with. I interviewed with a lot of the big sell-side firms like Merrill Lynch, Dean Whitter, Paine Webber and some smaller shops like Kidder Peabody. And basically, they were all looking for a level of experience, or a different type of experience than I had.

Back then the interview process was very different. The first question was always: Last position held. And the second question was basically to describe your responsibilities in that last position. I thought I had some good work experience. I had worked at McDonnell Douglas in their internal audit group, but that was not the type of experience that those firms were looking for at all. So the interviews didn't go very far. And at a certain point I walked into another firm, E.F. Hutton, and I answered that first question differently. Where it said, "Last Position Held:" I put Nose Guard, which was my position on Santa Clara's football team.

For responsibilities, I put: Personally responsible for keeping the center off the linebacker, protecting the cutback lane, and generally disrupting the backfield. The interviewer started reading and just laughed when he read my first answer. Most importantly though, he put the papers down. So instead of just being a college kid who didn't have the type of experience that they were looking for, it was just me and him talking. I think that's super important. If you're a young person looking for a job and you're talking to somebody who could potentially hire you, it's critical not to just be your resume. That personal connection is what opened the door for me. When we were done speaking, he told me he'd hire me if he could but that he'd get fired if he did. But then he told me that he had a buddy over at Prudential-Bache who might take me on as an intern and that he'd be happy to introduce me, which he did.

I had a great interview with the Pru-Bache manager, and I got the internship. I was going into the last term of my senior year. I had already completed all my graduation requirements and only needed 8 units to graduate, all of which were electives. I ended up getting 4 units for the internship and taking acting for non-majors for the last 4, which was

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really fun. I also ended up working about eight hours a day, without pay, on my internship at Pru-Bache. During that time, I studied for and passed the Series 7 and worked closely with two senior advisors doing grunt work for them.

My internship had technically ended when I graduated in June, but I didn't leave. I just kept coming in to work every day even though I still wasn't getting paid. A couple weeks after I graduated, our branch moved into a new office in a brand-new building next door, and I moved right along with them. As I was settling into my new desk, my manager came in and kind of scratched his head and he said, "I can't fire you, because technically you don't actually work for me. I'm pretty sure that at some point having you come into work every day without paying you becomes illegal, so I'm going to have to formally bring you on and send you back to New York for training." So he hired me and sent me to the firm's formal training program in Manhattan. In October and I think the first part of November in 1985, I spent several weeks living across the street from Madison Square Garden and taking the subway every day to and from the training center near the corporate headquarters. And that's how my career started.

**G&D:** Once you broke into the industry, what else did you do before you started Saratoga and what gave you the confidence to start your own shop?

***"The market dropped 22% in a day, that's like losing almost a quarter of the wealth that had been accumulated in the stock market throughout all of history in a day. You didn't know that things were going to bounce back the way that they did."***

**KT:** MacGreggor ("Greg") Phipps recruited me into the Prudential-Bache Portfolio Management Program. I actually started managing money with discretion in 1986 for a small handful of my own clients and had about a year of experience under my belt when the stock market crashed on October 19, 1987. This was a pretty dramatic event, and it's just really hard to explain to people what it was like. The market dropped 22% in a day — that's like losing almost a quarter of the wealth that had been accumulated in the stock market throughout all of history in a day.

You didn't know that things were going to bounce back the way that they did. You didn't know if it was 1929. It was a crazy period, but I made it through. Shortly after, Greg Phipps gave me a book called *The Intelligent Investor* by Benjamin Graham. I read and absorbed Graham's book. But, it was the appendix called *The Super Investors of Graham-and-Doddsville*, which really put a hook in me. It was written by Ben Graham's former student, Warren Buffett. Since then, I've followed Berkshire Hathaway very closely. Until 1994, I practiced what today would be thought of as an old-fashioned Graham and Dodd style value approach. But in 1994, Robert Hagstrom published a book titled *The Warren Buffett Way*. In it, he answered a lot of questions that I'd been asking myself and he introduced me to a number of other really important influences on Buffett beyond Graham. I spent the next several years studying the works of Phil Fisher, John Burr Williams and everything I could find on Charlie Munger. By 1995, my thinking on investing had evolved and I also knew that I didn't want to work for a big sell-side Wall Street firm anymore. So nearly 30 years ago, I brought my small handful of clients with me and started my own business on March 1st of 1995. That little firm is what grew up into Saratoga Research & Investment Management today. But I think it's important to understand I wasn't really trying to start something as much as I was trying to get away from something. I

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just didn't like the culture of the Big Wall Street firm, and I knew that I didn't need them to invest the way I wanted to.

**G&D:** You mentioned Graham, Buffett, and Phil Fisher. Who is the investor, mentor, or family member that has the biggest impact on you and your investment philosophy?

**KT:** So, professionally Greg Phipps was really the only mentor that I had who I knew personally. Personally, I'd say that Pat Malley, my football coach at Santa Clara and especially Benny Pierce, my old high school coach were huge influences on me. They were both huge parts of who I am today. But as an investor, my biggest influencers in terms of the way I think about investing were introduced to me through books. I've never spoken with Buffett. I've sent him a couple of letters over the years and I've been to several Berkshire annual meetings but I've never had the opportunity to meet him. I wrote him a letter asking for a meeting way back in the day and he replied by sending my own letter back to me with a handwritten note on the bottom that said, "Dear Kevin, too many requests, not enough time. Good luck with your career. Come to the meeting." And he signed it WB. For a couple of months, I did exchange a series of letters and faxes (I was asking questions, and he was answering) with Charlie Munger – our conversation was focused on the role of maintenance capital expenditures in the calculation of owner earnings. Anyway, after a couple months of back-and-forth we ended up finishing our discussion on about a 5-minute phone call, which was fun.

***"I don't know if starting the business shaped the philosophy or the philosophy shaped the business. My investment philosophy was really inspired by the Robert Hagstrom book, The Warren Buffett Way, and shaped by all the follow up reading that stemmed from it as I studied all of Buffett's other influencers."***

**G&D:** Looking back at your story, you were a football player who thought of a very creative way of breaking into Wall Street, in addition to having the courage to start your own firm. How do you think that story impacted you as an investor today?

**KT:** I don't know if starting the business shaped the philosophy or the philosophy shaped the business. My investment philosophy was really inspired by the Robert Hagstrom book, *The Warren Buffett Way*, and shaped by all the follow-up reading that stemmed from it as I studied all of Buffett's other influencers. Those are what really spurred my evolution beyond the old-fashioned Graham & Dodd style value investing methodology that I'd practiced up to that point. It was as much about quality as it was about valuation. But I also learned a lot in those early years from running the business — especially from doing all of the accounting and the financial work, and it really gave me a much more concrete understanding of the critical importance of cash flow. When you run a small business, you've got money coming in, you've got money going out, and you have obligations for the money to go out and you have got to find the money to come in. You really learn to understand how important cash flow is relative not just to accounting income, but survival. My basic financial statement understandings in terms of balance sheet, income and cash flow were greatly enhanced by having started a small business and running the

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business and doing this all in conjunction with studying our own companies that we invested in.

**G&D:** Could you please give us a brief overview of SaratogaRIM's strategy?

**KT:** When we can do so at sensible prices, we invest in the stocks of companies that are financially sound and not using more than moderate levels of financial leverage. They generate high-quality owner earnings and possess what we believe are sustainable competitive advantages which can enable them to earn persistently above average profitability looking forward. I personally think of us as value investors within a relatively small universe of predominantly large, very high-quality businesses. But because we're truly long-term investors, with average holding periods of over 7 years, it's probably just as accurate to describe us as quality investors who happen to be very value sensitive. It's important to understand that we're not traders — our preference is to let our portfolio constituents do most of the heavy lifting for us over time by compounding persistently above average profitability.

**G&D:** The large cap space is a highly efficient market. How do you develop a view or process that is different than that of the market?

**KT:** Much of the time it's efficient, sometimes it isn't. About a decade ago an institutional consultant asked me, "Why do I want to pay you to own Apple? I can get that passively." We had made a pretty sizable investment in 2014. I told him that he wasn't paying us to own Apple. He was paying us not to own companies like GE, Intel and PG&E. Over very long timeframes, those long enough to include full market cycles measured either peak-to-peak or trough-to-trough, avoiding companies that were most susceptible to extreme deflationary or inflationary environments can result in solid risk-adjusted returns. Avoiding companies that are too expensive contributes also.

**G&D:** How do you determine whether a company has a competitive advantage? In other words, how do you define "moat"?

**KT:** We tend to use sustainable competitive advantages and the word moat interchangeably. In general, we adopted the Morningstar framework of five moat sources: Intangible Assets, Switching Costs, Cost Advantages, Network Effects and Efficient Scale.

**G&D:** You have a very successful career. What do you think contributed to the firm's long-term success?

**KT:** We're very popular with rich people whose primary concern is staying rich and with institutions focused on risk control and long-term risk adjusted returns. After huge up moves like we've seen over the last couple years, it's easy to forget that markets also go down.

> ***"When we can do so at sensible prices, we invest in the stocks of companies that are financially sound and not using more than moderate levels of financial leverage. They generate high-quality owner earnings and possess what we believe are sustainable competitive advantages which can enable them to earn persistently above average profitability looking forward."***

Although past performance can never guarantee future returns, we've historically performed very well during

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drawdown periods, and the bigger the bear market, the better we've done at least in relative terms. When you think about the mathematics of compounding, over the long haul, it's just far more important to avoid big losses than it is to generate huge gains. If you don't lose 50% in the first place, you don't have to make 100% just to get back to even.

**G&D:** How do you go about generating ideas?

**KT:** Our approach is very process driven. We start with a screening process and quantitative analysis to limit our investable universe to companies that share a set of what we consider to be quality characteristics: 1. They are financially healthy and not using more than what we consider moderate levels of financial leverage. 2. They must generate high -quality owner earnings and can't be excessively capital-intensive. 3. & 4 Not only do they have to be profitable today, but they must have demonstrated a propensity to earn persistently above average profitability. And 5. Over time, for every dollar of retained earnings, they need to have demonstrated an ability to generate a dollar of shareholder value.

Out of over 4,000 stocks in FactSet's database, 364 companies currently make it through our screening process. But that's just a starting point for us. We then study those businesses qualitatively with an eye towards determining whether we believe a sustainable competitive advantage exists. If we do, we'll add it to our investable universe and start valuation modeling. Since I started the company, our investable universe has never exceeded 100 companies. There are literally fewer than 100 companies in the world that we would invest in at any price. We use DCF, and relative valuation metrics to establish probability weighted expected future returns. One area where we are probably very different is that we don't use beta as our measuring stick for risk. We have our own proprietary metrics based on what we consider to be real sources of risk on a forward-looking basis. We tend to think about risk in terms of potential sources of permanent loss of capital rather than relative volatility. We think about financial risk/leverage, business model risk/buggy whips and valuation risk like Cisco at the peak of the dotcom bubble.

**G&D:** Besides looking at businesses at the micro level, does your firm typically have a macro view?

**KT:** While we don't do any type of formal economic or market forecasting, we try very hard to remain cognizant of the market and the economic environment around us and where potential forward-looking risks might be lurking.

*"Our approach is very process driven. We start with a screening process and quantitative analysis to limit our investable universe to companies that share a set of what we consider to be quality characteristics."*

**G&D:** How do you gauge where we are in the market cycle?

**KT:** The term market cycle is kind of vague and overarching. I think it can encompass several different types of cycles all at the same time: economic cycles, interest rate cycles, credit cycles, innovation cycles, and valuation cycles for example. And while they're all separate and distinct, they're all part of what I'd call a broader market cycle, and they are all constantly evolving. I try to think about how ongoing or lurking changes in those sub-cycles might impact business conditions and market valuations at the individual company level.

**G&D:** Can you please share with us more

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## Saratoga Research & Investment Management

details about your screening process?

**KT:** We have 5 blocks of screens: Block 1 limits our investable universe to companies we believe are financially healthy, not too heavily leveraged, and likely to survive an extremely deflationary type of market environment like a recession, depression or credit crisis. Block 2 further limits our investable universe to companies that generate high-quality owner earnings (Net Income, plus non-cash charges like depreciation, depletion and amortization minus maintenance capital expenditures.) Block 2 does a couple things. First, it zeros in on cash generating capability and second, it limits our exposure to the ravages of extreme inflationary environments. The 3rd and 4th blocks are about looking for evidence that moats exist. In the screening process, which is entirely backward-looking by definition, Block 4 is essentially looking for the "wake" of a company with a moat – like the wake behind a boat.

Well, how do you determine if a company has a moat? Companies that have benefited from moats have earned persistently above average profitability. If they haven't earned persistently above average profitability, they don't have a moat – it really is as simple as that. The more important work comes later in our qualitative work where we need to determine whether what was special about a company in the past (as detected in Block 4) is still special today, and most importantly whether we believe it will continue to be special in the future because investing isn't about the past; it's about the future.

*"Well, how do you determine if a company has a moat? Companies that have benefited from moats have earned persistently above average profitability. If they haven't earned persistently above average profitability, they didn't have a moat – it really is simple as that."*

Block 5 is essentially a test of management's ability to create shareholder value over time. For every dollar of retained earnings, over time they need to generate at least a dollar of shareholder value. The way I like to explain this is for you to imagine that you're the CEO of a publicly traded company. At the end of the year, you've generated a dollar of real distributable earnings. If you think in terms of a decision tree, you can go one of two directions with that dollar. You can distribute it to the shareholders either by paying a cash dividend or by buying back stock, or you can retain earnings in the business, presumably to invest and try to grow the business, or make it more profitable or both. What we're saying in Block 5 is that we really don't care which way you go. But over time, we expect you to invest our money wisely and eventually we'll expect to see at least a dollar of increased value or we would have been better off getting the cash.

Since we started using this screening process in 1995, there has never been a day when more than 400 companies shared these characteristics. But this is just a starting point for us. When a new company makes it through the screening process we'll study it qualitatively. If we think we understand the business well enough, and after studying the business we believe that the moat detected in the 4th block of screens still exists and even more importantly, that it's likely to persist into the future, we will add it to our focus list which is what we call our investable universe internally. At that point we add it to our formal coverage and start building valuation models. Also note that there have never been more than one hundred companies on our focus list – today there are

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## Saratoga Research & Investment Management

eighty.

**G&D:** Thank you for sharing that with our audience. How do you ensure your investment process is repeatable?

**KT:** I tend to think of the attributes of quality investing and the benefits of utilizing sound valuation analysis as timeless principles. So, ultimately I believe what makes our approach repeatable is discipline in executing our process.

**G&D:** How do you know your investments are the best ideas in your universe?

**KT:** First of all, you have to define "best ideas". We tend to think of it from a forward- looking and very long-term perspective. It's not just what's working now. All of our companies are high-quality, but there are varying degrees of quality we have to consider. Likewise, there are valuation differentials that manifest in relative price to intrinsic value and expected future returns. The best ideas from our perspective are those with the most favorable tradeoffs between how much risk we think we're taking and what we think our returns should be looking forward. With most versions of our strategies, we try to construct adequately diversified portfolios of 25 to 35 sensibly priced quality stocks sourced from our investable universe.

Since 2015, we've also managed iterations of an Ultra-Focus version where we equal weight our highest conviction seven stock portfolio. We have back-tested and our highest conviction 7 stock portfolios have significantly outperformed the vast majority of possible 7 stock combinations randomly selected from our own investable universe.

***"The best ideas from our perspective are those with the most favorable tradeoffs between how much risk we think we're taking and what we think our returns should be looking forward."***

**G&D:** Thank you for the insight. How do you keep learning and expand your circle of competence?

**KT:** Individually by trying to never stop learning and collectively by seeking to gradually expand our investment team and accumulating domain expertise in the various different sectors we operate in, as well as complementary skill sets and demeanors. Of the 8 analyst/portfolio managers with research coverage on our investment team, one of them came with a CFA when I hired him but no graduate degree. One of them came with a graduate degree but no CFA when I hired him. The rest of them had neither. Today all 8 of them have the CFA and all of them now have graduate degrees or are working on finishing them up. Matt Keating was the one who came with the CFA, and I put him through Columbia Business School where he earned his MBA. We will never stop trying to learn and get better.

**G&D:** What is your approach to valuation?

**KT:** Discounted cash flow and relative valuation analysis.

**G&D:** How do you approach position size?

**KT:** It varies depending on the iteration of our strategy. Our original Quality version of our strategy, which may hold unlimited amounts of cash, has always been essentially equal weight, with 3 to 4% positions, but with flexibility to own half positions, at 1½ to 2%. In 2014, we launched a fully invested version of our strategy that we call Focus. The constraints are that cash can't be more than 5% of the portfolio, no individual position can be larger than 10% of the portfolio, but at least 50% must be invested in our top 10.

**G&D:** Risk management is a big part of the

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## Saratoga Research & Investment Management

business. How would you describe your approach to diversification and risk management?

**KT:** With most versions of our strategies, we try to construct adequately diversified portfolios of 25 to 35 sensibly priced quality stocks sourced from our investable universe. Since 2015 we've also managed iterations of an Ultra-Focus version where we equal weight our highest conviction seven stock portfolio. I tend to think of our whole process within the context of risk management.

By avoiding companies that are too heavily leveraged, too easy to disrupt, or too expensive, we avoid most of history's sources of permanent loss of capital.

*"Individually [and collectively, we are] accumulating domain expertise in the various different sectors we operate in, as well as complementary skill sets and demeanors... We will never stop trying to learn and get better."*

**G&D:** Given the size of your portfolio, how do you track company developments to ensure you are on top of everything?

**KT:** The analysts/ portfolio managers for each sector are responsible for tracking, modeling and valuing all the companies under their coverage. None of our analyst/portfolio managers cover more than nineteen companies and that's a two-person team per sector. For my part, I read 5 to 7 hours a day, seven days a week.

