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Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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Issue XXIV

Spring 2015



**Matthew
McLennan**



**Kimball
Brooker**

First Eagle Investment Management

Matthew McLennan and Kimball Brooker are the heads of the Global Value Team at First Eagle Investment Management. Matt joined First Eagle Investment Management in 2008. He started his career with Queensland Investment Corporation (Australia) in 1991. In 1994, he joined Goldman Sachs in Sydney before moving to New York

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**Josh
Resnick**

Josh Resnick is the founder and managing partner of Jericho Capital, a hedge fund focused on investing primarily in the global technology, media and telecommunications sectors. Josh founded Jericho Capital in 2009 with \$36 million in assets under management

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**Harvey
Sawikin**

Harvey Sawikin co-founded Firebird Management in 1994 and is lead manager of Firebird's Eastern Europe and Russia funds. He also serves on the Management Boards of the Amber private equity funds. Before

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**Eric Yip &
Mark Unferth**

Alder Hill Management

Eric Yip is a Managing Partner, Co-Portfolio Manager, and Chief Investment Officer at Alder Hill Management. Prior to founding Alder Hill, Eric spent four years at Appaloosa Management as Senior Analyst from 2010-2014, where he was responsible for the firm's equity and credit investments in real

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**Rolf
Heitmeyer
'06**

Rolf Heitmeyer '06

Rolf Heitmeyer '06 is the Co-Portfolio Manager of Breithorn Capital Management, a value-oriented investment firm with \$190 million in assets under management. The firm manages a long-only fund and a long/short fund. Prior to Breithorn,

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Welcome to *Graham & Doddsville*



Louisa Serene Schneider '06, the Heilbrunn Center Director. Louisa skillfully leads the Center, cultivating strong relationships with some of the world's most experienced value investors, and creating numerous learning opportunities for students interested in value investing. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.



Professor Bruce Greenwald, the Faculty Director of the Heilbrunn Center. The Center sponsors the Value Investing Program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners.

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We are pleased to bring you the 24th edition of *Graham & Doddsville*. This student-led investment publication of Columbia Business School is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA).

In this issue, we were fortunate to speak with seven investors from five firms who provide a range of different perspectives and investment approaches.

Matthew McLennan and Kimball Brooker of First Eagle Investment Management discuss their value approach to investing, shaped by their own respective professional histories, as well as their fund's resident value investing legend, Jean-Marie Eveillard.

Josh Resnick of Jericho Capital shares his perspectives on TMT investing, and discusses several ideas, including Amazon (AMZN), MercadoLibre (MELI), and Telecom Italia (TI).

Harvey Sawikin of Firebird Management discusses his transition from M&A lawyer to emerging/frontier markets investor focused on Russia and East-

ern Europe. Mr. Sawikin also discusses several interesting ideas, including Gazpromneft and Bank of Georgia.

Eric Yip and Mark Unferth of Alder Hill Management discuss their approach to investing across the capital structure and the benefits of bringing a credit perspective to the world of equity investing. Eric also shares lessons from his time with two legendary investors, Carl Icahn and David Tepper.

We are always proud to highlight CBS alumni, and this issue includes **Rolf Heitmeyer '06** of Breithorn Capital Management. Rolf discusses his deep value investing approach, and several ideas, including AXL, BBBY, and Hermes (RMS.FP).

This issue also contains pictures from the 18th annual CSIMA Conference, featuring Dan Loeb and Michael Mauboussin as keynote speakers. Additionally, we feature pictures from the Amici Capital Prize Competition.

Lastly, this issue includes the finalist pitches from the annual Pershing Square Challenge which took place on April 22nd.

When we inherited *Graham & Doddsville* as editors last year, we wanted to continue the tradition of providing our readership with high quality interviews and investment ideas. We also strived to provide diversity of thought and experiences via our interviews. We hope we have lived up to those objectives.

We are honored and privileged to have continued the *Graham & Doddsville* legacy, and we look forward to reading the next generation of issues, helmed by three outstanding individuals in Brendan Dawson '16, Scott DeBenedett '16, and Anthony Philipp '16. We want to thank Brendan, Scott, and newly-elected 2015-2016 CSIMA Co-President Michael Herman '16 for their commitment and dedication to *Graham & Doddsville* over the last year.

We are incredibly grateful to the investors we have met and who graciously shared their wisdom and insights with us. As always, we invite you to contact us with any feedback, and we thank you for reading.

- *G&Dsville* Editors



Keynote Speaker, Third Point's Dan Loeb, at the 2015 CSIMA Conference



Louisa Serene Schneider '06 with CBS student Jamie Lee '16 at the 2015 CSIMA Conference

2015 CSIMA Conference at Columbia Business School



Keynote Speaker Dan Loeb interviewed by Munib Islam, both of Third Point



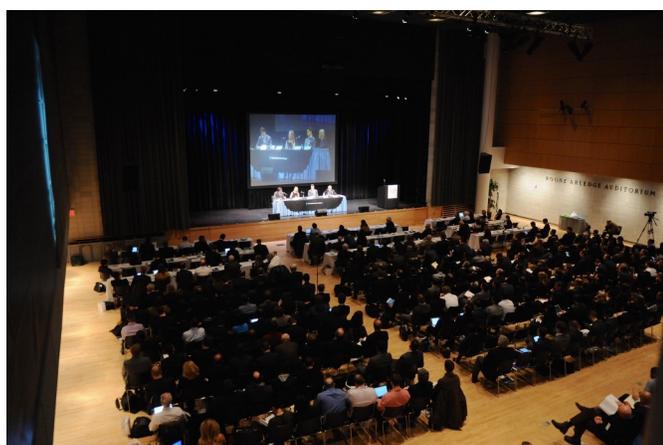
CSIMA Conference Coordinators (L-R): James Leo '15, Calvin Chan '15, Lou Cherrone '15, and Mike Appleby '15