**G&D:** Have there been any noteworthy lessons that you've learned over the past few years?

**KT:** Because I was a value investor before I was a quality investor, my instincts about prices relative to absolute valuations tend to tilt towards black and white. For example, never buy unless there's an adequate margin of safety between underlying intrinsic value and sell if a company is fully valued. That belief system has been embedded in the management of our original, cash unconstrained, Quality version of our strategy since I used to manage it myself. But over the years we've introduced various versions of our quality approach that are required to be fully invested all the time — like our Focus version of our strategy that is geared towards investors with different types of risk profiles and investment constraints — or to be used as equity slivers of more fully developed asset allocations beyond our management scope. In doing so, we've needed to pay much closer attention to relative valuation propositions between our own companies as opposed to my original more absolute approach to valuation. For these fully invested versions of our approach, over time I'd say we have taken on a much more Munger style attitude in terms of letting winners run to capitalize on the long-term benefits of internal compounding of persistently above average profitability.

**G&D:** Have there been any areas/topics where you've changed your mind?

**KT:** Again, being willing to continue owning stocks of very high-quality businesses that I consider to be pretty fully valued. In other words, absent a big enough margin of safety that would entice me to buy at current prices. This is the challenge — and, sometimes, a big concern of mine — with fully invested mandates.

**G&D:** What is your view on the market right now?

**KT:** The market is very expensive today by any measure. From these valuations I find it hard to believe that market returns over the next decade will come anywhere close to those

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## Saratoga Research & Investment Management

enjoyed over the last decade. I also believe that at some point over the next couple of years we could see a very deep drawdown as inflation and interest rates continue to normalize. Timing that drawdown is simply impossible. For now, momentum probably still rules the roost but who knows? I know it's a cop-out, but momentum should probably be expected to continue until it doesn't.

*"I've surrounded myself with people I think are smart and hardworking, but most importantly I trust them. Unquestioned integrity is a prerequisite."*

**G&D:** Saratoga is very proud of its employees. How do you identify/search for talent?

**KT:** I'm not sure talent is the right word. I've surrounded myself with people I think are smart and hardworking, but most importantly I trust them. Unquestioned integrity is a prerequisite. In most cases, because I think it takes somewhere between five to ten years to develop an analyst/portfolio manager from scratch, but also because of our ownership structure, I need to identify very high potential candidates when they are very young. Ideally this means proactively recruiting undergraduate students into a structured internship program. This also gives me time to work with them long enough to get to know them well enough to ascertain whether I trust them and whether they are the type of people I want to work with. Only rarely would I seek a veteran, and I would only consider one if he or she came with a very specific skillset I deemed complementary and I needed to fill a gap. Even then, at least in terms of the investment team, this person would likely need to come from a firm with a belief system that is compatible with our own.

Our CFO Travis Hanson is a good example of how I bring in veterans to fill gaps. In 2014, my second in command, Marc Crosby was filling the CFO role largely because, in addition to his CFA, he was also a CPA and had earned a master's degree in accounting. This was in addition to his being an important part of the investment team and working closely with our operations team. At the time, this made him the only other person in the firm besides me who had a thorough grasp on all financial, operational and investment elements involved in running our firm. It also made him a key cog in my succession planning. But to free him up for a higher role, I needed to find someone who could step into his CFO shoes.

My brother, who's been with me since day one running our operations, and whose wife was a college women's soccer coach, suggested I speak with the husband of the new women's coach at San Jose State who had just moved down from Portland — Travis Hanson. As I discovered, Travis had had quite a career in baseball making it all the way up to the 40-man roster for the Saint Louis Cardinal's as a third baseman. After a career ending injury, Travis had gone back to school and earned his MBA, and then became CFO of a brewery up in Portland. He was leaving to accommodate his wife's move down to San Jose; so we met, and very quickly I knew he was a perfect fit for us and I ended up hiring him as our new CFO. I've never regretted it for a second. Not too long after Travis got his legs under him in his new role, I swapped my old title of President for CEO, then named Marc Crosby as the President of Saratoga Research & Investment Management.

I have never used a recruiter, and I doubt I ever will. When I need something, I'm going to go out and find exactly what I'm looking for. Incidentally, today, in addition to myself, Travis and Marc are the other two members of our board of directors.

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## Saratoga Research & Investment Management

**G&D:** What does the background of a typical hire look like?

**KT:** I'm either looking for promising undergraduate students, or I'm looking for someone mid-career with lots of experience and is highly specialized with proven skillsets. That type of recruit would most likely come from within the industry and probably from a firm that views the world more or less like we do. People need to be trustworthy, reliable, hard-working, and smart — in that order. Genius is less important to me than being consistently not stupid.

**G&D:** Could you please provide more color on what your recruiting process looks like?

**KT:** It's case specific, depending on what part of the company has a need and what kind of role I'm looking to fill. For many years, having been a football coach at an academically oriented high school, I had a very deep pool of candidates to choose from. These were guys I already knew well enough to know whether I could see myself working with them for the rest of my life. That source dried up when I retired from coaching 12 years ago. Now, I've had to be more creative in looking for new sources likely to provide what I'm looking for and have to proactively go out and look for candidates that fit my requirements. For example, a couple years ago we executed a custom designed internship program targeting three potential candidates from Stanford.

**G&D:** How is the firm structured?

**KT:** The firm is structured as an S-Corp and is entirely employee owned. I still own a little less than half the firm, but my ownership will gradually decline to zero over the next 13 years as I gradually finance the sale of the rest of my shares to my teammates.

> ***"Our culture emphasizes direct communication, accountability and camaraderie supported by strong personal bonds."***

**G&D:** You have gathered a group of talented investors. What type of culture are you hoping to build?

**KT:** I'd like to think we've built an open and collaborative environment. Our culture emphasizes direct communication, accountability and camaraderie supported by strong personal bonds. I believe our environment promotes teamwork, trust, and especially continuous learning, helping us grow and improve together as a team over time.

**G&D:** How are the decisions made within your firm?

**KT:** Regarding buy and sell decisions, there's actually a lot of context that goes into this. Initial purchases and liquidations, as well as increases and decreases in position sizing are primarily the responsibility of the analyst/portfolio manager responsible for the sector who works in conjunction with me in my role as Chief Investment Officer. I still retain full veto power. Routine rebalancing due to client cash flows into or out of accounts are executed by our head trader.

**G&D:** Looking back at your career, what are the things you do on a regular basis to improve as an investor?

**KT:** I read at least 5 to 7 hours a day, seven days a week. I am constantly trying to learn and get better. I take classes too. I'm 62 right now. I graduated from Harvard Business School, through their three-year OPM program, just before I turned 60 and right now, I'm in my first year of a four-year program at Harvard that, if I make it all the way through, would result in a master's degree in

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finance. But over the last 40 years, my passion has been studying economic and financial history. Most of it has been studying on my own but I also seek out specific classes that I think would be fun. For example, a few years ago I spent a month in London taking a great summer school class at the London School of Economics studying “The Causes and Transmission Mechanisms of Financial Crisis.” Good times.

**G&D:** Do you have any advice for students looking to break into the investment management industry?

**KT:** If I was trying to get a job working for an investment management firm today, I would take a very different approach than I did. First, rather than trying to get hired right out of the shoot into the investment management industry, look for opportunities that would help you build expertise that would be valuable to a potential employer. If I were going at it today, I think I would try to get hired by a vendor selling analytical services to investment managers and become an expert with some critical pieces of the investment process. And while I was building up that expertise, I would simultaneously be trying to learn as much as I could about the investment management firms that my firm was working with (as customers of my employer) so when the time came, I would know which ones were the good ones. And they would already know me as an expert in some critical part of their process that they were paying good money for.

**G&D:** Do you have any “off the beaten path” advice you would give to younger investors who want to learn more about investing?

**KT:** There really aren’t any shortcuts. If you want to be a great investor when you grow up, read stories about, and writings by, great investors. Learn financial and economic history. Study valuation and finance and keep a world view. Pay attention to everything happening around you.

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

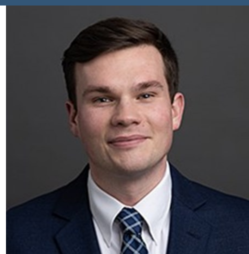
**KT:** At this point, pretty much all I do is work, but I love seeing my kids and my baby granddaughter.

**G&D:** How do you deal with stress?

**KT:** I work out religiously, eat well and try to get regular sleep.

**G&D:** Do you have any book recommendations to share with our readers?

**KT:** Read everything you can about great investors. I usually still point people towards writing on Warren Buffett and his teachers and I usually recommend that they start with *The Warren Buffett Way* by Robert Hagstrom. And again, study financial and economic history. Finally, make your reading very broad. Study every angle of the business, even those you don’t agree with. And while it’s not a book, another thing I have done is to read Barron’s every Saturday morning, front to back since 1985. Like I said earlier, I read a lot.



**Jared Duda ´25**
JFerguson25@gsb.columbia.edu

Jared is a second-year MBA student at Columbia Business School. Prior to CBS, he was an Equity Research Associate Analyst at T. Rowe Price and before that, completed a multi-asset class investment research rotational program at Fidelity Investments. He began his career in the audit practice at PwC. Jared graduated from Oral Roberts University with a B.S. in Accounting and received an M.S. degree from Vanderbilt University.

**Joe Ferguson ´25**
JFerguson25@gsb.columbia.edu

Joe is a second-year MBA student at Columbia Business School. He started his career as a consultant at PwC, developing statistical models for financial institutions. During his time at Columbia, Joe interned at Brizo Capital, a long-short global equities fund. He graduated from Vanderbilt University with a Bachelors in Applied Mathematics and Physics.

**Garrett Wallis ´25**
GWallis25@gsb.columbia.edu

Garrett is a second-year MBA Student at CBS. Prior to CBS, he was an investment analyst at Prudential Private Capital focused on private credit transactions in the Power & Utilities sector. He began his career at PwC in the audit practice and BVA Group focused on valuations and litigation disputes. Garrett graduated from Baylor University with a B.B.A. in Accounting & Finance and Masters of Accountancy.

## Valvoline, Inc. (NYSE: VVV) - Long
## 2024 Pershing Square Challenge (1st Place)

**Recommendation:** Valvoline as a LONG with a September 2027 PT of $83.58, representing +94% price upside and a 21% IRR. Returns are driven by capturing the white space opportunity and continued effective capital allocation. VVV's current valuation does not recognize: 1) management's now unhindered focus will allow the company to capitalize on the extensive white space; 2) terminal value is protected in the face of EV adoption, and 3) the company's attractive unit economics & cash flow profile combined with mgmt.'s disciplined capital allocation philosophy will make VVV a compounding cannibal.

**Business Description:** VVV is an operator and franchisor of vehicle service centers across the United States and Canada. Locations offer a variety of quick lube and light maintenance services like oil changes (conventional & synthetic), transmission fluid changes, battery/bulb/blade replacements, tire rotations, and other tune-up services. Following the sale of its Global Products division to Aramco in March 2023, VVV is now a pure-play automotive services company, with ~1,790 Valvoline Instant Oil Change ("VIOC") locations, 300 Valvoline Express Care locations, and over 100 Great Canadian Oil Change locations. 53% of Valvoline's locations are franchised.

**Investment Thesis:**

**I. Focused growth engine will allow the company to capitalize on white space and benefit from secular tailwinds.**

- With 1,800 units today, we believe management can reach its goal of 3,500+. The addressable market is large and highly fragmented, and our research points to significant white space for new units – we wrote our own code to scrape location data for all quick lube majors and analyzed the intersection of that data with state vehicle registrations. Leveraging that research and assuming current peak market density we estimate our lower bound of 9,200 units. On the other hand, assuming quick lubes dominate the DIFM market, we size our upper bound of 25,800 units. Both estimates far exceed the number of units today.
- Valvoline's store-count story is also supported by its attractive unit economics, a strong value proposition for both corporate & franchisee new unit development. Even during the past few years of high inflation, profitability CAGR'd faster than revenue, with EBITDA CAGR'ing 9.8% and Net Sales CAGR'ing at 8.6%. In addition, based on discussions with franchisees, we estimate capital deployed to new units will deliver 20%+ unlevered IRRs and 45% levered IRRs per unit.
- Valvoline also has the building blocks of a competitive advantage that will allow them to capitalize on the white space opportunity. Valvoline's management is singularly focused, while its competitors are distracted. Further, Valvoline has been investing heavily in its teams and technology, driving operational excellence that shows in its unit-level performance vs peers. Lastly, its combination of large, capitalized partners and scaled smaller partners represent a franchisee dynamic none of its peers can boast.
- VVV has consistently posted +HSD/LDD comp growth across the entire store footprint, comping between +7-10%.
- Shifting consumer behavior from DIY to DIFM is a major driver of traffic we see going forward. The DIY habit is largely drawn on income lines, as higher earners have more disposable income. With the 35 and under cohort being larger than its elders, we see room for significant traffic growth in the future as these generations reach their peak spending years.
- Additionally, Fleet and Non-oil change revenues represent an opportunity for increased ticket and volume as they continue to scale as part of the mix and grow faster than the core business. Specifically, the opportunity in fleet with its higher average ticket and increased box utilization is particularly enticing, which is why management has recently implemented a new CRM system to seize this opportunity.
- Historically, there has been debate around whether increased oil efficiency from synthetics will reduce quick lube revenues as the relative increase in mileage exceeds the price premium. However, we have found the opposite to be true. First, in talking to operators, it is clear that oil change frequency at this point is engrained in consumers. Additionally, Valvoline's own performance has shown that increased premiumization has not affected unit volumes to date. With this perspective, you can see how continued premiumization can drive further revenue growth as vehicles using conventional oil begin to phase out of the car parc.

**II. Terminal Value is Protected in the face of EV adoption.**

- The range of outcomes for EV adoption is quite wide with estimates up to 30% of the car parc by 2050. A "worst case" outcome still allows for meaningful FCF generation and management is already working on a 2nd Act.
- When it comes to conventional energy businesses people want to know how long the show can go on. The EV debate has a wide array of ever-changing opinions. So, we focused on trying to bound our assumptions as it relates to forecasted EV penetration. Between the EIA and Toyota's outlooks we deter-

## Valvoline, Inc. (NYSE: VVV) - Long

mined while the EIA forecast may be more reasonable at a 12% market share, we should evaluate the EV risk through Toyota's more punitive lens of 30%.

- Based on this level and assuming Car Parc growth in the historical range, the number of ICE vehicles on the road in 2050 would be 5% below today's level. What's important is this level still implies a TAM far greater than the current footprint of quick lube providers. It's also not a straight line to that point. In our analysis given an acceleration in EV sales and normal scrap rates, it is reasonable to assume that the number of ICE cars on the road may not be below today's levels until the late 2030s.
- We also think we are starting to see a deceleration in the EV Euphoria story. As the initial cohort of EV buyers matures, consumers are realizing that fueling or recharging costs are not the most significant cost of car ownership.
- The heavy price tag and short useful life of EV batteries has a direct impact on the residual value of these vehicles. This has been a major driver of higher financing and insurance costs for owners, which is a real cash cost borne by these consumers. This is further exacerbated by the unseen accrual cost that is a result of EVs relatively lower residual value. All in all, we are likely to see a deceleration in EV adoption if consumers remain under pressure.
- What's important though is Valvoline isn't waiting to be the last horse and buggy in town. The company recognizes that even in an EV world these vehicles will need some form of convenient quick service solution. The company's true asset is its network of conveniently located boxes with bays, basements, and team of trained automotive technicians which in a few years will likely be the largest and densest in the country. So, management has already begun taking steps to address this need and pilot maintenance services geared and advertised directly to the EV market.

**III. Compounding Cannibal.**

- This businesses' strong unit economics drives significant cashflow generation and conversion, which in the hands of honest management can create phenomenal returns for investors. Management has proven they don't waste cash and have continued to reiterate their plan to return capital to shareholders through buybacks. Through operational cash flows and its balance sheet, we expect Valvoline to buy back roughly 20% of the outstanding shares all while funding their extensive growth.
- Valvoline's commitment to returning cash to shareholders and robust economics position it to become an industry 'cannibal' like Autozone and O'Reilly, who've substantially grown net income and strategically repurchased shares to fuel share price appreciation. The precedent they set raises our level of confidence that Valvoline will be able to do the same. Moreover, Management's compensation structure, with its shift back to EPS-based incentives for the 2024-2026 period, further aligns with these shareholder-supportive actions.

**Valuation**

- In our base case, we modeled a Sep. 2027 PT of $84, representing +94% price upside from current levels and a 21% IRR.
- We arrive at this PT using a 22x forward P/E multiple on our FY28 EPS estimate of $3.98. This translates to a 16x forward EV/EBITDA multiple on our capital structure assumptions. Our base case algorithm from FY24 to FY27 is +10% unit growth, +8% SSS growth, around 27% EBITDA margins with high 20% incrementals, and 25% EPS growth. We're ahead of the Street on all metrics and near the high-end of mgmt.'s stated LT algo.
- We believe risk/reward is attractive here, right around 3.0x when assuming nearly 31% downside in our bear case.

**Key Risks and Mitigants**

**I. Competitive Landscape.** High degree of competition from national quick lube franchised concepts (e.g., Take 5, Jiffy Lube, Grease Monkey, etc.) as well as from local mom-and-pop operators and car dealerships. **Mitigant:** Valvoline's unit level outperformance, balance sheet, and scale should provide for increased flexibility regarding future strategic actions.

**II. Decreased Oil Change Frequency.** Increasing premiumization and price inflation may at some point result in consumer behavior shifting towards longer intervals between oil changes, commensurate with automaker guidance. **Mitigant:** Current behavior has remained unchanged, but future price increases and service mix shift should provide a backstop for decreased visits.

**III. EV Adoption.** Car parc mix may shift towards EVs in the long run, which could hurt the unit economics of VVV stores. **Mitigant:** The company is actively piloting EV focused maintenance services which will allow them to capitalize on increased EV adoption in some form.

## BlueBird Corporation (NYSE: BLBD) - Long
## 2024 Darden at Virginia Investing Challenge (2nd Place)

**Erik Listoe ´26**
EListoe26@gsb.columbia.edu

Erik is a first-year MBA student at CBS. Prior to CBS, he was an Associate at CSG Capital Investments, where he focused on distressed and special situations investing. He graduated summa cum laude from Purdue University with a Bachelors in Finance. He is a CFA Charterholder and member of CFA Society New York.