Keynote Speaker Michael Mauboussin



Shorting in Today's Markets Panelists (L-R): Jeremy Mindich, Whitney Tilson, Anthony Bozza, and moderator Bruce Greenwald



Full audience listening to Finding Value in Uncertain Times Panelists Tano Santos, Anna Nikolayevsky '98, Rick Gerson, and moderator Jason Zweig



Best Ideas Panelists (L-R): Lauren C. Templeton, David Samra '93, Alex Duran, and moderator Rishi Renjen

2015 Amici Capital Prize for Excellence in Investing (February 13, 2015)



Paul Orlin of Amici Capital with the four finalists



Amici Capital Prize attendees



Winner Luke Tashie '15 presents his analysis of Schibsted ASA (SCH:NO), profiled in the Winter issue of G&D



Judges discuss the four ideas



Judges and attendees listen intently to the finalists' idea presentations

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First Eagle Investment Management

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**Matthew
McLennan**

to **Goldman Sachs Asset Management GSAM**. In **2003** he founded **Global Equity Partners**. **Matt** received his **Bachelor of Commerce with first-class honors** from the **University of Queensland**.

Kimball joined **First Eagle Investment Management** as a senior research analyst in **2009** covering banks, commercial services, financial services and holding companies. He joined the **Global Value portfolio management team** in **2010**. **Kimball** began his career in **1992** as a financial analyst at **Lazard Frères & Co**. From there, he joined **J.P. Morgan** as an associate in the **Corsair private equity funds**. He was named **Chief Investment Officer** of the **Corsair Funds** and managing director in **2005**. **Kimball** received his **BA** from **Yale University** and his **MBA** from **Harvard University**.

Graham & Doddsville (G&D): Tell us about your respective backgrounds and how you became interested in investing. Were there any major influences or mentors along the way?

Kimball Brooker (KB): I grew up in Chicago and had a number of family members who worked in the securities industry, spanning a few generations. So I was around financial markets and knew about them, but gained more in-depth knowledge later in my career. I'd say that the generational differences were important in shaping my views. I grew up with two strains of

thinking: one of total trepidation from my grandparents who lived through the depression and one of optimism about the markets and the US, more broadly, from family who grew up post-war.

It wasn't until college that I became more interested in investing. A friend of mine gave me a copy of *The Intelligent Investor*, which was really my first systematic exposure to investing.

“When you look back on your journey, there is often a combination of internal motivations and external mentors who help inform your mental models over time.”

Some key ideas really resonated with me. For one, **Graham**, in some ways, bridged the gap between these two competing ways of thinking about investing. He lived through the roaring '20s with a lot of enthusiasm, speculation, and leverage. He also lived through what came afterward, so he had the benefit of personal experience, with both the boom and the bust experiences in his rear-view mirror.

Graham's distinction between investing and speculation really

caught my interest intellectually. He defined an investment as something in which, once you had done your research, you could have a level of comfort based on the level of risk you are taking. What was even more interesting to me was that his work, with concepts like margin of safety, incorporated a sense that mistakes could be made, and that you could face obstacles. For me, that was a very realistic way of thinking.

After college, I worked in an investment bank and learned quickly that investment banking wasn't for me. After a few years, I landed at **J.P. Morgan** and worked for a fund set up to invest in distressed situations, particularly in financial services. I was there for about 15 years, only leaving for two years to attend business school, and then I joined **First Eagle Investment Management** in **2009**.

Matthew McLennan (MM): I was born in Rabaul, Papua New Guinea. After moving to Australia at age six, I spent most of my childhood in the state of Queensland in Australia. I'd say my interest in investing stemmed from a desire to provide a sustainable platform for wealth creation. I grew up in a house that was full of love, but without electricity. We had a wonderful home surrounded by the woods, but it wasn't connected to the grid. I guess those were formative years: you start to think about what you can do to evolve your circumstances over time.

I had the benefit, early on as a high school student, of being interested in markets, of seeing

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all the “right” mistakes made. I had one teacher who wanted to create an investment club that would predict the Dow futures using Elliott Wave Theory. You can imagine how well that ended. It was also a time, in the 1980s, when corporate raiders were doing M&A, and consolidations were all the rage in Australia. Most of those stories ended very badly; stretched businesses overpaying and overleveraging.

In college, a group of friends and I created an investment club. I received a small amount of stock in a small regional bank from my grandfather, who always had an interest in investing. While I watched people trying to get rich quickly losing money quickly, this small regional bank compounded in value at a nice clip. It taught me the importance of a well-positioned business, prudently managed and purchased at the right price.