**Daniel Sohn ´26**
DSohn26@gsb.columbia.edu

Daniel is a first-year MBA student at CBS. Prior to CBS, he was a Special Agent in the US Army investigating national security crimes. He did a pre-MBA internship in Google's Privacy M&A Group and is currently interning at Rome Capital, a special situations fund. He graduated from Lehigh University with a Bachelors in Computer Science and Business

**Yifan Wang ´26**
YWang26@gsb.columbia.edu

Yifan is a first-year MBA student at Columbia Business School. Prior to CBS, she worked as a Consultant at Roland Berger and as an Internal Strategist at Shopee. She also completed a pre-MBA internship at Everest Growth Capital, a long-only equity fund. Yifan earned dual Bachelor's degrees in Finance and Mathematics from Peking University.

**Recommendation:** We recommend a BUY for Blue Bird Corporation (NASDAQ: BLBD) with a base-case price target of $65, implying a 16.1% IRR through 2027. BLBD is a leading player in the North American school bus market, with structural tailwinds from fleet electrification and a secular replacement cycle driving robust growth. At its current price of $41, BLBD offers a compelling asymmetric risk-reward profile with upside potential to $110 in a bull-case scenario.

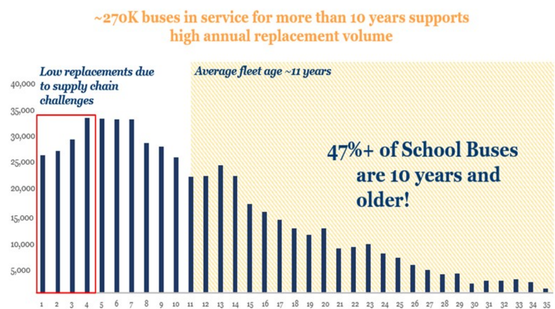
**Business Description:** Blue Bird Corporation is the largest independent school bus manufacturer in North America, holding approximately 30% market share. The company operates in a consolidated market with high barriers to entry, offering a comprehensive product portfolio across traditional diesel, propane, gasoline, and electric powertrains. Blue Bird sells its products through an exclusive dealer network that accounts for 99% of sales.

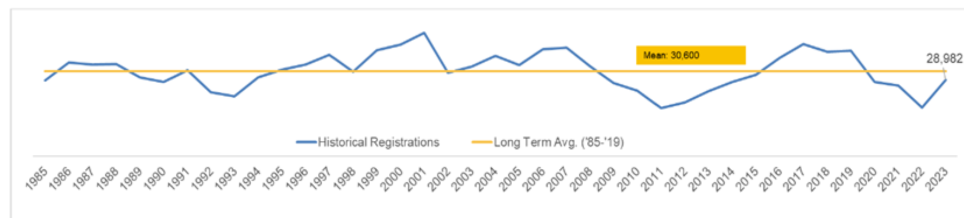
Recent strategic initiatives focus on expanding production capacity from 10,000 to 14,000 units annually by 2027, and capturing market share in the electric school bus (EV) segment. EV buses, which currently account for 13% of Blue Bird's backlog, offer significantly higher margins and are supported by strong federal funding through the EPA's Clean School Bus Program.

**Investment Thesis:**

**I. Robust Recovery in Demand**

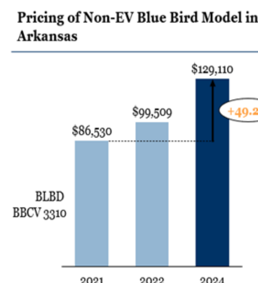
- **Steady Replacement Cycle:** Over 47% of school buses in operation are over 10 years old, with many nearing the replacement threshold of 12-15 years. This ensures strong replacement demand, which is rebounding post-COVID.
- **Market Growth:** Current industry sales remain below the 30-year historical average of 30,500 units annually, indicating significant headroom for volume recovery.
- **Pricing Power and Backlog:** Supply chain issues have abated, and new pricing pass-through contracts protect margins. Blue Bird's backlog supports visibility into near-term demand.

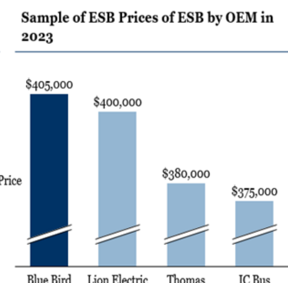



**II. Incremental Share Gains in a Consolidated Market**

- **First Mover Advantage in Alternative Powertrains:** Blue Bird is the only OEM manufacturing its own purpose-built chassis, offering flexibility to adapt to shifting buyer preferences. The company has also shown consistent market share gains in propane, gasoline, and electric buses. Demand spike from 2027 emissions regulations will pressure competitors on the supply side. Blue Bird's trusted position in alternative fuels will allow them to take share when competitors increase prices.
- **Industry Rationality Supports Margins:** The industry is characterized by disciplined pricing behavior, with Blue Bird's average selling price (ASP) rising at a 12.9% CAGR since 2021. Despite years of increased ASPs, Blue Bird's market share percentage has remained flat. Additionally, the company put in place price escalation provisions in Q2 of 2023 in order to shield from macro and supply chain concerns.



## BlueBird Corporation (NASDAQ: BLBD) - Long

- **Capacity to Scale:** With funding costs of ~$160m for the conversion of one of their existing facilities being split 50/50 with the DOE, Blue Bird will introduce an additional 4k/year in unit capacity to confidently meet any forthcoming increases in demand. With production capacity increasing to 14,000 units by 2027, Blue Bird is well-positioned to take incremental share from traditional competitors Thomas Built and IC.

**Former Sr. Executive at Blue Bird:**
*"And in fact, [Thomas and IC] delivered a few and they wouldn't work. They were way behind. And the reason for that is that both Thomas and IC get their chassis from their truck partnership. And the truck partnership relies almost solely on diesel. And getting their attention and getting them to integrate the EVs is hard."*

**Former Executive at Cummins:**
*"I'm not sure if there will be a lot of diesel alternatives left after 2027 because the effort to get the diesel that clean is very significant. And you need a lot of volume to justify that big effort, and I'm not sure a whole lot of others will have that volume necessarily."*

**III. Free Call Option on EV Growth**

- **Early-Mover in EV School Buses:** Blue Bird has deployed over 2,000 EV buses to date, outpacing close competitors. Its EV backlog penetration reached 13% in 2024, and the company is poised to capture 30-40% of new EV bus sales. Blue Bird has a scale and trust advantage over its closest EV Bus competitor Lion Electric, which is currently negotiating its liquidity position to avoid bankruptcy.
- **Unit Economics Drive Profitability:** EV buses generate ~5x the per-unit profit of diesel models, with gross margins of 27.3% versus 8.9%. Increasing EV penetration will drive substantial long-term margin expansion.
- **Strong Funding from Public and Private Investment Vehicles:** The EPA's Clean School Bus Program secures funding through 2028, supporting EV adoption. Assuming no further government stimulus programs, current awards are supportive of 6,300+ new units through 2028, of which Blue Bird models in ~2,000 across EV and Alts. Additionally, private capital and partnerships with Fleet Electrification as a Service (EaaS) providers lower barriers to EV adoption for municipalities and school districts. The largest US fleet operator, First Student, committed to 30,000 by 2035 — no slowdown in unit demand should be anticipated any time soon.

**Valuation**

- We apply a forward EV/EBITDA multiple of 7.5x, below peers like Lion Electric (111.7x) and Allison Transmission (9.7x), reflecting Blue Bird's strong growth potential.
- We assume CAGR of 10.4% through 2027, driven by EV penetration, capacity expansion, and pricing power. Margins stabilize at ~19% by FY27, reflecting operational efficiencies and a favorable product mix.

| | Bull Case | Base Case | Bear Case |
|---|---|---|---|
| Market Volume CAGR | 3.5% | 3.0% | 2.5% |
| Share Gain | 5pp | 3pp | 1pp |
| Price Raise | 4.0% | 3.5% | 2.5% |
| EV% of Buses Sold (FY28) | 13.0% | 11.0% | 10.0% |
| EV Sales Unit (FY28) | 2400 | 1000 | 750 |
| **2028e EBITDA** | 380 | 228 | 181 |
| 2027 Fwd EV/EBITDA | 8.0x | 7.5x | 7.0x |
| **2027 Target Price** | **$ 109.6** | **$ 65.3** | **$ 49.8** |
| **IRR** | **38.0%** | **16.1%** | **6.1%** |

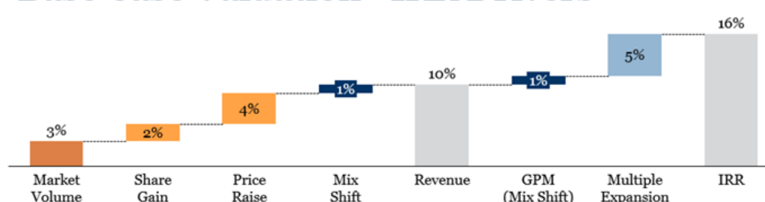
**Key Risks & Mitigants**

**I. Policy Risks.** Delayed or reduced federal funding for EV adoption. **Mitigant:** EPA funding is secured through 2028, and bipartisan support for clean energy initiatives reduces policy uncertainty. Fleet EaaS partnerships further insulate Blue Bird from reliance on direct federal funding.

**II. Competitive Threats.** New entrants or well-funded competitors could erode market share. **Mitigant:** Blue Bird's scale, manufacturing expertise, and established dealer network create significant barriers to entry. Additionally, there are three layers of regulatory hurdle (federal, state, and municipal) that make it nearly impossible for an entrant to challenge the incumbents.

**III. Operational Challenges.** Scaling production to meet rising demand poses execution risks. **Mitigant:** Blue Bird has successfully navigated supply chain challenges and benefits from exclusive supplier agreements through 2030. Additionally, Blue Bird is aptly expanding capacity to ensure it can meet any spikes in demand, whether through natural growth or failure on the part of its competitors.

**Base Case Valuation - IRR Drivers**




| Vs Consensus | FY23 | FY24e | FY25e | FY26e | FY27e | FY28e |
|---|---|---|---|---|---|---|
| Revenue | 1,133 | 1,340 | 1,479 | 1,605 | 1,759 | 1,884 |
| *y/y* | *41.5%* | *18.3%* | *10.4%* | *8.5%* | *9.6%* | *7.1%* |
| *Consensus* | | *16.9%* | *9.5%* | *10.0%* | *14.3%* | *6.9%* |
| Gross Profit | 139 | 257 | 286 | 309 | 331 | 355 |
| *Margin* | *12.3%* | *19.2%* | *19.3%* | *19.3%* | *18.8%* | *18.8%* |
| *Consensus* | | *19.0%* | *19.0%* | *19.3%* | *19.2%* | *18.5%* |
| Adjusted EBITDA | 87.9 | 179.5 | 191.4 | 205.0 | 213.3 | 228.3 |
| *Margin* | *7.8%* | *13.4%* | *12.9%* | *12.8%* | *12.1%* | *12.1%* |
| *Consensus* | | *13.4%* | *13.3%* | *13.2%* | *13.0%* | *15.6%* |

# Plural Investing

Chris Waller

**Chris Waller '18 is the Founder and Portfolio Manager of Plural Investing, LLC and Founder and Author at the Hidden Gems Investing Substack. Prior to founding Plural, Chris worked in London at Goldman Sachs Asset Management. Chris joined in 2013 and worked as a member of the investment team for the Global and International Small Cap equity funds. He has an MBA from the Value Investing Program at Columbia Business School and BA in Economics and Management from Oxford University.**

**Plural Partners Fund was launched in 2020 with the belief that in-depth primary research can uncover 'hidden gems' in the small cap universe. Some of this research is published in long form reports and available at the Hidden Gems Investing Substack.**

***Editor's Note: This interview took place on October 11th, 2024.***

**Graham & Doddsville (G&D):**
Chris, thank you for speaking with us today. To get us started, we'd love to hear more about your background and how you initially became interested in investing.

**Chris Waller (CW):**
Thanks for having me. I was born in Hong Kong, which is where my mother's side of the family is from, and when I was 12 years old, we moved to the UK, where my dad's side is from. I really grew up in the UK and moved to New York in 2016 when I did my MBA at Columbia. I first got interested in investing in September 2008, which was an interesting time to get started. I was 16 at the time in high school, and I had an economics professor essentially put me forward for a national investing competition in the UK. Like I said, it was a very interesting time.

I was immediately hooked and have been quite obsessed ever since. I was lucky that I read about Warren Buffett and *The Intelligent Investor* so early on. That was my style of investing from the very beginning. Towards the end of high school and during college I started running a portfolio with money from some friends who were very brave to trust me, and I've essentially been investing in one form or another ever since then. When I graduated, I worked in London at Goldman Sachs Asset Management on an international small-cap fund, looking at businesses not that dissimilar to the ones I look at today. Then I eventually came to Columbia and now run Plural Investing.

**G&D:**
In terms of investors, mentors, or books that have inspired you, you mentioned Warren Buffett and in your investor letters, you've also quoted Joel Greenblatt. Can you tell us more about key sources of inspiration for your investment philosophy?

**CW:**
I think the two investors who have probably had the biggest impact on me are Joel Greenblatt and his business partner Rob Goldstein. I was incredibly lucky that whilst I was at Columbia, Joel was still a professor there teaching a class. I was thinking about launching a fund at the time and he was kind enough to let me come to his office occasionally, which is also how I met Rob. I think a lot of what I try to do today and a lot of things that I've learned have been lessons that they've taught in the class and in other conversations. When you see me today being focused on small caps and fairly concentrated, looking at incentives for insiders and so on, these are some of the things that I've tried to copy. Joel wrote a great book – *You Can Be a Stock Market Genius*. I would certainly recommend reading and rereading that book. However, I think his biggest contribution as a teacher is his creation of the Value Investors Club.

It's a website where investors can contribute investment write-ups. I can't think of a better source where you have

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## Plural Investing

this investment and financial history documented over 25 years. One of the things that I did to learn is go through the website and pick out a couple stocks every month starting from the year 2000, when the website was just getting started, up until today. And I would read write-ups from each month and try to think about what would I have done in each situation. This approach effectively allowed me to simulate different investment decisions. One of the drawbacks that we have in investing, particularly long-term investing, is it takes a long time to learn from your own experiences. If you've got a three-year horizon and you've been working for nine years, you've only really got three time periods to look back upon. Value Investors Club is quite a good way to shortcut that learning curve if you're willing to go back and review old posts.

In terms of other areas, I do a lot of primary research. Bob Woodward is a journalist who is incredibly successful, and he teaches a masterclass online, which anyone can subscribe to. I found it to be very impactful in terms of some of the techniques of doing primary research and speaking to sources. There's also a book called *The Sleuth Investor* by Avner Mandelman, which is similar in some of the journalistic techniques it applies to investing. Another more recent book called *We Are Bellingcat* by Eliot Higgins, which is about the Bellingcat organization, looks at open-source intelligence. This includes social media accounts, and they've been able to piece together a lot of things in geopolitics, which I think is relevant in investing as well. Of course, this is all in addition to everything Warren Buffett has written.

**G&D:**

Let's turn to Plural Investing. Tell us about the fund, what drove you to launch it, how you chose the name, and other key decisions you made.

**CW:**

I apply a tried-and-tested approach that has a track record of being successful, if you can do it well. In his class at Columbia, Joel focused on the small-cap space as it's typically a less efficient market. If you do good valuation work, eventually the market tends to agree with you. The good thing is the opportunity still exists because the people who do good work tend to have success and raise more capital and then eventually graduate out of the small caps. That's what I'm trying to do. In terms of what I got right, it's generally been the right approach to look at small caps, particularly in Western markets, look at off-the-beaten path companies, concentrate the portfolio in the seven or eight best ideas.

I conduct in-depth research by speaking to about 20 people in the industry prior to investing. In terms of things that I've learned or would do differently, there are two concepts that I think about. One is return on time. When I initially got started, I think I probably spent more time looking at what you might call "cigar butts" or deep value stocks.

*"In terms of what I got right, it's generally been the right approach to look at small caps, particularly in Western markets, look at off-the-beaten path companies, concentrate the portfolio in the seven or eight best ideas."*

That wasn't most of the portfolio, but they were investments that I certainly considered. The problem with some of these companies is that if you spend a lot of time doing research and it turns out that it's not as mispriced as you originally thought, you essentially wasted the research because if it's a "cigar butt" or a low-quality business, you may not be able to revisit the idea in five or seven years.

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Whereas if you look at some higher-quality businesses, even if you do the work and it turns out not to be as attractive as you initially thought, that work is really not wasted as there will likely be another opportunity down the road when it becomes attractively priced. The other thing is return on stress. One of the most important things in investing is temperament, and it's something that we don't talk about enough. How do you manage stress? How do you manage your temperament? How do you have a process around that? Part of it is doing things on a daily, weekly, or quarterly basis. Part of it is there are certain investment ideas that are just not worth it in terms of that return on stress. For example, there are companies that are cheap but have questionable governance, so you're forced to justify to yourself why you made the investment. You can make a lot of mistakes that way.

In terms of the name, Plural Investing, I take quite a traditional investigative approach to value investing, but I've tried to supplement it with some data analysis and effectively combine multiple techniques, which is where the word Plural came from. I wouldn't overdo it in terms of portraying myself as particularly innovative in that way, but that's where the name came from.

**G&D**:

Let's now turn to your firm's investment strategy. You've mentioned that the firm seeks to invest in hidden gems and companies that are undervalued because they're small and perhaps because they receive little coverage or operate in unpopular industries. Could you tell us more about that?

**CW:**

I'm looking for seven to eight stocks that, like you said, I call hidden gems. They are boring small caps listed in Western markets, generally in old economy industries. One of the companies is in the banknotes sector, one is in storage tanks, and another is in cast iron boilers. These are not industries that most people are focused on and they receive limited coverage both from the buy-side and sell-side. Sometimes they offer good opportunities beyond any short-term worries or complexities. Often, I try to look for companies that are small but are the largest in a particular niche market. And that's important because it means that there are very few specialist investors looking at them. And a question that people sometimes ask is – is it better to be a generalist or specialist? If you can be a generalist but look at niches where there aren't specialists that you're competing against, you effectively negate that disadvantage that a generalist might have. A typical example from this year that worked out well would be TerraVest (TRRVF), which is a Canadian small cap business in the storage tank sector. It generated returns on capital of about 25%. A third of the company was owned by insiders and management had high integrity and very strong capital allocation skills. The company had limited debt and traded for 10 times free cash flow. Businesses like those are the type of businesses that I'm looking for. By focusing on such a small number of companies over a three-to-five-year period, I can end up spending months researching a specific company or an industry.

That is what gives me the time to talk to 20 people in the industry and to source those people and set up the interviews. One other interesting thing is I typically write up a report of about 30 to 40 pages with my findings, and I will then share that with my sources. I've found that to be quite helpful because these niche industries don't tend to have any research, which gives these people a reason to speak to me. And those reports then get shared around and I find that other sources eventually start reaching out to me, which then makes things a lot easier to keep building up my knowledge over time.

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**G&D**:
You mentioned a focus on old economy industries. How did you come to focus on those specifically?

**CW**:
Consumer and industrials have always been industries that I found easier to understand. Going back to the point of specialists, if you look at healthcare as an industry, there are clearly a lot of specialists in certain parts of healthcare. You could say the same for banks, technology and certain types of energy as well. Generally I'm trying to move out of those spaces. I think old economy industries are really where a lot of opportunities lie because people tend to want to focus on the more interesting, more exciting parts of the market.

**G&D**:
With regard to Plural Investing's focus on small-cap companies, do you see any fundamental risks to investing in small-caps relative to mid- or larger-cap companies?

**CW:**
There are two that I would highlight. One of them is liquidity. The other one is governance, and I mean that quite broadly – the shareholder base, the board, the executive management, and then the actual culture of the company, which influences how the employees behave. I think it's important that all four parts of that governance structure are aligned. In the small-cap space you can see particularly large differences in alignment and quality at each of those levels. That can happen at any market cap size, but with small-caps in particular you have to be careful.

***"I think old economy industries are really where a lot of opportunities lie because people tend to want to focus on the more interesting, more exciting parts of the market."***

If you look at shareholder base, for example, there was a time many years ago I was looking at shipping companies. There are certain companies out there with an ownership base that is more interested in growing the number of ships because they get paid a royalty on how many ships they own. Their incentive in that case is really to grow the fleet, rather than do the right thing for the shareholders. In other cases, there may be a controlling family shareholder which is more interested in the family rather than the shareholder base. If you look at the board, quite often it can be filled with people who are less independent than what you would typically see at a large-cap level – friends of the CEO, or people who I would call on the "board circuit".

At the executive level, a lot of these smaller companies have management teams that want to grow and graduate to running larger businesses. That may not be the right thing for shareholders. These are all risks that are present at any market cap, but I think they're particularly heightened at the small-cap level. And then of course there is trading liquidity. There's a history of small-cap funds that have gotten into trouble because of that. It's not the liquidity when you enter the stock that matters, but rather the liquidity when things go wrong and you're trying to get out quickly that really matters.

**G&D**:
What is your view on the recent rotation into small caps from their larger peers? We've also seen more private equity activity in small caps, especially in Europe. How might this potentially impact your opportunity set?

**CW:**
I can't tell you when it will change, but I think that at some point the gap in performance between small-caps and large-caps will probably reverse. We've just been through one of the biggest periods of underperformance for

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## Plural Investing

small caps and particularly small-cap value stocks versus large caps. Maybe the early 2000s, late '90s was another period. I think this is also particularly big outside the US. The UK, for example, has had a tough time, particularly in the small caps for a few years now. Historically, that is not something that has persisted. There are good opportunities there and those continue to present themselves.

**G&D:**

When it comes to managing a fund, how do you think about investment horizon and picking the right investors that align with your strategy and companies?

**CW:**

It is important that if you say you're going to invest for three-to five-years, that you have a business and a client base that can do that. In terms of picking the right investors, I try to be very transparent about the time horizon of my investments. This is not a fund where the strategy is to minimize volatility. We are viewing risk as probability of permanent loss over that time period. It's inevitable that there will be some drawdowns along the way, particularly in small caps.

We need to be able to take advantage of those drawdowns because a lot of the money is made in those down periods. I try to be very transparent to investors about that. In the back of every letter I write, I include a set of principles, which is effectively modeled off the Buffett partnership ground rules. There are certain things that I promise in terms of what I can do for you as an investor, but also a couple things that I'm looking for in return. One of those is I will be judging my performance over five years, but at a minimum I would ask for three years from you as a client to be able to take advantage of those drawdowns.

The other thing I write is that you should expect that there will be drawdowns along the way. And so please do not invest an amount where, if there is a 20% drawdown, you're going to lose sleep. There have been times when I've mentioned that to prospective clients and they haven't invested as a result, but these are the sorts of difficult choices you sometimes have to make to ensure alignment, otherwise you can't execute the strategy.

**G&D:**

When your investment is closer to the liquidity limits and you have a drawdown, you might want the company to repurchase their own shares. However, repurchases can potentially decrease the liquidity further. In those situations, how do you think about capital allocation and what actions would you want to see from the management team?

**CW:**

There are conflicting views on this, and I think there are reasonable arguments on both sides. I prefer a company to allocate capital in a way that maximizes intrinsic value per share. If the stock is trading below its intrinsic value, I would like them to buy it. Now, in terms of the impact on trading volumes, it's important to recognize that liquidity in dollar terms is a function of both the number of shares traded as well as the share price. For example, if a company were to buy back 5% of their shares, that may reduce trading volumes by 5%, but if the share price goes up by 5% because of the positive signal the company is sending, or the fact that there are just fewer shares to divide intrinsic value by, then actually in absolute dollars, the dollar liquidity might be the same or it may actually go up from the attention generated.

**G&D:**

What is your overall framework for managing a short portfolio in your fund? Is it to help upsize your long positions or is it to generate alpha?

**CW:**

The fund is typically close to 100% long and at most 10% short. If you think about this research process of trying to do in-depth work and focusing for

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## Plural Investing

three-to-five years, it really lends itself to long investments. The reason that there is the option of making shorts is because sometimes I do come across things in the research process where a company is an attractive short. The goal here is to make the most money for clients and I would hate to be in a situation where we came across a good short and were not able to take advantage of that because of a limitation that we've placed on ourselves. The shorts are there to make money, they tend to be small and rare, but it's not to hedge anything out.

**G&D:**

You've mentioned a preferred time horizon of three-to-five years. Can you elaborate on your overall philosophy for the fund's investment horizon and your view on the role of valuation catalysts?

**CW:**

The reason I think about being comfortable owning businesses even if the market were to shut down for five years, is that it places certain constraints on you and helps exclude a lot of companies. If you had to be comfortable owning a business for that period of time, you would probably think much more seriously about competitive, technological or regulatory changes. In terms of governance, you take more seriously the people you are partnered with. Having that sort of thought process protects you from making certain mistakes.

The other thing it does, which may be more controversial, is it helps you manage your commitment bias, especially when you've done a lot of work on a business but find risks that make you uncomfortable. You may have a gut instinct that says "there is something wrong here" that you are rationalizing to yourself. Maybe it is because the stock is cheap. And if you frame it over that five-year period, that becomes something you can't own over that horizon. If there is a catalyst that is even better but I do not view catalysts as compulsory.

**G&D:**

With that strategy and philosophy as the backbone of Plural Investing, tell us how you go about generating ideas. What factors about an opportunity lead you to believe that you may have an edge over the market?

**CW:**

I don't do any quantitative screening. Most of my ideas come from reading write-ups. I'll read every write-up within my market cap range that gets published on Value Investors Club every week. The Manual of Ideas or MicroCapClub are other great sources. What I'm looking for is a business that I think I could understand.

As a valuation hurdle, I'm really looking for an idea that I think is worth only half of what the intrinsic value will be in three years' time. If that intrinsic value gets recognized, that's effectively a 25% IRR. So that's something that I'm looking for from an initial write-up which tends to exclude most ideas.

At that point the first step of the research process is really about other reasons for exclusion. If I think about governance, those factors I mentioned earlier in terms of shareholder base, board, management and culture, that is an area where I find that most small caps get excluded.

> ***"I'm really looking for an idea that I think is worth only half of what the intrinsic value will be in three years' time. If that intrinsic value gets recognized, that's effectively a 25% IRR."***

There are just a lot of companies where governance and incentives are not properly aligned. That's the biggest factor.

The second area is the economics, particularly strong unit economics. Scale is important in a lot of industries. I'm not going to invest in any company that is at a

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competitive disadvantage. And there's probably a third category, for which I would use a term that's maybe a bit provocative, called "nonprofits". I'm interested in companies that generate free cash flow or if they don't today, there's a good reason why that is going to change in the future. Unfortunately, I do think that there are a lot of ideas that get written up today that generate a lot of EBITDA, but not free cash flow. Those are ideas that I exclude very quickly.

**G&D:**

Circling back on valuation, can you touch on what kind of valuation levels you like to see in your investments and what key metrics you look at to derive intrinsic value?

**CW:**

I typically look at free cash flow three years from now. Free cash flow is the key thing that I'm focused on, and I think three years is a timeframe that is short enough that you should have an understanding of what the economics are going to be. But it's also a long enough period for underlying changes and company investments to start to make a difference. Typically, the companies that I invest in are trading at low-double-digit multiples of free cash flow today. I think that in three years' time they're going to be trading at high-single-digits.

**G&D:**

Once you've found an idea, how do you go about researching it? Your letters and write-ups show that you conduct significant primary research. You've also mentioned that you use quantitative tools. Could you walk us through your overall research process?

**CW:**

I would probably split it into four steps. Roughly speaking one day, one week, one month, and then an ongoing process. It doesn't always work out perfectly like that. The key areas that I'm looking for are typically the same at each stage, but I'm going deeper.

> ***"Typically, the companies that I invest in are trading at low-double-digit multiples of free cash flow today. I think that in three years' time they're going to be trading at high-single-digits."***

The first one would be the economics of the business. It's really important to understand in detail what the unit economics are and then what are the competitive advantages that ensure those economics stay the way they are or improve. The second area is governance, which we've talked about. And then of course valuation and why is the market presenting this opportunity to me. At the very first step, one day or less, it's usually about the exclusion, and a lot of that is around governance. At the one-week phase it's about reading the easily available material. That includes all the annual reports and transcripts for the company and for competitors.

The part of my research, which is the most interesting is then the one month where I try to find about 20 people in the industry to talk to. I think about who would I like to talk to? How do I reach out to them and get them to speak to me? That is the part that's really the bulk of the work and that's also why I write up the research to give them a reason to talk to me and to initiate a second or ongoing conversation. Often the most valuable part is when I send the work afterwards and we have another discussion that can be more detailed and nuanced.

It is important to be able to verify this type of qualitative discussion with actual data or documentation. One example I could give that I did recently was in looking at a company called Watches of Switzerland (WOSG), which is a retailer of Rolex and other luxury watches. A key question in that industry is what do waitlists for Rolexes look like? Are they declining as rapidly as some investors suspect? An example of data

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analysis in this case would be collecting reviews on Reddit. There are 3,500 reviews that all contained the exact model of the watch purchased, the date it was purchased, how long the customer actually had to wait, rather than just a theoretical wait time, and the country that they made the purchase in. And effectively you can build out the waiting list for each Rolex model and you can see what that was like pre-COVID, what the impact of COVID was, where it is today, and how it's trending. You can look at customer reviews, employee reviews, and different industry data. Those will be different ways to try to validate what you're hearing qualitatively. The interesting thing is then when you bring that data back to the sources and ask them, "How should I interpret this?" it can really create some interesting discussions. The research shouldn't end once you've made an initial decision on a stock. I try and go to things like industry events, trade shows and events like annual general meetings. It's an ongoing process to continue to talk to people in the industry.

**G&D**:

Going back to management and governance, could you touch on the traits of a management team that will make you comfortable with an idea and how you go about vetting that management team?

**CW:**

There are a lot of variables to look for, but the three key factors I look for are integrity, customer focus, and strong capital allocation skills. I think it would be a mistake to only focus on the capital allocation side of things. On the integrity point, unfortunately in the small-cap world, there are a lot of management teams that are promoting their stock and not necessarily the people you want to be partnered with. What I've learned is that there is really no price at which it's justifiable to invest in those companies. I've made such mistakes in the past. I've seen other investors make the mistake of trying to justify a company that's maybe trading at a low single digit multiple of earnings that has a management of low integrity.

In terms of how you research that, it's good to look at what management has promised over a long period of time, and particularly to look at small promises where it would be quite easy to go back on that promise, and essentially build up a list of every little promise that they've made and then look at what actually happened. Another way to research is to do reference checks, and I do those quite often. You have to be careful with reference checks because by their nature they tend to be positive, but they can be useful. I also think that the managements that are really of low integrity are quite obvious if you have spent time researching the company.

Customer focus is also really important. There is a danger when investors over-rely on Excel spreadsheets and overlook the importance of customer acquisition and retention. Customers don't just appear and retain by themselves. An important indicator of customer focus is, what does the management team do when helping the customer is going to cost the company in the short term? At that point, do they still put the customer first? What you'll find is most management teams do not. Every management team will say they do, but if you look for example at the travel industry, during COVID a lot of these management teams did not put their customers first. And the ones that did ended up gaining a lot of market share and that's why that's important long-term.

> ***"Customers don't just appear and retain by themselves."***

And then the third one, capital allocation, that's something a lot of investors look at, and I research that in similar ways to a lot of

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investors.

**G&D**:

We touched on this briefly but how do you think about portfolio construction and positioning sizing?

**CW:**

I hold seven-to-eight positions, which is typically the vast majority of the fund. That is a number that gives you most of the benefits of diversification without the negatives. That means most positions are about 10 to 15%. In an exceptional circumstance, I can go to 20%. When sizing these positions, I'm typically focused on the downside. That is always important, but it is important to be focused first on the downside when you have a concentrated portfolio.

The other thing I try to overlay is more qualitative factors. There are certain things that are important, but just quite hard to quantify, for example, if there's some sort of industry dislocation or if there are certain red flags – insiders selling the stock could be a red flag. I try and overlay those sorts of risks on top. With a concentrated portfolio, usually the decisions are around trade-offs if I've got a better idea that is competing to get into the fund. And it's a nice problem to have and that is typically the way that a lot of these portfolio decisions get made.

**G&D**:

You mentioned the importance of time management. Can you tell us about how you allocate your time in a typical day between analyzing current positions and evaluating new ideas?

**CW:**

I reverse engineer it. With seven-to-eight stocks over a three-to-five-year period, I need to find about two ideas per year. You can probably do deep work on an idea four or five times a year, which means that by the time an idea gets to that stage of a research process, about two of those have to work. So my goal in every quarter, and it doesn't always work perfectly this way, is to find at least one idea that's interesting enough that I'm willing to do that level of work on it. And then the way I split each week is I usually allocate Monday to Thursday to looking at new ideas and Friday to Sunday to looking at existing ideas.

My primary source of ideas is write-ups and I usually read 15 to 20 write-ups a week. In terms of the ongoing monitoring of those positions, I usually have between 10 to 20 links or sources that I'm looking at each week to keep on top of what's happening in the industry. For example, it might be a trade magazine or a newsletter, online industry forums, LinkedIn accounts of certain people in the industry or management, employee reviews, customer reviews, different social media. And then just looking at the transcripts of companies in these industries. Luckily, I'm in relatively small industries, and there are usually not dozens of companies in them, but I try and make sure I'm on top of the reports and earnings of all of those companies.

> *"My primary source of ideas is write-ups and I usually read 15 to 20 write-ups a week."*

In terms of time management over time, more of my time has shifted towards monitoring rather than completely new ideas. That's because I'm building up a database of companies and industries that I've done work on. I have a watchlist that I try to keep to about 100 stocks, with about 30-to-35 that I'm watching as closely as if I owned them.

**G&D**:

Let's get to individual ideas and positions starting with Watches of Switzerland (WOSG). Can you walk us through the thesis and how you came across the opportunity?

**CW:**

WOSG is a UK-listed

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company. It is about a $1.5 billion market cap. It trades at 12 times free cash flow today and will likely grow earnings at double-digit rates in most years. I think it's trading at half of its intrinsic value in three years' time. The company is a retailer and partner to Rolex and other luxury watch brands. Most of the company's value lies in its relationship with Rolex. Rolex do not sell watches themselves. You can't buy a watch directly from Rolex or online. They only sell through authorized retailers like WOSG, which is one of their most trusted retailers and partners. The company has economics that are very different to a typical retailer and much more similar to what a subsidiary of Rolex would look like.

It benefits from qualities like long customer waitlists that sometimes run into years. There's no price competition from other retailers, no inventory risk, and no online competition. WOSG has worked with Rolex for over 100 years. It was Rolex's first authorized retailer, and over time, Rolex has reduced the number of retailers it uses, thereby concentrating an increasingly greater share of the market in the retailers that remain. In the UK for example, there are 90 Rolex stores today, of which 41 are Watches of Switzerland stores. So WOSG has half the market in revenue terms and that number has been going up significantly. It's gone up from 35% 10 years ago when the current CEO took over. In the US, there are 280 Rolex stores and WOSG is the number one player with about 10% of the market.

A lot of the success the company has achieved has come from the current CEO, Brian Duffy. He's someone who is very competent, experienced, and well-incentivized. He owns £40 million in stock. He joined in 2014 and his idea was to invest significantly in the store base to improve customer experience, which is what Rolex really cares about. That is what has grown their market share so significantly because it has allowed WOSG to go to Rolex and say, "We can do for you in the US what we've already done in the UK." In the US market, in some cases, you have a lot of mom and pops that have owned a watch store for generations. They cannot invest $10 million into a store like WOSG can. So WOSG is effectively becoming a vehicle for Rolex to roll up the US market, which is about 15% of the global market.

*"WOSG has grown 30% per annum in the US over the last five years. Still this company trades at 12 times free cash flow."*

That's a long runway to deploy capital. WOSG has grown 30% per annum in the US over the last five years. Still, this company trades at 12 times free cash flow. The primary reason for that is Rolex acquired another retailer late last year and the potential impact of that acquisition on the WOSG-Rolex relationship concerns investors. The other factor is cyclicality. The luxury watch market was really boosted after COVID, and that has reversed. That has impacted the secondary market, but it has not really impacted Rolex because Rolex sells off a waitlist.

**G&D:**

Digging into this recent acquisition by Rolex, do you see any compelling reason for them to bring retail in-house? We understand Audemars Piguet did something similar as opposed to partnering with retailers like WOSG.