I was fortunate to have mentors in college such as Don Hamson, a professor at the University of Queensland, who taught me early on about anomalies, such as the value effect, and a lot of theory around capital structure, which I found very interesting. I took my first job with Don at the Queensland Investment Corporation, where I ultimately ended up being responsible for the company’s global equity portfolio. The Queensland Investment Corporation was a state pension fund, a CalPERS-like entity that had quasi-privatized. Working there provided me a great opportunity to look at asset allocation as a whole and taught me about the different

styles of equity investing, because we also used external managers. The experience was formative.

I joined Goldman Sachs in 1994, and in my 14 years there, was fortunate enough to have many mentors. A few truly shaped my thinking during that period. Paul Farrell, who managed the small cap funds, had worked previously with Lou Simpson at GEICO. He introduced me, broadly, to the readings of Warren Buffett and Charlie Munger. Also, Mitch Cantor, who ran the large cap funds, had previously been at Alliance Bernstein, and introduced me to Ben Graham’s theories of paying low prices and looking for businesses with low multiples of normalized earnings power.

Later on in my career at Goldman, I was fortunate enough to be a co-founder of the high net worth investment strategy group. I worked with Sharmin Mossavar-Rahmani, who was the head of fixed income business at the time. She taught me a lot about fixed income investing and episodic investing in high yield during liquidity crises. By that point in time, I was managing a global equity portfolio and in that role we also had to make value judgments about equities and other economically sensitive assets, such as commodities, high yield bonds and currencies.

Here at First Eagle Investment Management, we are able to make all of those decisions on a single platform. Since I joined the team, Jean-Marie Eveillard and Bruce Greenwald have been very valuable mentors - Jean-Marie teaching me the

value of patience and gold’s role in a portfolio and Bruce distilling a mental model for competitive analysis and explaining how to synthesize valuation-thinking across businesses that do or don’t create value.

While at Goldman Sachs, I hired a few talented analysts who had graduated from Columbia University’s Value Investing program where Bruce’s book, *Value Investing: From Graham to Buffett and Beyond*, was required reading. His valuation thinking really resonated.

I have also been mentored by John Arnhold who astutely repositioned the First Eagle business over time with his father, Henry Arnhold, who co-managed our first fund in 1967 with George Soros. Both John and Henry have taught me the benefit of being a fiduciary outside the world of investing.

When you look back on your journey, there is often a combination of internal motivations and external mentors who help inform your mental models over time.

I joined First Eagle in September 2008, a week before the financial crisis. Sometimes great things emerge out of crisis. We’re in a business where temperament is a key asset - being patient, maintaining a long-term perspective, staying mentally flexible. Working together at First Eagle through the financial crisis reinforced the importance of maintaining prudent underwriting standards for Kimball and I. As difficult as the environment

First Eagle Investment Management



Christopher Crawford '16, Tyler Boone '16, and Brandon Cohen '16 field questions from the judges at the Pershing Square Challenge in their presentation of Fiat (FCIA).

was to navigate, it created investment opportunities and also generated solidarity for the team around its underwriting standards. It was a blessing in disguise.

G&D: *Could you discuss other ways your philosophy might have changed over time? Did the financial crisis in '08 and '09 cause you to think about things differently today than you would have otherwise?*

MM: The past decade underscored principles that we individually believed in already. As a value investor, you want to buy assets cheaply. You have to view equity as a residual claim on a business, so capital structure is very important. Identifying and normalizing earnings power as a reflection of the underlying assets and market position are very important.

Through the financial crisis, investors' learned about the nature of equity as a residual claim as there were opaque portions in the balance sheet assets of many financial firms that were large relative to the thin equity sliver. Many of these businesses had tangible equity that was only 2-3% of assets, so if you bought a business at book value, no matter what you paid for the equity, you still paid 97 cents for the assets. If the opaque portion of the assets was more than the tangible equity, you didn't have a margin of safety.

It brings one back to basic principles of investing: the true value added is often in acts of omission. I think if you look at the history of First Eagle as a whole, some of the key turning

points in the track record were acts of omission: we were not in Japan during the late '80s, even though Japan was the largest component of the MSCI World Index; we were out of tech in the late '90s, even though it was the largest component of the markets; avoided financials in the last cycle; had a limited presence in the BRICs over the past few years.

“If you look at the history of First Eagle as a whole, some of the key turning points in the track record were acts of omission [...] It's the ability not to force capital to work that makes the difference. I think the crisis really underscored those lessons.”

The thematic growth trends - all of those were great at the time - often attract a lot of capital, flowing indiscriminately to indices and index funds and worse still among competing firms. For us, the rubber meets the road one security at a time. If you look at the underwriting decisions that Jean-Marie made, or those that Kimball and I and the team have made, the acts of omission occurred when we couldn't find good businesses at good prices. It's the ability

not to force capital to work that makes the difference. I think the crisis really underscored those lessons.

KB: I would also add that, coming out of the crisis, generally a number of the businesses we owned not only survived, but really improved. They were relatively well-financed, with no contingencies in capital structure, well-positioned within respective industries, and well-managed. Many of these companies were able to take advantage of the dislocations during that period at the expense of their weaker competitors. When selecting securities, it's important that investors underwrite defensively to help protect capital. But during difficult periods, those same defensive characteristics often allow businesses to take advantage of those circumstances.