**CW:**

The retailer they acquired, Bucherer, is about 5% of Rolex's sales globally, and operates primarily in Europe. They have half of the Swiss market, which is where Rolex is based, and they also have some market share in the US. From Rolex's perspective, it's important to not prioritize 5% to an extent where you end up marginalizing 95% of your distribution. When they made this acquisition, Rolex publicly stated that the

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acquisition was because the third-generation founder of that business, Mr. Jörg Bucherer, had no natural successor. He actually passed away quite soon after that acquisition. Rolex was in a situation where this company, which was half of their distribution in Switzerland, was going to be sold to a competitor like LVMH or a private equity firm that may not behave in the way that Rolex wants.

This was largely a defensive move. Rolex stated the importance of maintaining the Swiss heritage and protecting the transition. Rolex is a nonprofit, so that makes it very different from companies like LVMH or Swatch Group (SWGAY), for example. It is run by the Hans Wilsdorf Foundation, which is a non-profit that donates most of its cash to the district of Geneva. Per the former employees at Rolex I spoke to, Rolex has the problem of too much cash because it can only donate to this specific area.  If they did want to make more money, the easiest way to do that would be to raise their prices. It would increase profits without impacting how many watches they sold.

What I found interesting is that everyone I spoke to in the watch industry was convinced that Rolex is not about to enter the direct-to-consumer market in any significant way, for some of those reasons that I've described. The margins that these retailers are making are usually about 10% or below. A smarter way for Rolex to take back some of the economics, which is something they've done over time, is to reduce the number of retailers but continue to increase production so that you have more and more watches being sold at each store. This increases operating leverage for remaining retailers and helps them generate greater profit.

***"Everyone I spoke to in the watch industry was convinced that Rolex is not about to enter the direct-to-consumer market in any significant way."***

This also increases Rolex's share of the economics without any big change in the business model. One thing I did push people in the industry on is, "Let's just imagine Rolex did want to really go into direct-to-consumer in a big way. Well, what could they do?" And the answer was always, "Well, in the UK, Watches of Switzerland has caught the market." Realistically the only way to do that would be to acquire the company, which would not be what I'm looking for, but is not a terrible outcome either.

**G&D**:

In terms of valuation, you mentioned that one of the benefits that you see is WOSG resembling more of a subsidiary than a retailer of Rolex, and that's what makes it valuable. But the market seems to be a little put off by that and the company's concentration of suppliers with Rolex. What do you think it will take for the market to see eye-to-eye with you on this relationship that you see as so valuable?

**CW:**

In my analysis I broke out the returns on capital for the Rolex side of the business versus everything else. The Rolex side of the business generates 40% returns on capital, which matches with multiple people in the industry saying that getting a license to sell Rolexes is like getting a license to print money. But the non-Rolex side of the business only generates returns slightly above cost of capital. I would encourage the company to continue allocating capital to where it generates the best returns rather than diversify for the sake of seeming less concentrated with Rolex.

To get the market to recognize the strong partnership it has with Rolex, WOSG should make acquisitions of mom and pops, particularly in the US, that have a Rolex license that WOSG can redevelop. Or to open stores in those markets where Rolex will essentially move the allocation of watches from the incumbent to WOSG. WOSG is opening a store on Bond Street in

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London, which is a three-story, 8,000 square foot store that is going to be the most impressive Rolex store in the world. When marquee stores like that get opened, it demonstrates how strong the relationship is.

**G&D:**

WOSG has recently diversified into luxury jewelry. Do you see that as an additional sources of value?

**CW:**

WOSG recently acquired the US license to jewelry producer Roberto Coin. Per my estimates they paid 6 times free cash flow. Jewelry is only about 10% of the business today and I don’t think it is going to become a major part of the business.

In terms of whether it adds a lot of value, if they can do a great transaction like that, that is fine. But I would go back to the point that I would prefer that the capital gets allocated to the great business, which is the Rolex business. What I would not try to do is diversify into a lot of different areas that maybe have slightly higher margins but don't generate the same returns. And I think broadly speaking, they will deploy capital to the better business over time.

**G&D:**

Let’s switch to Seaport Entertainment Group (SEG). Can you walk us through the thesis and how you came across the idea?

**CW:**

SEG is a spinoff from Howard Hughes (HHH), which is a real estate firm that is 38% owned by Pershing Square. As part of the spinoff, Seaport conducted a rights issue to raise capital to redevelop some of the properties. What is interesting is that Pershing Square is not only keeping its shares and subscribing to its rights, but oversubscribing and backstopping the entire rights offering. I think that tells you how attractive they think the price of this offering is.

HHH is primarily focused on master-planned communities where it has the control and can determine how those properties are designed and the speed at which they are released to the market. And its stock over the last few years has been weighed down by these assets in the Seaport district in New York. One of the reasons for this spinoff is to effectively bundle these less desirable assets into a “bad co”, which is now SEG, which transforms HHH into this pure play master-planned community business. That has led to indiscriminate selling of this stock, as investors have wanted to get rid of this for quite a while. Each SEG share is also worth about 5% of what a HHH share was worth.

SEG owns a group of properties that are currently loss-making and that I think will turn around. It includes some retail and office buildings that are partially empty in the Seaport District of New York, a loss-making food court, a plot of land called 250 Water Street that is currently undeveloped, some restaurants, JVs, air rights and even a baseball team and ballpark in Las Vegas. It's a complex set of assets.

Bill Ackman was the chairman of Howard Hughes for 13 years, including when this transaction was announced, and Pershing Square is backstopping the entire rights issue at $25 a share. That means if the shares were to fall below $25 prior to the rights issue and people were not going to subscribe, Pershing Square would end up subscribing to the entire offering. And that would result in Pershing owning about 72% of the company. I think making a commitment like that means that Bill Ackman thinks this is very attractively priced at $25. The pushback is that the stake in Howard Hughes is worth six times more than the stake in Seaport for Pershing Square, even if they become a 72% holder. But there are ways they could have done this spin off without this Pershing Square backstop. Typically, a spin-off doesn't necessarily have a backstop like that. Owning 72% of a publicly traded company could also bring some regulatory and reporting

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complications to Pershing. I don't think this is something that they would've done lightly to support another position, which means that they must think it's cheap.

Anton Nikodemus is the new CEO coming in. He is 60 years old, relocating to New York from Las Vegas, and he's been based in Arizona and the Vegas region for most of his life. What likely drove him to make that move is the $12.4 million in stock and options he is receiving, and I don't think he would've made this move unless he thought that these assets have a bright future and were very attractively priced today.

Lastly, SEG has a market cap of $330 million post-rights issue and it's got $50 million of net cash – net of the non-recourse mortgages. The actual gross cash totals about $170 million. Howard Hughes invested at least $1.3 billion into these assets. And if you add JVs and air rights and so on into that, it's probably closer to $1.5 billion. You are getting these assets at about 20 to 25 cents on the dollars that were invested, and you have an incentivized and competent CEO coming in that is going to recover a significant portion of that value. If he does so SEG is probably worth a multiple of where the stock is trading at today.

**G&D**:

How did you become comfortable around the $25 a share valuation of SEG?

**CW:**

This is a turnaround. There is a wide range of outcomes, but the price you pay is an important determinant of how much risk you're taking. At $25, there are reasons to believe that most of the potential outcomes are well above that number. And the way I've tried to think primarily about the downside is to say, "Okay, as a group, this is a basket of assets that have clearly been problematic, but actually there are a few of these assets that have done very well." One of those assets is 250 Water Street. Howard Hughes invested $180 million into this piece of land, another $60 million in terms of legal fees and preparing it for development.

It is very rare to find land like this that is ready to go, fully permitted and titled. It's a nine-minute walk from Wall Street and is fully approved for a 27-story building with 550,000 square feet of space, including apartments overlooking the Brooklyn Bridge. If you look at the economics of a developer – what it would cost for them to actually develop this and the sorts of rates they could achieve on the apartments and the retail and office space – the math works out to about $180 million. Not compensating for all the legal fees and so on that have been incurred, but still a very significant amount of value in comparison to a $330 million market cap.

The Fulton market building, also in the Seaport district, is a fairly small property, but it's fully leased up and generates $5 million in earnings per year. If you apply a 6.5% cap rate to that, that is $75 million. If you add 250 Water Street, the Fulton market building and just the net cash, that gets you not far off the current market cap, and that doesn't then include the other billion dollars that HHH invested in the remaining properties.

**G&D**:

What are your thoughts on the re-leasing potential for the empty office space in the Pier 17 building?

**CW:**

Pier 17 is probably the most valuable property. HHH invested $600 million into Pier 17. I think the property is roughly break-even today. It includes five restaurants on the waterfront, about 213,000 square feet of office space, and a rooftop that is a very successful venue for concerts. There is a lot of improvement potential. The office space is only half leased. COVID happened, we now have remote work and demand for office space has structurally declined in New York.

Anton Nikodemus, the new CEO, has a background in

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entertainment and is looking to redevelop that space into an entertainment concept. This will attract a much larger number of visitors to this area, which is then going to benefit all these properties. If run well, this building could probably generate about $30 million in earnings. Depending on what cap rate you assume on the earnings, that is a very significant amount of value compared to the market cap today.

**G&D:**

Do you have any advice for students looking to break into the investment management space? If you were to hire an analyst, what types of qualities would you be on the lookout for?

**CW:**

I would recommend anything to do with investigative research, like for instance the Bob Woodward class on the MasterClass website. Funds are looking for people who are passionate and willing to do the work. If you're willing to do that type of primary research, it's a really good way to demonstrate those qualities and to stand out from the crowd. I've talked about Value Investors Club a few times. I think there's no better learning resource than that.

Anything you can do to get feedback on your work is valuable. There is no better way to get feedback than running a personal account. There's no substitute for that type of first-hand experience. Probably the last thing I would say is, go to Berkshire Hathaway every year. I think it's a great place to meet a lot of people in this industry and it is good fun and easy to do as well.

**G&D:**

And to finish us off, we know you have a very busy schedule from Monday to Monday, but any fun hobbies or things that you like to do to blow off some steam?

**CW:**

I'm a big soccer fan. I try and play at least once a week. I'm a long-suffering fan of Manchester United – I don't know if that counts as a hobby anymore because it has not brought a lot of enjoyment. Me and my wife also like to travel and we travel quite a bit. Our next trip is to Switzerland, for the first time actually. We're also going to Manchester to watch a Manchester United Game at Christmas.

**G&D:**

Great. Well, thank you so much, Chris. This was a very insightful discussion and we loved hearing about Plural Investing and your background.

**CW:**

Thanks for taking the time to speak to me. It's been a pleasure.

# Bryant Street Capital Management

**Elie J. Mishaan**

**After graduating from The Johns Hopkins University in 2005, Elie Mishaan completed a 2-year analyst program in Mergers & Acquisitions at Lehman Brothers. He then joined Corsair Capital Management as an analyst, focusing on companies going through change, including M&A, spinoffs, divestitures, etc. As the senior analyst at Corsair, Elie was responsible for a significant portion of the investment book and the firm's relationships with those underlying companies. In 2020, with a strategy informed by his 15 years working with companies and management teams looking to unlock value through various corporate actions, Elie launched Bryant Street Capital Management. The goal at Bryant Street is to identify value-creating transformations, engage with management, and invest in a concentrated portfolio of these opportunities for 3-5 years at a time. Elie and his family reside in Woodmere, NY.**

***Editor's Note: This interview took place on September 30th, 2024.***

**Graham and Doddsville (G&D):**
Elie, thank you for speaking with Graham and Doddsville. We have been looking forward to this interview. As an introduction, will you please walk us through your background and how you initially became interested in investing?

**Elie J. Mishaan (EJM):**
I attended The Johns Hopkins University for undergrad. I was preparing for the LSAT but hadn't necessarily always dreamed of being a lawyer. I just figured I would enjoy law school. That plan was disrupted during winter break of my junior year, when I interned at a start-up small-cap-focused hedge fund.

It was my first exposure to investing and I loved it. I was doing basic analyst work. But what I remember finding most interesting during those few weeks was the management meetings that we did. I found talking to these executives about their businesses, the headwinds and tailwinds they're experiencing, and how they'll create value to be fascinating. Having learned a ton and enjoyed it, I had to pivot and find a way into the investment industry. I quickly put together a résumé and applied to the investment banks for a summer internship.

Thankfully, I got an offer for a summer position at Lehman Brothers in investment banking. I returned to Lehman after graduation, joining the M&A team from '05 to '07. I was placed in the Power and Utilities vertical and got some great exposure to large transactions and smaller asset deals as well. Unfortunately, a large utility merger I worked on for over a year fell through – such is the industry.

Midway through my second year at Lehman, at the peak of the market, I was naturally looking to move to a private equity firm or hedge fund. What I enjoyed about the work I did at Lehman was researching companies and valuing them – the lengthy deal processes, lengthy slide decks, and general corporate bureaucracy I found less interesting. So a hedge fund seemed to make much more sense for me than a private equity firm.

At the time, I was reading the Buffett Annual Shareholder Letters, Joel Greenblatt, and Graham and Dodd to start getting up to speed on value investing. I eventually joined a special situations fund called Corsair Capital Management ("Corsair") as an analyst. Ultimately, I was at Corsair for 13 years covering most of our big positions. My time at Corsair informed and really crystallized the investment approach I wanted to adopt when starting my own firm.

**G&D:**
That's great. Let's talk about your firm, Bryant Street Capital

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## Bryant Street Capital Management

Management ("Bryant Street"). Can you share an overview of the firm and how the lessons from your prior experience informed the way you've structured the firm?

**EJM:**
Acknowledging that there are many ways to structure a portfolio and that you can make money as an investor doing many different things, I wanted to focus on three things when I started Bryant Street: concentration, duration, and management engagement.

Many special situations and value investing funds run a portfolio full of spinoffs, mergers, divestitures, post reorgs, etc. Our focus at Corsair was to run a very diversified book of these special sits, with an investment horizon of 12-18 months, and with a material cash position. That recipe has worked well for Corsair and its LPs for over 30 years.

But I always wanted to be more concentrated and I gravitated more to that approach over my years as an analyst. I would often say – unscientifically – you can't love more than 15 stocks at a time. So, by the time I was ready to launch Bryant Street, I wanted to be very concentrated and have conviction in the names that we own. When we have done the work to develop deep conviction and we "get it right" – I want the investors in our fund to do very, very well. We typically hold only ten to twelve long positions at a time.

I also wanted to invest for longer than the typical special sits fund. Especially when a company is executing a major transformation, a three-to-five-year outlook allows for the positive outcomes of that transformation to flow through the organization, impact competitive positioning in the industry, and ultimately financial results. We focus on stocks that we believe can double or triple – or better – over that three-to-five-year period.

> *"I always wanted to be more concentrated and I gravitated more to that approach... I would often say – unscientifically – you can't love more than 15 stocks at a time."*

It became evident to me as an analyst that companies that execute a transformation which improves pricing power or strengthens their competitive positioning versus their peers – whether through operational improvements, M&A, new management teams, or otherwise – continued to create significant shareholder value for years into the future. In addition to that, my conviction in a business and a management team that executes well grows over time. That's why years three, four, and even five could provide compelling returns for our partnership and are usually our preference versus selling winners and looking to replace a great investment with something new that we don't know as well and/or a management team we are less sure of. Of course we are always searching for our next compelling investment. But a very high bar has been set by some of the great investments we've made so far.

Lastly, I wanted to be as closely aligned with management teams as we would be if we were buying these companies privately. Only a small fraction of the shares that are traded in the market today are owned by investors that meet with management on a regular basis. But even for many of those fundamental investors, the relationship between the funds and the management teams may not be a true partnership. In the hundreds of management meetings in which I participated before starting Bryant Street, many of which were in a group setting, the investors and management are typically on opposite

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## Bryant Street Capital Management

sides of the table, literally and figuratively. When stock performance is strong, the relationship is easy and cordial. But when stock performance is weak, the relationship changes: investors start to get very prescriptive, questioning management's command of the narrative, their personal stock ownership, etc. I find that the public market's psychology tends to affect and shape investors' relationships with management teams in a way that is not constructive to their own investment process.

I wanted to create an environment where we were engaging with the management team with a three-to-five-year lens, which allows us to think more rationally as investors. I think our long-duration investment approach really allows the relationship to start off more-closely aligned and to build even stronger over time. It also leads to very informative conversations about long-term value creation.

On a purely human level, understanding that the CEO, CFO and others in management are just regular people with families has improved our relationships as well. They're leading an organization with thousands of employees who are looking up to them for direction. Walking into a meeting and telling a CEO to sell his or her company might feel good for a portfolio manager who is down 25% on a stock and the math could make perfect sense. However, that CEO has a family, his or her kids might be in high school or college, and he or she has employees to care about. Furthermore, if we have found a great CEO and a high-quality business, why would I want to sell it at a sizable discount to what I think the value of the business will be only a couple of years from now? Of course it could help our near-term performance. But we want to maximize our returns over five-year intervals, not five-month intervals. We prefer a great management team to unlock value as a standalone entity and then look to sell from a position of strength and at a much higher valuation than to search for a bailout from a falling stock price as some activists often pursue.

I think that if you can interact with the management team that way, both on a strategic level and on a personal level, there's much to gain. What we gain is obviously not "next quarter is going to be better or worse" or "here's what the numbers are going to be." The real value is that we gain conviction in the management team that they are leaders, possess great judgment, and will allocate capital well. When one of our management teams announces capital allocation, like a tuck-in acquisition for instance, we don't immediately assume the worst. We are usually very excited and say, "Oh, this is great." If they're acquiring competitor XYZ versus buying back their own stock, and we know they're on top of that math internally, acquiring XYZ must be a great investment. The bottom line is that I want to engage with management as a genuine long-term partner. And the relationships we've developed since launching the firm have been incredible. I attribute the success to the way we approach the dialogue.

> ***"The real value is that we gain conviction in the management team that they are leaders, possess great judgment, and will allocate capital well."***

Management engagement, long duration, and a concentrated portfolio are what I wanted to establish when I launched Bryant Street and they are the keys that position us to win

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## Bryant Street Capital Management

one name at a time. And when we win, our investors do very well.

**G&D:**
Can you tell us about your investors, how you decided that you wanted to partner with these people, and how you expressed your philosophy in launching the fund?