MM: One of the great lessons of the crisis was learning the difference between volatility, which most people perceive as risk, and a permanent impairment of capital, which is what we believe is risk. Many of the great businesses Kimball referenced were actually down 30% – 50% during the crisis. These businesses experienced negative volatility, but no permanent impairment of capital. As a result, generally the businesses were able to gain a stronger market position, to buy back stock at very low prices, and to emerge with more earnings power per share. Even though the businesses' stock prices went down during that period of time, intrinsic values accreted. On the other hand, there were many stocks that looked cheap, such as the financials,

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but because the businesses had so much leverage, the equity was wiped out by the crisis. Not only was there volatility, but there was also permanent impairment of capital.

G&D: *When Graham & Doddsville interviewed Jean-Marie Eveillard in 2007, he commented on his evolution as a value investor, from a Graham and Dodd approach to a Buffett investment style. Has there been another evolution in the philosophy at First Eagle with you managing the portfolio?*

MM: I think both Kimball and I stand behind by the adage, “if it ain’t broke, don’t fix it.” However, there have been minor areas of evolution. For example, we’ve been very focused on making sure we have the best trading execution. Markets have changed, too, in terms of how trading occurs. I think that’s given us a bit more flexibility. We’re not high trading frequency: the average holding period for the Global Value Team is about six or seven years. Still, we build big positions gradually, and work our way out gradually. Having a talented and experienced trader like Doug DiPasquale heading First Eagle’s trading desk has been invaluable.

The evolution from Graham to Buffett continues. Many companies we own embody business model scarcity, have a degree of pricing power, and by virtue of their market position are resilient. In crisis, these businesses can be opportunistic. In good times, they can distribute cash flow to shareholders. We have sharpened the saw, if you will,

in terms of how we think about business model duration.

The big change, to a certain extent, has been exogenous. If we look at debt in the world - household, corporate, sovereign debt relative to nominal GDP around the world - it’s higher today than it was in 2007. The financial architecture of the world is less healthy than it was a decade or two ago. That implies that we’ve had to become more aware of the role of currencies and sovereign risk. Jean-Marie casts a wary eye to what can go wrong from a top-down standpoint. We cast that same wary eye given how the world’s financial architecture has evolved.

G&D: *Talk about your idea generation process: how much of it is informed by a top-down view versus specific bottoms-up analysis?*

KB: We keep an eye open to macroeconomic events and conditions around the world, but it doesn’t really drive our decision to buy anything. We’re not thematic investors; we’re much more focused on security-specific decisions. I will say, however, there have been circumstances where we have been uncomfortable with an entire industry as a result of macro concerns, in which case we move on. As a result, the macro view might inform a decision to not do something.

MM: To add to Kimball’s point, I believe a core problem in the world is monetary superabundance. It has reinforced the need to seek scarcity in businesses in which we invest. We don’t make top-

down calls on which country or which sector, as Kimball said, but we seek scarcity in a business model, a market position, or in tangible assets that are hard to replicate.

We look at the market as if it is a block of marble and we chip away at the pieces we don’t want. If the business doesn’t embody the right characteristics, if the capital structure has excessive contingency, if management behavior is imprudent, or if the price is wrong, these are all reasons not to own it.

At First Eagle we chip away at the 90% of the universe we don’t want. The residual we feel, incorporates a margin of safety that gets represented in the portfolio. No individual investment is perfect. In the context of Graham and Dodd, Kimball alluded to how important it is to create a process that’s error-tolerant. By seeking what we believe to be a multi-dimensional margin of safety, we hope to implement that process over time.

KB: When you hear people talk about risk management or portfolio management, it’s often at a 50,000-foot view. What often seems lost in the defense of capital are really the individual companies in the portfolio and the managements running those companies. You know that some challenges will emerge and management will have to confront them. By investing in businesses that are well-positioned, with an element of scarcity and what we believe to be a margin of safety, we improve our chances of handling the inevitable challenges.

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G&D: Are there any particular practices that have helped you key in on distressed areas? How do you think about that?

KB: At various periods of time, there will be an industry, country, or region that has hit an air pocket. You can often find businesses that have been sold somewhat indiscriminately without regard to valuation. Sometimes those periods can last for years. Take Japan for example, which until recently, had been neglected or ignored by investors because of concerns about the economy, demographics, and corporate governance.

MM: At First Eagle, we tend to take an incrementalist approach to capital allocation. We have roughly 150 securities in our portfolios. The world of concentrated investing often has negative behavioral side effects. People tend to have commitment bias to their ideas. When an idea is either in or out of a portfolio the logic structure is binary, it can force people to be desensitized to disconfirming evidence when they've made an investment.

Charlie Munger often claims that the best opportunities are those already under your nose. We often source opportunities from what we already own. From a bottom-up perspective, we can pinpoint which securities are out of favor and allocate capital at the margin to those securities. We also trim capital off the securities that are closer to, or in excess of, what we believe to be intrinsic value. So we employ a natural "opportunity-recycling" process.

G&D: Would you give an example of a security that you currently own where you feel it's undervalued and you've reallocated capital to that?

MM: National Oilwell Varco (NYSE: NOV), a business held in the First Eagle Global Fund and Strategy, has a very strong market position. It provides high technology components, rig subsystems, and after-market equipment to the drilling rig market around the world. It is highly-regarded for more complex fracking or ultra-deep water extraction solutions.

"Benjamin Graham made it clear that intelligent investing is all about arithmetic. We spend a lot of time thinking about how to reconcile the multiple we're paying with the underlying arithmetic of the investment return."