**EJM:**
Over 13 years in the industry I developed many relationships through idea dinners and other networks. I spoke to a couple of those more experienced people about what the appetite would be for my fund, and they were very encouraging. My focus was on starting out with investors I would be proud to partner with. We were in a couple of processes with family offices for seed capital before we launched. This was in early 2020. When COVID hit, those conversations stalled. Despite those setbacks, I decided in the Spring of 2020 that I needed to get my track record going. The plan was to manage the fund for three plus years, establish a track record, and then go out to raise additional capital. The initial investors wound up being four or five current or retired hedge fund managers that had been hearing my ideas for many years, including the managing members at Corsair. We launched with approximately $9.5M from those fund managers that believed in us. Now that we have 4 years under our belt, we think it is the right time to put some resources into growing. It's a long sales cycle, it's a grind, but we're excited to continue to hopefully show good returns and build the business.

**G&D:**
We really enjoyed your comments on being in partnership with management and the longer-term approach. Curious, why is three to five years the optimal balance in terms of the horizon? A private equity business owner could have said five to ten years, or potentially even longer.

**EJM:**
That's a great question. I'll answer it in two ways. The first is being realistic about public market investors. It's hard enough to pitch a public market investment strategy, especially when what many large allocators want is a hedge fund that primarily manages volatility and hopes to achieve returns of 1% per month. It is a unique characteristic of investors specifically in the public market – the liquidity of the public market creates an unusual psychology. Being realistic about that psychology, which is averse to volatility and is very focused on each quarter and each year in a vacuum, building a business with a seven-to-ten-year approach to the public markets would be very difficult. Three to five years is right between those markers. It's the compromise between the typical hedge fund and private equity approaches to duration.

I also believe that longer-term horizons present more room for thesis creep. It can lead a stubborn manager with conviction to say "No, I'm right, even though it's been five years, and we haven't made any money." I think that three to five years is a good sanity check for me. By the way, that guideline doesn't prohibit us from investing in a company for more than five years. My prediction for a couple of companies that we own today is, if they're not bought by strategic competitors or private equity firms in the meantime, we might own them for more than five years because they continue to create value in myriad ways, from business transformation to balance sheet improvements. But for the names that underwhelm us over the first couple of years of our involvement, whether in terms of operational progress or valuation improvement, it's good to reassess the position. Are we on track to achieve what we wanted in this investment? Has timing merely been pushed out or is there a problem with our original thesis? Obviously, these decisions are made on a case-by-case basis. But it is healthy for us to re-examine a position after some time has passed rather than get comfortable with a name

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sitting in our portfolio for 7 years.

**G&D:**
With that background on your philosophy and fund strategy, can you talk about how you identify compelling ideas that fit within your transformational corporate action playbook and are reasonably expected to play out in that investment timeframe?

**EJM:**
Well, first, we filter for all the special situations – like mergers and spinoffs for example. Some ideas can be quickly pushed aside if we're not going to understand the business drivers or if there is limited forward visibility in the financial results. Other ideas might initially pique our interest, but after half a day of work we'll determine it's not for us.

We also really like the combination of a new management team entering or initiating a transformation at the company. We will determine the quality of the new management team that's being brought in or promoted and whether they are right for the situation at hand. Have they executed something like this before?

At any given time, there are dozens of these events transpiring and sometimes they're interesting right away. Sometimes it's not interesting for one reason or another and we want to take another look six months later. There's a consistent pipeline of companies going through these transformations, and that's where we're looking for our ideas.

**G&D:**
Can you talk about why your approach to all ideas as potential longs is your preferred method for working smart and managing your time efficiently?

**EJM:**
That's also a really good question. I like to say that my day job is finding companies for us to invest in for three to five years. We do work to understand the business, the competitive environment, the transformation being executed, and management. When we approach every opportunity as a long, we can disqualify some names right away, put other names "on the backburner" and follow them in the event something changes, and identify those names that fit neatly into our circle of competence as potentially very interesting long-term investments. For the latter, we keep doing the work to get to know the company better.

Through more diligence, perhaps we find that the balance sheet is of low quality, and we don't think it's going to get better. Or perhaps we find a big red flag in the business that would have caused us to push it aside immediately if we had known it upfront. Lastly, perhaps we don't quite get there on the management team. For the names that do remain compelling, we'll reach out to the company to introduce our firm, begin to develop the relationship, and get both modeling and strategic questions answered.

But our process also uncovers shorts for us, albeit less frequently. We typically don't allocate any of our time to outside short ideas. What's more interesting and efficient for us is to focus on long ideas to help locate short opportunities. When we determine that the long thesis on a company is completely wrong, that is very exciting to us. That doesn't immediately mean it's a short. But that excites us when we figure out, "Here's what the long bias is and why we did the work as a potential new long idea. Here's why a top shareholder pitched it to us. However, it's completely wrong." Those are how we find our short ideas.

One example was a pitch we heard from a front-page shareholder of a smaller company. Key to the value proposition was the trading range of the company's perceived comps. Our process led us to the conclusion that the true nature of the business is entirely different than the businesses of the comps the company and the analysts were using. The "real" comps were more established companies

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that traded either in-line with the target company or at material discounts. That can be a good short opportunity – the business drivers are not what shareholders thought, and the stock is actually expensive. We expect the shareholder base will have to change over as soon as it becomes apparent to everyone that the business, the balance sheet and/or the management team are not what they thought.

***"What's more interesting and efficient for us is to focus on long ideas to help locate short opportunities. When we determine that the long thesis on a company is completely wrong, that is very exciting to us."***

In 2023, we were short an AI related company that was obviously getting the halo benefit of being an AI beneficiary. We thought that even though in the near term they were an AI beneficiary, they were in fact destroying their own business by making money selling their data to AI companies. So, not only did that data-related EBITDA not deserve a multiple, but it would ultimately turn a corner and lead to a degradation in the financial results of the company.

That worked very, very well. We covered that at a 50%+ loss in the stock. Through that research process, we ended up doing a lot of work on one of their public competitors. That public competitor is slightly different in that only one of its two segments is going to be disrupted by AI and it was 5-6x leveraged. The 50% return we got on the first short was a company with a clean balance sheet. AI short #2 is a leveraged company, and we think half of their EBITDA has significant risk to it.

I think this is probably answering a different question than just our efficient approach to sifting through stocks. But while we're on the topic of shorts, I think we should have been putting on larger short positions than we have. I think that we had a lot of conviction on a few of these that we were right on, and in hindsight, they should have been larger short positions and will be in the future if the opportunity presents itself.

To put a fine point on your efficiency question, we think not focusing on the short side helps our efficiency on the short side. Our process limits us to just the dumpster fires – the alpha short opportunities that we think shareholders of the stock don't understand.

**G&D:**
Can you talk about how you go about vetting management, their track record, and why the team is right for the particular opportunity that you've selected?

**EJM:**
Every situation is different. The first thing we do is listen to past earnings calls and management presentations. I prefer listening to calls rather than reading them as I think something gets lost when you're just reading the words on paper and missing the tone. In-person meetings are obviously the most valuable, but listening to the calls is a good start.

We don't like over-promotional management teams, so the first thing we want to see is the track record of the CEO or CFO at this company or at previous stints at public companies. We want to understand how their quarterly, annual, and long-term results stacked up against their guidance. Then we try to research the actual value they drove versus being part of an overall great outcome, which is sometimes very hard to discern. I find that investors often latch onto a great story with a great outcome, either a successful sale that profited investors or great results with terrific stock performance. It's worthwhile – if possible – to find out whether this management team was really driving that.

That can be hard to figure out, but that's

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been a factor in a couple of cases where the person that took over the company wasn't really a value driver. There's a spinoff we looked at where part of the story was that the CEO had created a ton of value in another company in the same industry and sold it to a bigger competitor. In our diligence, it wasn't that clear to us this person created so much value. It may have just been great timing for him or her – the company fit exactly what this particular competitor wanted to acquire. But I don't know whether the management actually created that much value.

> ***"I prefer listening to calls rather than reading them as I think something gets lost when you're just reading the words on paper and missing the tone."***

I usually ask our business school interns to spend some time each day on LinkedIn looking through the connections of a management team and trying to get in touch with them. If once a week we send out messages to five people who know someone on the management teams that we're looking at, hopefully over the course of a month, we will get a couple of people willing to speak with us. I think nothing replaces two things: 1) interacting with the management teams, which we consider the most important thing; and 2) trying to learn about their past experience and the value they've created at other companies.

**G&D:**
And talk to us about the situations where you feel that your partnership with the management team adds value and how you try to add that value?

**EJM:**
We don't take activist positions and we don't write public letters. We write a monthly letter to our investors, which we use to interact with management as well. Every letter focuses on one of our portfolio companies, and I'll usually send that to the management team of the company instead of addressing a letter directly to management. We communicate our thoughts through that process.

Most of it is usually positive, hopefully. It's important to acknowledge that we know very little compared to the people running the company, and we strive to come into situations with appropriate humility. We don't want to lead our communication with management by being overly prescriptive or telling them what to do. We feel the humility and research-based way we express ourselves comes across in our conversations with management and makes those relationships more productive.

I think that approach creates an environment that leads management to seek our view of things every so often. We've had management teams in conversation tell us they enjoyed our letter, agree with our perspective, and want to delve into a topic with us. "What are your thoughts on the balance sheet? What are your thoughts on capital allocation? Would you love us to pay a dividend or not? Doesn't mean we're going to do what you're saying. We're curious as to your thoughts."

We're never going to say, "You need to buy back your stock now." We might say, "Listen, you're inside the company, you know more than I do about the headwinds or tailwinds that you're experiencing right now. The worst thing to do is to buy back stock and then come out next quarter and disappoint everybody. Don't do that. We'd love you to shrink the share count over time because we think your stock's worth two or three times what it's trading for, but we'd love for you to do that at the right times."
If a business has tailwinds, or they announce a great deal, yet the market doesn't understand it and the stock's down a lot, a buyback can be very accretive. It is a great decision especially if management has

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conviction that they can meet or beat future expectations – that's a company that should start buying stock now. A lot of times we will ask them questions to get them thinking. They're smart and capable leaders and of course they're already thinking. But we will ask questions such as, "Have you considered an accelerated share repurchase program?" We can learn a lot from hearing management's answers to questions like that. If you have a company that's going to buy back stock programmatically, it doesn't mean they're not creating value. They could be doing a great buyback. But that doesn't tell you as much about their thought process today regarding the value of the company.

Conversely, when I engage with a company and ask, "Why'd you just announce a billion-dollar buyback? That sounds like a lot," and the answer is, "We think we might want to be aggressive when the stock is weak. We love what's going on in our business, etc.," obviously that's a bullish response. I don't love it when management teams say to us, "We have a balanced approach to capital allocation. We're paying a dividend, we're buying back stock every quarter, and we're looking at M&A." I think companies should be doing the best thing at all times with our cash. They shouldn't pay dividends if buying back stock creates more value. They shouldn't buy back stock if they can acquire a competitor for a lower multiple that also has strategic rationale, brings synergy opportunities, improves the growth profile of the company, and is potentially accretive to margins.

Management teams ask us what our thoughts are, but we learn a lot more about the company in those conversations by focusing on how management rationalizes their decisions. We get to see how comfortable and convicted they are. We get to see how nervous they are about competitors. Every situation is different, but when we engage with management and they ask us thoughtful questions, we find that very valuable.

And if we can help management in some other way we will do that as well – whether introducing them to new investors or to companies we have relationships with that could help them. In one situation, we brought very good funds into a secondary offering that one of our portfolio companies was doing. All of these things help management, the company, and us shareholders as well.

**G&D:**
Thanks, that's very interesting. Before we move from research to portfolio construction, a question: do you typically conduct your own primary research, or do you rely on other types of resources?

**EJM:**
We don't rely on any other research organizations. We do all our own primary research. It doesn't mean we never will. But I think that there were times in my career where I had access to certain data that – while it provided some insight – was never comprehensive.

Let's take expert networks for example. When I want to read about a call that one of these expert networks has conducted, I can get value from it. But sometimes it's very anecdotal. I recall speaking to someone who was at a competitor company, and they were trashing the company I was focused on. There was both helpful information and also some clear bias. It was difficult to know what – if anything – to do with the information.

However, I do like to know what the chatter is inside an industry is. That's another use for LinkedIn – to find people beyond management to learn more about an industry. The investment community will talk about numbers and valuation, but we also want to know what people in the industry are talking about, if possible. Those can be very different conversations. Our current approach to organically sourcing

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industry chatter works well for us. But we can always evolve our approach if it makes sense to do that.

**G&D:**
Great. On the portfolio side, can you talk about your approach to building the portfolio and how you think about balancing risk and reward, especially regarding factor exposure and concentration, for example?

**EJM:**
I'll start with concentration and sizing positions. Our top five positions usually amount to 50%+ of the portfolio, because we have the highest conviction in each of those business opportunities or management teams. Positions three through five are each sized at roughly 5% of our capital, plus or minus a percent. That is the core of the portfolio. We might also own a small position in a few stocks that we believe have the upside we're looking over the coming years, but whose businesses or management teams we are still trying to gain more conviction in.

What I want to avoid is investing in any company that causes me to freak out the night before the earnings release. Anyone who's been an analyst at a hedge fund knows what that's like. Businesses like that tend to disappoint, if not immediately, then over time. We try to stay away from those. If there is any element of the business that is not as good as some of our other businesses, those are smaller positions. But if it's actually an unpredictable, volatile business – we try to avoid it.

This is true even if the other factors are extremely compelling. The company could have a credible path to increase their margins substantially or maybe we think the company is a takeover target. We have to ask ourselves how much we love the business. Revenue visibility, pricing power, moat, and balance sheet can all play into that determination – but they must be addressed. If it's not as good as our favorite ideas, then it's going to be a small position, or not a position at all.

**G&D:**
How do you think about industry exposure at a broader portfolio level?

**EJM:**
We're not a factor-focused fund. If we own more than one company that will benefit from the same tailwind or event, and I'm very convicted on that tailwind or event, I'm happy to benefit. But generally, looking at industry, while it's not my primary focus, I still don't want to have seven out of our twelve positions in the same industry. For example, in the first couple months of the fund, we had a position in a company called SPX Corp (SPXC) that was in the HVAC space. I had followed the company and had been meeting with the management team for many years and had a lot of conviction in the company. We'll get to specific names later in the interview, but I wanted to make room in the portfolio for some new names that we considered to have superior alpha potential. So while we had conviction SPXC was going to be a $100+ stock, we ultimately sold our position after it more than doubled, in order to allocate capital to that factor in a more alpha generative way.

Today, we are spread across media, consumer discretionary, and industrials. We'll also have data and information services companies from time to time, and less frequently a position in a financials company. Sometimes we have a bit more exposure where we have a bit more knowledge. We are a generalist fund, and while I did two years of banking in the power and utility space, our view is that industry-focused experts in resources and power will outperform a generalist fund over time in those niche-type industries. You can throw REITs and biotech into that bucket as well. There are ways to make money investing in those industries, we just don't feel that's our sweet spot.

**G&D:**
You talked about how your fund's approach has

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been primarily based on lessons that you learned prior in your career. You also spoke about the opportunity of sizing up shorts more over time might generate more alpha. Can you talk about lessons in your career – on a specific company basis or in terms of portfolio construction – that you've come to appreciate, and how those inform your philosophy going forward?

**EJM:**
I wrote an investor letter in 2023 introducing a new investment to our LPs. To introduce that stock, I wrote a very brief abridged case study of a company that was a significant position of mine at Corsair. That company was Installed Building Products (IBP). About ten years ago, I received an email from one of the banks running the IBP IPO introducing me to the company. IBP is an installer of residential insulation. I became pretty interested in the business. I'll pause and say that curiosity is essential to success in this business; if you don't love what you're doing, this business – like many others – is just too hard.

Anyways, there were a couple other companies that we were looking at, including one building materials company we owned that was a position of mine. If you rewind back to 2014, the topic of housing starts was very prevalent in financial circles. The recovery from the Great Financial Crisis that began in 2010 was slowly filtering back into new home starts. One area of focus for investors back then was whether the economy would return to 1.5M housing starts. At the depths of the financial crisis, we were at less than 500k. I became interested in the residential and commercial construction markets, which could help me with some of my names – so I attended the IPO roadshow for a small company thinking I might learn something. I was fascinated as I sat through the 90-minute IBP road show, without even knowing the numbers yet. Founder & CEO Jeff Edwards and CFO Mike Miller presented a compelling case for rolling up the industry.

I think there are three valuable lessons from my IBP experience. First, as trained value investors, it's in our DNA to focus on the numbers. But if you only look at the numbers and get deep in those weeds without picking your head up, you can miss the bigger picture. I went to a roadshow and was pretty sure I wanted to invest in the company before I even knew any of the company-specific numbers.

That leads me to the second lesson: focus on the management team. At these road shows, many of the investors are sitting, eating, and networking with each other. I take a different approach; I want to hear every word the management team says. When the presentation concludes, I will walk right up to the front. If I can talk to the CEO, CFO, or chairman of the board – I am going to make the most of that opportunity. The interesting management presentation at the IPO roadshow led me to following management around for as long as they would tolerate me. I've even had scenarios where I am literally in the elevator with management after the presentation and then walking them to their car as they try to run away from me.

The third lesson, which may be the most important, is: it doesn't matter where the stock has been, it matters where it is going. This theme can play out in a couple of ways: 1) never let yourself believe you have missed an opportunity just because a stock is up a lot; and 2) selling stock because you've already earned a high return is not a great reason to sell a stock. Both of these were at play in the IBP story.

On its way to becoming a "twenty-bagger," IBP offered new investors many opportunities to buy the stock, but it was easy for them to think they "missed it." It also offered current shareholders many opportunities to sell because "it was already up so much." Inevitably, some investors made the mistake of thinking they

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"missed it" when they saw the stock chart after it tripled. It was a "7-bagger" from that point forward. Other investors who had the great fortune of owning IBP, inevitably made the mistake of selling way too early because it had done so well. Both examples teach the same principle: it doesn't matter where a stock has been, it matters where it's going.

This also brings us back to one reason we launched Bryant Street: duration. Once we've built deep conviction, why sell a stock when we believe there is still value to unlock? Having earned a great return is not a reason in and of itself to divest a position. The same is also true when a stock is weak. If we believe the business is worth a lot more over the three-to-five-year duration, you can add to the position and do very well if you are thinking rationally. The stock being lower is not a reason to sell it. It might be difficult to live through, but you have to trust your process and buy more if the thesis is intact.

Shareholders who are selling are not stupid, but many are not incentivized to contemplate what will occur years into the future. They are selling because they need to make money this month, this quarter, or this year. Their time horizon is fundamentally shorter-term.

Going back to IBP, who was rolling up installation businesses, you had temporary decreases in EBITDA margin as they integrated tuck-ins over time. Those bumps might have caused the stock to temporarily trade off, but over our time horizon, the long-term value of the business had increased. So when you have conviction in your investment process and conviction in a particular investment, you can size that position up when the market becomes backward-looking. Adding to positions in those scenarios can generate very strong incremental performance.

***"It doesn't matter where the stock has been, it matters where it is going. This theme can play out in a couple of ways: 1) never let yourself believe you have missed an opportunity just because a stock is up a lot; and 2) selling stock because you've already earned a high return is not a great reason to sell a stock."***

**G&D:**
That is a terrific example. We feel compelled to transition from the IBP case study to your position in Limbach Holdings Inc. (LMB). Can you talk through the thesis, how you originally discovered the company, and why you're so excited about the opportunity?

**EJM:**
LMB hit our radar when they announced a new CEO. Mike McCann was the COO of the company, having spent his entire career there. He's been at the company for 20 years or so at this point. He worked his way up, became the COO and then was promoted to CEO. So, we discovered this company undergoing management transition and started doing the work. And the more we looked at it, the more it reminded me of IBP.

At the time, LMB's market cap was about $300M, well below our portfolio's median market cap of ~$4B. Our sweet spot tends to be the $1-$10B SMID cap space, but we're not overly dogmatic and are happy to invest in smaller or bigger companies as we find compelling opportunities. But we focus on that SMID cap wheelhouse because we find that companies in that range can generate real strategic value on both sides of their ecosystem, beyond just their core operations. SMID cap companies are large enough to do accretive tuck-ins, which present value creation

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opportunities through synergies and economies of scale. Companies in this market cap range also have exit opportunities as acquisition targets for larger strategic competitors and private equity firms. Even though we do not rely on take-outs, we do like to gain conviction that our portfolio companies hold strategic value to other companies. For $1-$10B market caps, both sides of their ecosystems are available as potential levers to pull to drive value for shareholders. Limbach is on the smaller side, but it still has both elements.

The first thing that stood out was net cash on LMB's balance sheet. There are not a lot of industrial companies with net cash on their balance sheet. A lot of value can be created with this balance sheet. The next thing we uncovered was that expectations were way too low. Consensus for 2023 was $30M of EBITDA. We couldn't get anywhere below $40M of EBITDA when we modeled it out. So it seemed like a great opportunity in the short-term with a lot of long-term potential from allocation of capital.

However, an operational transformation is really what hooked us in. Historically, LMB was a general contractor for non-residential construction. The company managed buildouts of data centers, factories, warehouses, distribution centers, etc. They were active in healthcare, education, and universities as well. As a GC, salespeople were incentivized to drive revenue and backlog, with little focus on margins. The business was lumpy, and cash generation was unpredictable. Those are not the attributes of a business that we like to invest in. That was 80% of the revenue.

The other 20% was the byproduct of that business. At the conclusion of many of these buildouts, some customers would say, "Hey, any chance you can maintain or service some of the systems in the building?" The services business focused on HVAC, plumbing, electrical systems, mechanical systems, elevators, escalators, etc. That was the byproduct of the GC business, but not the focus of the company. The COO we mentioned, Mike McCann, began a transition toward inverting that 80/20 business mix a couple of years ago.

McCann looked at the business and said, "Wait a minute, 20% of our revenue is ODR (Owner Direct Relationships), where we're doing maintenance and services. That business is more predictable and has higher margins. Why are we focused on GCR (General Contractor Relationships), which is low margin and unpredictable?"

We did work on LMB in the first half of 2023, after McCann was promoted. LMB had already accomplished plenty and the stock had more than doubled by the time we were getting excited. The ODR revenue contribution had already grown from 20% a few years ago to 50% in 2023. That gave us a lot of confidence, despite the higher valuation. With proof points, we were not investing in a "pie in the sky dream;" Mike had already executed a lot of this. Now our bet is "Can he get the revenue mix to shift from 50% ODR to 80% and what would the numbers look like?"

To give you a sense of the order of magnitude, the gross margins in GCR are 10%-11%, while ODR gross margins are 25%-30%. So the mix shift alone will create step-function improvements in profitability. Beyond the mix shift to a higher margin business, there's also a halo effect from focusing on maintenance and services. Not only is LMB growing that side of the business every quarter, but it's also improving their GCR process. Now they are focusing on only the GCR projects with the highest return on invested capital. In fact, some legacy GCR projects weren't profitable – so shrinking GCR down to its best projects and avoiding the unprofitable projects will drive even more accretion.

The other major opportunity is using the

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balance sheet to roll up a fragmented industry. LMB's goal is to take their free cash flow, which is going to be $40M+ annually, and buy smaller companies. And they're starting with no debt – so there's even more capacity if they can find bigger targets. LMB recently announced a $20M acquisition at 5x EBITDA that we believe will be 2.5x EBITDA in 2026 post synergies. Pretty powerful use of capital.

The roll-up will also open up new regions for LMB. Currently, the business is concentrated on the eastern half of the US: New Jersey, Pennsylvania, Ohio, Michigan, Tennessee, and Florida. They have 20 branch locations, and they want to expand into other markets. So there's plenty of white space on the map.

Now let's talk about IBP and the similarities. IBP was doing the same thing. Like LMB, IBP spends very little on CapEx. Neither of these companies holds much inventory, and if they do, it's for a matter of days. So as an investor, I'm not taking material balance sheet risk in terms of inventory and working capital.

Since I don't need to use my capital there, it can all go to M&A. That's what IBP did, and they were rolling up companies at single digit multiples. On day one of IBP owning a tuck-in, the purchase multiple was even lower just from the synergies of integrating a local service provider onto a bigger platform with economies of scale. The IBP approach was to direct free cash flow toward accretive tuck-ins. LMB is going to do the same thing: keep allocating free cash flow toward rolling up mom and pops for mid-single digit multiples of EBITDA that will ultimately trade at a higher multiple within consolidated LMB. I have the pattern recognition because I've seen this with IBP already. The better thing about LMB is that their balance sheet is net cash.

Starting this roll up journey with net cash is very attractive. Investors don't need to assume any leverage on the balance sheet to get to very attractive growth. When we first looked at the company, they were doing $30M of EBITDA. It has already doubled a year and a half later. And we feel that EBITDA can double again from organic growth, margin expansion, and M&A over the next three years with no debt. But I have actually encouraged Mike and the team to take on some leverage and do even more deals if they can. That would accelerate value creation.

Over the next two years, we expect LMB will reach $100M in run-rate EBITDA and have almost zero CapEx – so I'm paying 9.0x. I'm very, very comfortable buying LMB here because comps like Tetra Tech (TTEK), Comfort Systems (FIX), Trane (TT), AAON (AAON), and even SPX (SPXC) trade for 20x-25x 2025 EBITDA less CapEx. While LMB stock has almost tripled since we bought it originally, we've bought more on the way up. We think that there's a lot of value here that they can create, and we have significant conviction that they'll create it. Our most recent discussion with management was very encouraging. They have built a lot of confidence in their M&A strategy now that they've done it four times.

> ***"The IBP approach was to direct free cash flow toward accretive tuck-ins. LMB is going to do the same thing: keep allocating free cash flow toward rolling up mom and pops for mid-single digit multiples of EBITDA that will ultimately trade at a higher multiple within consolidated LMB."***

LMB is a great example of what we're looking for. We try not to focus on opportunities that are just financial engineering. We want to focus on management teams that are improving the operations

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of a company, which should result in stronger competitive positioning, better free cash flow and capital allocation opportunities. Mike is improving the company through a mix shift and an M&A strategy. And we have real conviction from the fact that they have already demonstrated that they can execute what they're telling me they're trying to do – and it will flow through their P&L.

*Top: EJM with VRT Chairman Dave Cote (right) and VRT CEO Gio Albertazzi (middle)*

*Bottom: EJM with VRT CFO David Fallon*

**G&D:**
That's extremely compelling. You have the mix shift that's more cash generative, you have a fact pattern that supports they're going to be able to execute that mix shift, and then you have a great use of the cash. We all had an opportunity to read your letters and LMB sounds like a really exciting opportunity.

Perhaps we will transition to Vertiv (VRT). Can you run us through the thesis there, and similarly, how you found the company and got excited about it?

**EJM:**
Vertiv is a much bigger company today than when we first looked at it. Its $50B market cap is the largest in our portfolio by a large margin. When we first got involved, it was right in our wheelhouse with a $6B market cap. Historically, Vertiv was the Network Power business inside Emerson (EMR). They sold that business in 2016 for $4B at a low teens EBITDA multiple to Platinum Equity, who then owned it privately for a few years.

In 2019, slightly before the SPAC trend became a boom, Goldman Sach's Raanan Agus – who is a legend in the investing world (Columbia JD/MBA '93) – teamed up with legendary executive and former Honeywell (HON) CEO Dave Cote. They set out to find a company that had a leading market share in a good industry, had margin expansion opportunities, and could create competitive advantages under Cote's guidance. VRT would be the only pure-play in the public market and boasted the #1 market share (15% at the time, now materially higher) in power distribution and thermal management products and maintenance services to hyperscale, co-location, and enterprise data centers.

Agus and Cote scrubbed through hundreds of companies before settling on VRT. We first connected with Agus and Cote in late 2019/early 2020 and I'll never forget the context. I was on vacation with my family in Disney World at the time. It was 3pm and I left my wife and kids stranded to find an empty booth in a Disney restaurant to join the conference call with Goldman Sachs and Dave Cote.

> ***"I'll never forget the context... It was 3pm and I left my wife and kids stranded to find an empty booth in a Disney restaurant to join the conference call with Goldman Sachs and Dave Cote."***

Cote talked about all the efficiencies he would implement in the manufacturing facilities and how the supply chain was an opportunity as well. He said he

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## Bryant Street Capital Management

wants VRT to "grow revenues while keeping fixed costs constant." What he accomplished previously with the celebrated Honeywell Operating System was going to be re-created at VRT. Having spoken to folks who witnessed Cote's "genius" as he walked through facilities during the SPAC process, we got very excited.

It was certainly surprising to take notes on that call about margin opportunities knowing it had been a PE holding. We all think private equity firms maximize margin. So, what more could there be to do? The first thing we did was evaluate their competitors, including Schneider (SU FP) and Eaton (ETN), to get a sense for where margins could be. Note that VRT competes with segments within those bigger companies, segments within segments really. We estimated that the comps were operating at 15%-20% EBITDA margins as compared to VRT in the low teens. Cote's projection that he could expand margins by 500bps seemed plausible, and we felt he was a better agent to unlock that margin than any private equity executive. Cote is a master at squeezing margins out of manufacturing, supply chains, and distribution networks.

One of the other highlights of Cote's pitch was investing more in R&D. At the time, in 2019 and 2020, VRT was spending $175M on R&D annually on $4B of revenue. Today, VRT is spending more than $350M on R&D. Why would he want to increase expenses if he's trying to drive margin? Because he knows from experience that innovation and higher value products create efficiencies for his customers and they'll pay you for that innovation. Pricing power is one hallmark of a great business that has a "moat." You hear a lot about moats in the value investing world from legends like Buffett, Einhorn, Ackman, and Greenblatt. Cote wanted VRT to not only be more efficient on the cost side, but to also innovate to achieve pricing power and to build a wider moat versus the competition.

Having gotten to know Cote very well over time, we also realized that the 500bps goal was likely a mid-term opportunity that he could probably outperform over time. He was highly confident in his ability to achieve it, having walked through dozens of VRT facilities. Factoring in more operating leverage as product innovation drives accelerating revenue growth made 20%+ EBITDA margins in the realm of possibility several years out. A lot has happened in the world since then, including inflation and an AI boom, but it remains impressive that VRT is above 20% EBITDA margins 5 years later. Impressive yes, but not surprising to us given our conviction in Cote and CEO Gio Albertazzi.

***"Cote wanted VRT to not only be more efficient on the cost side, but to also innovate to achieve pricing power and to build a wider moat versus the competition."***

When the company debuted, the balance sheet and its 3.5x leverage was an area of concern for some. However, our conviction in demand growth and in the margin expansion opportunity at VRT made 1.5x-2.0x leverage visible as a possibility a few years down the line. Interrupting that path to deleveraging was a very synergistic acquisition in late 2021 that the market hated given the interest rate hikes that were about to start. The stock was falling because they levered to do the deal and because inflation created price/ cost issues. Fortunately, we were able to rationally analyze the long-term benefits of the acquisition and the margin expansion that would appear once the pricing issue was fixed. That process led us to add significantly to our VRT position in 2022. We knew it might hurt our short-term performance as a fund, but that in the long-term we'd be creating a ton of value for our partners.

The original thesis was

*(Continued on page 63)*

that the great management team would deliver excellent operational execution and margin expansion, creating a ton of value in the business and free cash flow, which can be used to de-leverage the balance sheet. Once the balance sheet is healthier, you can lean into buying companies and buying back stock. Longer-term – and remember VRT was a $6B market cap back then – perhaps you have a bigger industrial company come in and buy the business, yielding a great exit for shareholders. Now the market cap is much bigger, around $50B, so some of that takeout potential has been limited, but it's only because management has done such a great job creating value for shareholders.

*EJM with LMB CEO Mike McCann*

**G&D:**
We love the set up. You have an industry-leading manager controlling fixed costs plus exposure to the secular growth of the data center industry, which is a relatively less price sensitive customer because those companies are growing so quickly and there's an arms race to take market share.

Moving on to the closing remarks section of the interview. What are some things that you do on a regular basis to improve as an investor? In tandem, what advice do you have for MBA candidates who are interested in the investment management industry and trying to improve as analysts?

**EJM**:
I think those two questions are related. When you're running your own portfolio, there's so much to learn, but I'll start with the second question on advice. I mentioned this before, but you must be curious and love doing the work. The only way to love this job is to be curious. You have to love looking at companies and understanding the underlying drivers of the results, both quantitatively and qualitatively. You need to do the work to ultimately have a view on why future results will deviate from what everyone else thinks.

Having that level of curiosity when you're starting out in the hedge fund industry is how you'll secure an internship and convert that to a full-time position. There are too many people trying to do the same thing and everyone's smart. You really need to love it. And when you do have that love, and that rare curiosity, you're going to be rewarded by learning more and more with every company you look at.

Shifting gears to me specifically, I think at my stage in the life cycle of the hedge fund business, I learn a lot from managing through different market environments and from studying the mistakes and successes of specific investments. There's so much that I've picked up in the four years since I launched Bryant Street.

I've learned a tremendous amount about my own psychology. "What is Elie Mishaan's psychology when markets are great or when they're weak, and how has that impacted the portfolio in a positive or a negative way?" That's something that I can look back at. Because over these four short years, the amount of macroeconomic upheaval and volatility has been tremendous. Economic cycles seem to be shortening.

I've been through three major bear markets in my career. The first was the GFC, when I was at Corsair. The second was during COVID. And the third, which to me was the greatest challenge, was 2022 which saw accelerating inflation, rising interest rates and a comprehensive selloff in almost every stock no matter how the individual businesses performed. Those factors and the fact that many

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stocks saw drawdowns of more than 50% made 2022 particularly difficult. Fortunately, we trusted our process which led us to invest heavily into our favorite ideas at very low prices. While that hurt our performance in 2022, it ultimately led to great performance for us in 2023 and thus far in 2024.

I have said that, in 20 years, I am certain that I will look back and say 2022 was the most important year of my career. I think in that type of market, we could stick to our knitting of being long-term investors and not traders, but still manage the portfolio better. In the second half of 2022, we sold a handful of smaller positions and allocated that capital into our favorite names, as mentioned. I think we could have acted more quickly to sell out of the smaller positions. In that type of investing environment, I think it makes sense to both conserve capital more quickly and rely solely on the highest conviction names. Everything else can go, ride with the best names. Had we acted sooner, we still would have had negative performance for the year 2022. However, 1) the drawdown would have been smaller, 2) we would have had more dry powder to allocate to our favorite ideas at low valuations, and 3) 2023 and year-to-date 2024, as great as they have been, would have turned out to be even better.

So we have been taught a lot by the market in the four years since the launch. I also need to learn from our individual investment successes and failures. We mentioned SPXC. I sold it because the multiple eclipsed our view of fair value, and I wanted to make room for other names with similar value drivers. That stock is up another 50% since I sold it. That hurts a lot. If I just take that in a vacuum, it seems like a stupid decision. But that's not the correct takeaway, because I allocated that capital to two companies that have outperformed SPXC: one was a new position (LMB) and the other (VRT) we already had a position in but increased our exposure to. As an analyst who has known SPXC and its management team for 8 years, it hurts. But, as a portfolio manager, I recognize that we made the decision that needed to be made at the time. The goal is to invest in what's going to get you the best return from today into the future. You need to rank companies by your level of conviction and lean into your best, highest conviction opportunities.

I'll summarize by saying this: my advice is to learn from your successes and mistakes, to stay curious and never stop learning and doing the work to gain conviction. And once you've done the work and you have that conviction, trust your process and lean into the best ideas.

*"... learn from your successes and mistakes, to stay curious and never stop learning and doing the work to gain conviction. And once you've done the work and you have that conviction, trust your process and lean into the best ideas."*

**G&D:** Thank you so much for spending time with us today. We really enjoyed the conversation. It has been terrific to meet and speak with you.