With the price of oil moving from over \$100 to under \$50, we believe NOV's prospects for the next 12 to 18 months will suffer pretty dramatically. Despite challenging short-term fundamentals, the company has a leading market position and about \$12 billion of backlog and net cash on the balance sheet. We believe it is well-positioned to emerge stronger from this crisis.

National Oilwell Varco has the potential to improve its position both in its core wellbore and rig systems segments as well as the after-market segments of its business. For example, it may be able to buy good companies to supplement these segments at low multiples of cash flow in a distressed situation. It could also continue to buy back its stock at depressed levels.

We can't predict the bottom of the energy market or the bottom of National Oilwell Varco's order book. However, because of its strong position in segments of the energy capital expenditures that are growing and unconventional, we are comfortable with the company's long-term prospects and its potential to be an even stronger force over the next decade. NOV trades at a single-digit earnings multiple based on trailing peak earnings and around 5x trailing peak EBITDA. If you think this is a business that in five to seven years could have higher peak earnings and higher peak EBITDA, and you look at where the private market multiples have been for energy M&A, this is an example of time arbitrage where we may experience further downside volatility in the short term, but where we feel comfortable possibly owning a security for the next five to ten years and where we've added a little bit on weakness here.

G&D: How do you think about intrinsic value? What methodologies do you look at and at what discount to intrinsic value do opportunities begin to interest you?

KB: First we try to determine

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Bill Ackman with incoming CSIMA Co-Presidents Michael Herman '16 and Damian Creber '16 at the Pershing Square Challenge following their 3rd place finish.

the sustainable level of earnings for a given business. There are many businesses that, for various reasons, are either under- or over-earning their sustainable levels. To ascertain intrinsic value, we assess what we believe normalized earnings will be and the sustainability of those earnings.

From there, it's really a triangulation. We review past transactions, like the National Oilwell Varco example, that involved well-informed buyers acquiring businesses. We also look at what multiples produce sensible returns relative to the nature of the business.

MM: Benjamin Graham made it clear that intelligent investing is all about arithmetic. We spend a lot of time thinking about how to reconcile the multiple we're paying with the underlying arithmetic of the investment return. There's a willingness to pay higher multiples for franchise businesses. By going in at 10x – 12x EBIT, you could get a 6% normalized free cash flow yield that can potentially grow 4-5% sustainably over time, and thus you may achieve the prospect of a double digit return. If it's a businesses that is more Graham in nature, with no intrinsic value growth, we may be inclined to go in at 6x – 7x EBIT, where we get our potential return through a low double digit normalized earnings yield.

Having those simple mental models and looking for the arithmetic to work also gives us the fortitude to deploy cash in crisis. We had our lowest cash levels in early 2009, not because we correctly timed

the market bottom, but because we saw businesses available at the right prices.

G&D: To what extent do you attribute your cash position to a lack of current opportunities, versus optionality on future opportunities?

MM: We can't predict what the future will bear. At First Eagle, we view cash as a residual of a disciplined underwriting approach and as deferred purchasing power. Typically, it arises because we're selling stocks that are close to what we believe to be intrinsic value or that have gone through intrinsic value. In more expensive markets, it's more difficult to identify new ideas that meet return hurdles, thus the cash builds.

We don't feel the need to force cash to work just because it is a zero-cent yield today, because the return to cash has two components: it has the current yield, and it has the option of redeployment in distress. We feel, given the state of the financial architecture, there will be more windows of opportunity over the coming years to buy businesses that offer potential return hurdles in windows where the markets are less complacent.

G&D: Can you talk about your sell discipline?

KB: There are two main reasons to sell. First, if your investment thesis is inaccurate or you own something that wasn't what you thought it was. Second, the sell decision can be linked to intrinsic value. Once a stock price converges with what we believe to be the

value of the business, we'll discuss it in the context of trimming. In many cases, intrinsic value is not a static number. It can grow. When we feel a stock is at or above intrinsic value, we'll trim the position. If the stock price rises far north of intrinsic value, we may have to exit the entire position.

G&D: Are there any common themes in past investments that have been very successful? What about those that have not worked according to plan?

MM: We're very process-oriented at First Eagle. We believe in systematically analyzing our mistakes, as well as our successes. In fact, we have an annual offsite where we do a post-mortem to review what's worked best over the last five years and where we have seen permanent impairment of capital. Then we perform the "should have, could have, would have" analysis. So given what we knew at the time, we discuss the filters we could have applied differently to reach better outcomes.

Certain threads of continuity emerge from that analysis. On the positive side, we've found top-performing companies that were not necessarily in hot growth categories, but rather they have business models that persisted over time, and the companies have held strong, stable market positions.

One pattern we've seen is the involvement of a founder or a family that is also generational in their capital allocation perspective. That combination of a persistent cash flow-generating business, and

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stewards that share a long-term horizon, has tended to produce some of our best long-term investment ideas.

On the other hand, if we look at the less-attractive tail of the portfolio, there haven't been many mistakes where we went in at elevated prices. Instead, it's typically been a more asset-intensive business, where there's a legacy issue to some of those assets which imputes declining profitability, and the company needs to reinvest to sustain its earning power. Unfortunately, asset-intensive businesses often lack pricing power. What sometimes occurs is a need to reinvest during a time of weak pricing power, and this results in balance sheet deterioration and reduced earnings power.