**EJM:** Great, thank you guys. It's great to meet everybody. Good luck and we'll be in touch.

# Baron Capital

**David Baron**

**David Baron '09 joined Baron Capital in 2005 as a research analyst. He was named portfolio manager of Baron Focused Growth Fund in 2018 and Baron Capital US All Cap Focused Growth Fund in 2024. David was named co-president of Baron Capital in 2024. He has 22 years of research experience. From 2002 to 2005, he worked at Jefferies Group as a gaming analyst. David graduated from Emory University with a B.B.A. in Finance in 2002 and from Columbia Business School with an M.B.A. in 2009.**

***Editor's Note: This interview took place on October 10th, 2024.***

**Graham and Doddsville (G&D):**

David, thank you for taking the time. We're very excited to speak with you today. To begin, could you walk us through your background and how you first became interested in investing?

**David Baron (DB):**

I went to Emory University and graduated in 2002. After that, I worked for three years at Jefferies doing sell-side research focused on the casino, gaming, and lodging industries, before joining my father at Baron Capital, where I worked for two years. I then attended Columbia Business School and rejoined Baron after completing my MBA.

I've always been involved in investing and research, having grown up around it with my dad. I'd go through stock research with him, discuss the industry, pitch stocks, and really explore what makes a good business in addition to what makes a good stock. I focused on understanding the value drivers for stocks and examined not just the income statement, but also the cash flow statement and the balance sheet. I wanted to ensure businesses were sustainable and had something competitively unique about them that others couldn't replicate — features that could help drive pricing power and growth in the future.

**G&D:**

That's great. Could you share how your early exposure to investing shaped your perspective? What — whether family, mentors, or influential books — has had the most significant impact on your investment philosophy?

**DB:**

With my dad in the business, I was involved in stocks and managing portfolios from an early age. In high school and college, I gained experience by running portfolios in economics classes and reading various books about investing and marketing. I studied finance at Emory's undergraduate business school, which gave me a solid background in the fundamentals. I enjoyed what I was doing in my classes, and that led me naturally to equity research on the sell side after Emory. I really believe that if you like what you're doing, you'll be successful at it.

**G&D:**

Great. Can you give us a brief overview of Baron Capital? What do you think has been the key to its long-term success, and how has the firm's investment philosophy evolved?

**DB:**

Our investment philosophy has remained remarkably consistent over the years. It's the same approach we've followed over 42 years, focused on long-term investments in unique and differentiated companies and, importantly, in people. We strive to understand what makes a particular company special, whether it's a technological advantage, a distinctive product, or unique data that's been built up over 25 years. Management is also very important; we want to be sure their interests align with ours. Ideally, management owns a significant portion of their net worth in the company.

We also look for large addressable markets where the company can penetrate and disrupt. If a company has that large addressable

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market, a unique ability to capture a sizable share of it, a balance sheet that can finance growth, and high returns on capital with strong pricing power then we're all in.

When a stock's price declines on earnings due to a margin miss, often caused by investments in growth, we often see that as an opportunity. Many investors focus on the short-term, but at Baron, we use these price dislocations to either initiate new positions or buy more when the opportunity is attractive. If insiders are buying more stock, that further strengthens our confidence in the investment thesis.

***"We strive to understand what makes a particular company special, whether it's a technological advantage, a distinctive product, or unique data that's been built up over 25 years."***

**G&D:**

As a co-portfolio manager on the Focused Growth Fund, how do you go about identifying high-growth opportunities? What factors are most important when determining if a company has sustainable, long-term potential?

**DB:**

It's more just making sure that there is something unique about the opportunity. It might be a technological advantage that competitors can't match, such as with Tesla or SpaceX, or a data advantage that's been built up over many years, like with FactSet, MSCI, or CoStar. We also seek companies with large market opportunities — like the cloud in software, which benefited companies such as Guidewire Software. We prioritize businesses with high rates of return on invested capital and those with robust balance sheets and strong cash flow profiles, enabling them to self-fund their growth.

Also, insiders having large stakes of their net worth involved in the business and expected continued growth are important features. We ideally like to see low turnover in the employees of the business, both in middle management and executive management. Finally, just to reiterate, it is important that the business can continue to grow without taking on more debt or equity and can fund the growth themselves.

**G&D:**

Can you talk about how you generate new investment ideas? What are the most critical aspects of your research process when assessing potential new ideas for the portfolio?

**DB:**

Our investment team comprises 45 individuals, including 12 portfolio managers and the rest as analysts. Each member is sector-focused, so everyone develops deep expertise in their specific industry, pitching their best ideas daily, and emphasizing leaders in the field. Hedge funds might have different horizons or quality requirements, but even the best companies can experience downturns. At Baron, our focus is on revenue growth, ensuring that our companies have substantial market opportunities to penetrate.

This is why, at Baron, we focus on revenue and ensuring that there are large opportunities in the market that our companies are penetrating. We are looking for double-digit annual revenue growth in these businesses. As long as we see that double-digit growth rate and our thesis is correct, we will use downturns to continue to buy a company's stock. For our thesis to be correct, the company should not be seeing new competition, or if they are experiencing competition, the market should be large enough that the business continues to grow at a steady rate. We want to see this steady growth and improvement both in the business and the drivers – that is, whatever the KPIs we are focused on.

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*"We are looking for double-digit annual revenue growth in these businesses. As long as we see that double-digit growth rate and our thesis is correct, we will use downturns to continue to buy a company's stock."*

**G&D:**

Over the years, what has your due diligence process looked like when evaluating new ideas?

**DB**:

My process centers on constantly speaking with management, not just every quarter after they report earnings, but every month as well. We go beyond just having management visit you in your offices, but actually get on planes and visit them at their headquarters, as we believe management is typically more open with us there. This is partially why COVID was so difficult for us because we were all at home working on our laptops, and that is not conducive to collaborating and running a business, especially one that is so people-oriented like investing. It is imperative to have that face-to-face interaction, which is why we are all in the office five days a week. We believe that we work better together and make fewer mistakes, which is the goal and my father's philosophy. Of course, everyone makes mistakes, but we focus on learning from our mistakes and improving for subsequent investments. One way of improving and minimizing mistakes is through analyzing our more successful investments. We examine why those investments were successful and apply that to other investment theses.

**G&D:**

Have there been any noteworthy lessons that you have learned over your career or any areas, topics, or investment ideas where you have changed your mind that you want to highlight?

**DB:**

Ultimately, investments rest on the CEOs and CFOs and their capital allocation decisions. As soon as I see management misallocating capital, I know it's time to sell and move on. Misallocation can appear in many forms — companies not achieving expected returns, investing capital in areas without generating value, or acquisitions that fail to be accretive.

In such cases, regardless of the stock's price, we'll exit the position. There are too many other opportunities to hold onto a position where we lack confidence in management's decisions. Capital allocation is one of the core responsibilities we're paying management for, so if they're not performing there, we move on.

**G&D:**

Could you talk about your view on SpaceX, how did you get involved and what is your conviction around the management team?

**DB:**

Our involvement in SpaceX began through our investment in Tesla. It was difficult to get equity in SpaceX, but after completing our due diligence and concluding that the company would make an interesting investment, we were able to secure capacity through our relationship with Elon. SpaceX operates two different businesses: the launch business and the Starlink business. The reusability of SpaceX rockets allows for cost reductions of around 70% compared to competitors. While other companies charge $100-200 million for a launch, SpaceX does it for $10-15 million, and we expect costs to continue to decline over time. The fact that even competitors use SpaceX for their launches is indicative of its advantage.

SpaceX is leveraging its launch business to drive the Starlink business. If customers want to use SpaceX rockets to launch satellites into space, they must also give SpaceX some of their

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wireless spectrum to help Starlink's business. As SpaceX is now effectively a monopoly, being the only one who can do these launches, the company is leveraging that power to make their service the best. I think the fact that airlines and cruise ships are using Starlink, and that it is become more commercialized is important for SpaceX. It validates the technology and thesis. Starlink has 4 million members today and there are 3 billion people without good internet service, so there is still a huge market opportunity to grow and expand, and satellites are the optimal path. Being the leader on the launch side is what has enabled SpaceX to pursue this opportunity set.

SpaceX has a great cash flow and balance sheet profile. They are not burning cash. We'll see whether the company is listed publicly or not over the next couple of years, but that should be positive for the stock as people are clamoring for the equity.

**G&D:**

Were you initially excited about SpaceX because of Starlink, or was it the launch business?

**DB:**

Starlink was what truly excited us. The launch business itself was initially riskier. SpaceX was nearly bankrupt during its startup phase due to these launches. Now that the launch business has been proven, the risk has significantly decreased. Similarly, investing in Tesla today is much less risky than it was eight or nine years ago when it was on the brink of Chapter 11. Both businesses are much more stable today, with strong balance sheets supporting growth, making them easier to invest in than a decade ago.

***"Starlink was what truly excited us. The launch business itself was initially riskier."***

**G&D:**

On a position like SpaceX, how do you think about liquidity and potential exit opportunities?

**DB:**

Eventually, SpaceX will likely IPO, which would provide us with liquidity, but we'll hold onto our position even then. We see significant growth in the business and aren't looking to exit just because of an IPO. We want to avoid taxable gains and unnecessary distributions for our investors, so our thesis on SpaceX remains intact whether or not they go public.

**G&D:**

For the next position, could you talk about Spotify and your thesis for the company?

**DB:**

At its core, Spotify is a great platform. The company has a well-known brand and it continues to invest in improving the platform through adding new services, podcasts, and audiobooks. Spotify's goal is to make the platform the best that it can be. People are concerned that while Spotify has approximately 30% share of the market today, their product is a commodity given Apple and Amazon also have offerings. However, in our view Apple and Amazon have many other offerings to worry about than music. Their music businesses are secondary to their respective businesses, whereas with Spotify, music is their core business. As previously mentioned, Spotify has 30% of the market with 600 million subscribers; however, only 200 million of those subscribers pay for the platform. In other words, there are 400 million that don't, and there's an opportunity to upgrade them away from the free offering. Furthermore, as Spotify improves the service, more people will be willing to pay for it.

As we have established, Spotify has a huge base of subscribers, and the company believes that in the next four to five years, it can grow from 600 million to a billion subscribers. Spotify is also raising prices and all of the price increase falls right to the bottom line. Spotify is able to raise prices without

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experiencing significant churn, which is similar to Netflix. Customers are willing to pay $14, $15, or even $16 a month as they are listening to music daily whether in the car or when they work out. There is leverage in the business model, and Spotify continues to grow at a 20% plus rate, given the subscriber growth and price increases. Spotify is able to generate strong gross margins that we think can continue to increase with price hikes and decreasing churn.

Spotify also has a strong cash flow profile. The company generates significant cash with strong free cash conversion and low capital intensity. Its balance sheet is solid, with a net cash position, and over the next six to 12 months, we anticipate a capital return program, either through dividends or buybacks, which would benefit investors. A potential dividend could attract dividend-focused investors to the stock. Furthermore, Spotify is founder-led, with Dan Ek holding a 15% ownership stake, aligning his interests closely with ours.

We expect Spotify to continue achieving 20% + revenue growth as the business performs well. While some view Spotify as operating in a commoditized market, we believe that the record labels need Spotify as much as Spotify needs them. Labels rely on Spotify for distribution, which helps drive demand for new songs. Eventually, customers might even be able to purchase concert tickets through Spotify.

Finally, Spotify's AI is going to be a game-changer. Their AI is designed to help customers create personalized podcasts, music, and playlists. Though it's still early, this AI initiative has the potential to drive substantial growth for Spotify in the future.

**G&D:**

For the last position, what is your thesis for On Holding, and how do you view the growth potential in the athletic footwear and apparel market?

**DB:**

Like the other businesses we invest in, On Holding operates in a large market with immense potential. While Nike has been investing less in recent years, On has seized the opportunity to create a better sneaker. They've focused on enhancing athletic performance, especially for marathon running, and are now branching out into other activities, such as tennis. They recently signed athletes Ben Shelton and Iga Świątek, using this marketing momentum to expand into apparel. Historically, On's growth has been primarily domestic, but there are substantial opportunities in Europe and China. Although they're based in Switzerland, they're still gaining market share even there. In addition to Switzerland, they see a global market opportunity, and with On being only 10% the size of Nike, there's considerable room for growth.

In comparison, Nike is seeing flat or declining growth, down 5-10% this year, while still trading above a 20x EBITDA multiple. If On's business can double its earnings over the next two to three years, we believe it should trade at a much higher multiple than Nike. Last year, On generated $2 billion in revenue. We anticipate this to increase to $4 billion by 2026, with the potential to raise their margins from 15% to 20%, meaning EBITDA could go from $600 million to approximately $800 million.

*"If Nike is trading at 21 times earnings while its business is shrinking 5-10% annually, and On is growing 25-30% annually, we believe On should be valued at 30-35x EBITDA."*

I mean, what's that worth? If Nike is trading at 21 times earnings while its business is shrinking 5-10% annually, and On is growing 25-30% annually, we believe On should be valued at 30-35x EBITDA.

Those numbers would

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imply a $25 billion business that today is trading at $15-16x EBITDA? I think that sets up for attractive returns, partially due to On still being founder-led and all the founders still owning about 30% of the business. On's management is not selling, even though the stock has almost doubled over the past 18 months. We at Baron expect to still see further gains in the industry.

On is also expanding into apparel. Their focus isn't solely on sneakers and footwear; they're targeting the significant opportunity in apparel as well. On has been seeing strong attachment rates from customers who buy their sneakers, and we believe these rates will continue to improve as they grow.

**G&D:**

As an investor, what are the things you do regularly to keep improving?

**DB:**

I am constantly on the phone with our companies and talking to them. We're not solely focused on quarterly earnings. Instead, we look at dislocations and price drops as opportunities to either buy more of a stock or initiate new positions. We also ensure that even if a stock's price increases significantly, we can still aim for low double-digit to mid-teens returns over a four-to-six-year period. Our focus is on maintaining our long-term approach and building significant positions in our companies.

I think of our business more like private equity investing in the public markets, taking big positions in public companies and holding onto them for the long term. The average investment holding for our firm is approximately eight years, as of today. We want to make sure our clients understand that and that our clients' investment horizon is the same as ours. While our investment horizon may be slightly shorter than that, our goal in the future is to increase our clients' investment horizon, so we are not having to sell stocks to meet redemptions and sell stocks at bad prices when we see strong future potential for that business. We do not want to be selling at poor prices below where we think the business is intrinsically valued.

*"I think of our business more like private equity investing in the public markets, taking big positions in public companies and holding onto them for the long term."*

**G&D:**

Do you have any advice for MBA students looking to break into the investment management industry? What qualities do you look for when hiring analysts?

**DB:**

We look for individuals who are engaged with the markets, actively building their own portfolios, and genuinely interested in understanding why they're drawn to particular stocks. We want to know what makes each company they choose special. Are they speaking with management teams or just investor relations? Potential candidates might not have the same access that you would on the buy side to the CFO or CEO, but they can definitely contact investor relations.

We encourage candidates to visit companies to get firsthand insights. Understanding a company's barriers to entry, its competitors, suppliers, and customer sentiment is crucial. In addition to company research, we expect primary research involving conversations with stakeholders, suppliers, customers, and competitors, leading to a comprehensive understanding of both the company and the industry.

**G&D:**

The last question we had for you is what do you like to do for fun outside of investing? Do you have any fun hobbies?

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**DB:**

I enjoy working out, playing tennis on the weekend, and spending time with my kids. I have two boys, 10 and 12 years old, and my older son is actually having his bar mitzvah this year, so we are in the process of planning for his bar mitzvah, which is always fun. I really enjoy hanging out with my family and kids, and I get to work out here and see my dad and brother every day, so that is nice for me. But I need some separation between business and pleasure, so I try to do that.

**G&D:**

Congratulations to your son and thank you again for taking the time. This has been an absolute pleasure. We appreciate you taking the time.

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***The Heilbrunn Center for Graham & Dodd Investing***
Columbia Business School
645 West 130th Street
Geffen 673
New York, NY 10027
212.854.1100
valueinvesting@gsb.columbia.edu

**Visit us on the Web:**
***The Heilbrunn Center for Graham & Dodd Investing***
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http://www.csima.info

**Contact Us:**
vlo25@gsb.columbia.edu
ameylan25@gsb.columbia.edu
jmorcos25@gsb.columbia.edu
srenaut25@gsb.columbia.edu

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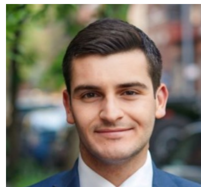
**Graham & Doddsville Editors 2024-2025**

**Vincent Lo '25**
Vincent is a second-year MBA student at Columbia Business School and a member of the Value Investing Program. He currently serves as the Chief Investment Officer at Kathmandu Capital, a concentrated value fund specializing in small- and mid-cap international equities. Before founding Kathmandu Capital, Vincent worked as an Equity Research Analyst at the Irvine Company, contributing to its long-only, U.S. equity-focused single-family office. Prior to that, he served as an Equity Research Associate at Ladenburg Thalmann. Vincent earned a B.A. in Management Science from the University of California, San Diego, and is a CFA Charterholder.

**Andrew Meylan '25**
Andrew is a second-year MBA student at Columbia Business School concentrating on investment management. He recently interned at Franklin Equity Group (Franklin Templeton) covering industrials, focusing on auto suppliers. Prior to business school, Andrew worked in direct lending in the growth-stage technology space, first at Silicon Valley Bank and then at TriplePoint Capital LLC, with experience in asset-backed and mezzanine finance. Andrew graduated cum laude with a B.S. in Accounting from Santa Clara University where he was a member of the varsity water polo team. Andrew is from Los Angeles, CA and enjoys spending his spare time in the ocean or the mountains, cycling, surfing, skiing, reading, and cooking.



**John Morcos '25**
John is a second-year MBA student at Columbia Business School and a member of the Value Investing Program. He recently completed a summer internship and continues to intern as an Analyst at Miura Global in New York. He began his career in Private Wealth Management at Merrill Lynch, focusing on third-party manager due diligence and portfolio construction. He holds a BSBA in Accounting & Financial Management from Bucknell University, graduating in 2019, and is originally from Miami, FL.

**Stephanie Renaut '25**
Stephanie is a second-year MBA student at Columbia Business School and a member of the Value Investing Program. Prior to Columbia, Stephanie was a VP in Private Equity at Caisse de Dépôt et Placement du Québec (CDPQ). Prior to CDPQ, Stephanie was an analyst in Leveraged Finance at BNP Paribas. Stephanie graduated from the Dual BA Program between Columbia University and Sciences Po with a major in Economics and Political Science.