Also, asset-intensive businesses tend to have longer tail assets. With those come management teams that promote their desire to reinvest and grow the business. As a result, there's less return of capital.

If you think about those two classes of business, with the cash-flow business, the passage of time shrinks the enterprise value, because it's generating cash and can pay down debt or buy back stock. The asset-intensive business has poorer positioning and legacy assets. As a result, the passage of time actually increases the business' enterprise value, because it may need to replace the legacy assets, and may not have the pricing power to generate the earnings, so it needs to borrow.

A bad case has a combination of diminished earnings power and greater enterprise value.

While the starting valuation may have been good, the terminal valuation was less attractive. In the former is a business with earnings power grinding higher, while enterprise value is shrinking, producing an increase in the real value.

“...we believe the margin of safety is embedded in the quality of the business. You have to weigh that against discipline on valuation.”

G&D: What about errors of omission? Have you noticed any patterns in businesses you've consistently avoided that, in retrospect, would have been great investments?

MM: At First Eagle, we've likely been too frugal when it comes to great businesses. For example, we've typically looked to buy 70 cent dollars. I think the mental model of paying 70 cents for a business makes great sense; if the normal equity is priced for 7% returns, and you're going for 70 cents on the dollar, you're starting with a 10% ROI. Closing that valuation gap over five to ten years may generate a low-teens return.

If it's a great business, there's an argument to be made, not necessarily for paying 100 cents on the dollar, but for paying 80 to 85 cents on that dollar. As Charlie Munger would say, it's a fair price for a great business. Your time horizon's long enough that you're capturing less spread day one, but if the business has a drift to intrinsic value of 4-5% a year, held for a decade, you may potentially reclaim that and then some. The more patient you are, the more you're potentially rewarded for holding good businesses.

I think there have been a number of great businesses we invested in that, with the passage of time and benefit of hindsight, should have had a more substantial position size and where we could have seen adequately rewarded even with slightly higher entry multiples.

KB: There is a school of thought, which I believe Charlie Munger has expressed, that the margin of safety is embedded in the quality of the business. You have to weigh that against discipline on valuation.

MM: I think there's a subtle addendum to that discussion. Traditional Graham investing has, arguably, a lower return on time invested. If the business is not growing in intrinsic value, once it gets to what we feel is intrinsic value, the investment needs to be replaced in the portfolio. There's an element of maintenance capital expenditures in terms of research, which tends to be higher for those kinds of businesses than ones that you can own for a decade or

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longer while intrinsic value improves.

Obviously, if you own a great business, and it gets too expensive in valuation, you should replace it. If it's starting to price that future growth, you've mortgaged that value-creation drift. Unfortunately, there is no maintenance capex-free investment strategy at all. The return on time invested is also an important consideration.

G&D: First Eagle is known for using gold as a potential hedging mechanism. Is there an investment case for gold or gold mining stocks?

MM: I think that gold is still broadly misunderstood in the investment community. People often say to us, "If you want a hedge, why don't you buy credit default swaps or do a put option on the S&P 500 Index?" First, all of those instruments have some degree of counterparty risk.

Second, most forms of option-based hedging are expensive. If you look at the cost of implied volatility, it's typically greater to buy at-the-money options than the risk premium for the underlying assets.

Third, those instruments are time-definite. I remember buying puts on the S&P 500 Index in 1999 that expired worthless about a month before the market collapsed.

We believe that the best potential hedge has to be a real asset outside the world of man-made securities and counterparties. This is where I believe gold is most often misunderstood. Warren

Buffett is an investment hero of ours. And he has criticized gold because he believes it is useless. But it's precisely gold's chemical inertness that makes it useful as a potential hedge.

Consider useful commodities such as oil or copper, which tend to have a sensitivity to the market and broader economic activity that's close to one-for-one. Those are not actually hedge assets, but market- and economically-sensitive assets. In order for something to have limited sensitivity to crisis, it has to be close to chemically inert and not that useful in an industrial context. In fact, if you look at the historical price of gold, it's had close to no correlation with equities, and in extreme states of the world, has been negatively correlated with the valuation of equities.

Because of gold's inertness, it is resilient. The stock of above-ground gold is over 50 years of one year's mining supply, which means that, not only is gold the most resilient real asset from a demand sensitivity standpoint in our opinion, but it's also the most resilient in terms of its supply character. If mining supply is only 2% of the stock of gold and that supply was to increase by 30% due to some unexpected technological development, it would only increase the rate of growth of the stock of gold from 2% to 2.6%.

For pretty much every other commodity, silver being an exception, the stock of those commodities is a fraction of a year. Those commodities are produced for use because they're useful. The supply of those commodities will vary

with the annual extraction. We've seen the impact on oil markets this year.

Gold is unique in terms of its demand-side resilience and its supply-side predictability. We can know with virtual certainty what the supply of gold will be in 5, 10, or 15 years. What other commodity can we say that about?

We look for scarcity in securities, and gold is one of the scarcest elements on the periodic table, with less than one ounce of it per capita in the world. The stock of gold has been roughly constant the last 40 years at about 0.8 of an ounce per capita globally. Gold is also very dense. In fact, people often joke that you could fit trillions of dollars of wealth in a swimming pool, or a hundred million dollars of wealth on a library shelf full of gold bars. Low storage costs increase gold's attractiveness. If you think of the opportunity cost of holding a real asset, the higher the economic sensitivity, and the less the density, the higher the opportunity cost of storage, because you've got to pay to store it, and you should get a risk premium. But if something's naturally economically insensitive, naturally resilient and naturally dense, the opportunity cost of storage is very low. That's why, if you go through a process of elimination, there's no other element on the periodic table better suited to be a monetary potential hedge than gold.

Since the breakdown of the Bretton Woods agreement in the early '70s gold traded at trough valuations during the

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Graduating CSIMA Co-President, Brian Waterhouse '15, presents his long recommendation for CDK Global at the 2015 Amici Capital Prize for Excellence in Investing.

peaks of systemic confidence like the late '60s or the late '90s. During periods of systematic concern, such as the early '80s, pre-Volcker, after the second oil shock and large inflation; or even a couple of years ago when Standard & Poor's downgraded United States debt, and the Euro was on the verge of collapse, gold traded at its peak valuations. It's interesting to note that, over a 40-year period, both gold and equities have roughly maintained values relative to world nominal GDP per capita, but in inverse cycle time.

People often criticize gold because they believe it has no expected return. If the supply of gold per capita is constant but the money supply and world GDP per capita is growing, then the equilibrium price of gold has a positive drift because the assets you're hedging, and the income you've built to purchase that hedge, are growing in value. Gold has had a return which is expressed in capital gains over the long term, as opposed to yields. The irony is that it is sovereign debt today that has no return.

Gold is an important part of First Eagle portfolios and an important part of our philosophy of humility. If we knew with certainty that the system was resilient, we wouldn't need a potential hedge. But to the extent that 70% of our portfolios are invested in enterprise that's sensitive to the state of the world, and to the extent that we see generationally high levels of debt and complicated geo-politics, we value that potential hedge.

G&D: Would you take us through other investment ideas?

KB: We own Bank of New York (NYSE: BK) in the First Eagle Global Fund and Strategy. It's a combination of asset management and what we refer to as "Wall Street plumbing" - custody, clearing, and administration of assets. Those two fee streams account for just over 80% of Bank of New York's business, as opposed to most banks, which rely on credit intermediation and interest income.

We bought Bank of New York a few years ago because we believed it was under-earning in a few dimensions as a result of interest rates and operational expenses which had room for improvement. Bank of New York waived fees on its money market funds because interest rates were too low. And, due to the timing of the Mellon merger, which happened just before the financial crisis, the company never really had a chance to attack its expense base until now. In addition, the company was re-segmenting its customers in an effort to enhance profitability. When we bought the company - and we still think there's a discount to intrinsic value - it was earning returns on tangible capital that were attractive. We believed the balance sheet was clean and liquid.

One long-time position in First Eagle Global is Groupe Bruxelles Lambert (GBLB.BB), a holding company owned by two families that have a strong investment history. It's a simple company to understand

because it owns half a dozen publicly traded large European blue chip companies. Our view is that it continues to trade at a double discount, in the sense that if you do a sum of the parts comparison with the public price, that's a discount. Additionally, a number of the businesses it owns have been trading below intrinsic values.

MM: With multiples and margins at historic highs today, the scarcity and resilience that we seek out are not obviously available. Many great consumer staple companies are trading at 25x earnings, so you have to look for the unobvious. Take for example, Oracle (NYSE: ORCL), in First Eagle Global, an idea originated by Manish Gupta and a position we've built over the last few years. It's the leading provider of relational databases, with a very dominant, stable market share position. It's also a leader in the applications that attach to that database: enterprise resource management applications, middleware that helps those applications communicate with the database, and some of the underlying hardware.

With Oracle, people were worried about the threat from the cloud. Yet the company has such scale economies in R&D that it was able to play "fast-follower". It doesn't need to invent every new technology because its platform is already entrenched in the corporate world and can be built out over time.

In a world where consumer staples are expensive, we've sought out corporate staples. A relational database is an

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extremely difficult thing to change and thus falls into the latter category. Mark Hurd, the Oracle CEO, gave the analogy that changing a database is like performing a heart transplant on a marathon runner while he's running a marathon. This is a mission-critical application that the whole business IT architecture is built around.

If you look at the historical profit stream of Oracle, it's more like a Colgate Palmolive than a volatile semi-conductor or software company. It's very stable because the vast majority of EBIT comes from installed maintenance, not from new license revenues. With multi-year maintenance contracts, 90% plus retention rates, and built-in inflation escalators, Oracle is a cash flow machine.

It's also chaired by founder Larry Ellison, so its management has a long-term focus. Since management gets paid in equity-related incentives, their incentives are aligned to ours, as shareholders. This is a company that's buying back stock, has traded at a mid- to high-single-digit free cash flow yield over the last few years, and has underlying EBIT from the maintenance stream that can compound out at a 6% or 7% clip. The arithmetic works for us.

G&D: You mentioned a double discount with respect to GBLB. Is the thesis that there's a perception gap that should close over time? How much do you care about catalysts if so?

KB: There's a related question:

"Why should there be a discount?" We don't see a reason. Normally, you could apply a discount to a company like that if the assets it owns weren't that good, if there were tax-leakage, or if the management were bad. We think none of that applies to Groupe Bruxelles Lambert. It's in an advantageous position, similar to Berkshire Hathaway, where it can take advantage of investment opportunities that others won't.

"Ultimately, as an investor, you will make mistakes despite best efforts. It's a very humbling business. The people I've seen succeed in this business have stuck to it and have been obsessive about learnings from their mistakes."

MM: On that point, I would add that Groupe Bruxelles Lambert has a model of soft control. It has board representation, and has exhibited discipline by making sure that its companies are distributing cash flows and healthy dividends.

KB: We don't need a catalyst, because it's almost always built in the price. From our perspective, if the company

continues to buy back stock, which is what it's been doing, at a discount to what we think it's worth, which is what Groupe Bruxelles Lambert has been doing, that's value-added.

MM: Going back to the 70 cent dollars discussion, if you can buy in through the holding company at a 30% – 40% higher earnings yield because of the discount, the internal economics just compound at a more attractive rate.

G&D: Do you have any advice for aspiring investors or other students at Columbia Business School who would like to sit in your seat one day?

MM: Read voraciously. Learn more broadly about behavior, philosophy of thinking, biographies, and history. Get a sense of the possible. Look at the repeating cycles in human history. There's an abundance of material out there, so you can build your own invisible board of directors, if you will. That's incredibly important.

The second piece of advice I'd give is to persist. Ultimately, as an investor, you will make mistakes despite best efforts. It's a very humbling business. The people I've seen succeed in this business have stuck to it and have been obsessive about learning from their mistakes. This improves the value of their human capital over time.

G&D: Anything else you might recommend reading?

MM: I'd recommend biographies on John Law and Richard Cantillon by the Professor Antoin Murphy. I suggest those books because

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this was the point in time, historically, where we had the evolution of paper money in Europe. One sees some of the benefits of paper money, in that it frees up capital for investment and productive enterprise, but one also sees the risk of paper money, in the intrinsic agency risk embedded in the political process, where there's an excessive issuance at the bank level, or the central bank level of such currency. John Law and Richard Cantillon were fascinating characters, because they both had different mental models of how the economy worked and were both leading theoreticians.

Their mental models are well captured in these books. In some ways, John Law was pre-Keynesian, and Richard Cantillon was pre-Austrian school of economics. Richard Cantillon wound up wealthy, John Law destitute.

G&D: Do you have any parting words to share?

MM: Jean-Marie Eveillard has often spoken about the fallibility or the limits of knowledge. I think it's important to focus on controlling what you can control, such as your own behavior and temperament. At First Eagle, we spend a lot of time thinking about how to improve our approach to investing. If you've studied history, you can see the recurring mistakes in human behavior through hubris, dogma or haste.

At First Eagle, we also strive to embody the inverse of those behavioral defects into the way in which we allocate capital.

We recognize that the future's uncertain, that's why we stick to a margin of safety approach, why we're willing to own some gold as a potential hedge, and why we're willing to own cash and not force the cash to work if the arithmetic doesn't make sense. All of that stems from the temperament variables rather than a crystal ball.

G&D: This has been great. Thank you very much for taking the time to meet with us.

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and has grown the fund to \$2 billion. Before founding Jericho Capital, Josh was a key principal at TCS Capital during which time he helped grow the fund from \$5 million to over \$3 billion. Previously, Josh was a Managing Director at KPE Ventures, a media, entertainment and technology venture capital fund, and prior to that an analyst at Fox Entertainment Group in Los Angeles. Josh began his career as an analyst in the media and entertainment investment banking group at Bear Stearns. Josh graduated *summa cum laude* with a B.A. in Economics from Emory University. Josh serves on the Board of Directors of the Child Mind Institute in New York City.

Graham & Doddsville (G&D): Can you tell us about your background and path to investing?

Josh Resnick (JR): I grew up in Jericho, New York, which is where I came up with our fund name. My father was a dentist, but he followed the stock market, and we always used to talk about stocks. Through those conversations, I became interested in Wall Street and investing.

After my freshman year at Emory University, I spent the summer interning at Republic National Bank. I was so inspired by the pace and the intelligence of people who worked on Wall Street, I knew that was what I wanted to do. During my junior year, I focused all my energy on building a background that

would be attractive for investment banking.

The following summer, I worked at Bear Stearns and joined their Investment Banking Analyst Program after graduation. The first project I was staffed on was Time Warner's acquisition of Turner Broadcasting Systems. This was happening at the same time that Netscape was going public, and we were also involved in selling a company to AOL. You could just see that the media and telecom and technology industries were going to be very dynamic places over the course of my lifetime.

At the end of my analyst program, I had an opportunity to join Fox in Los Angeles, which was one of our clients. During my time at Fox, I was spending every minute of my free time looking at stocks. I had a lot of fun thinking through industry dynamics and taking positions based on my research.

I eventually left Fox for a brief stint to help my friend's brother launch a venture capital fund. The subsequent internet meltdown convinced me that I didn't want to invest in the private markets. I wanted the flexibility of exiting positions if I changed my mind on an investment.

In 2001, I decided to join Eric Semler shortly after he launched TCS Management, a long/short hedge fund focused on the TMT sectors. Eric and I had a number of mutual friends and former colleagues, and we really hit it off. When I joined, it was the two of us and our CFO sitting in one office. I was

involved in the investment decisions, but Eric was the sole portfolio manager. We did well in 2001, held up in a tough market in 2002, and had a great year in 2003. We developed a reputation for generating independent and interesting ideas and were able to grow the fund nicely thereafter.

As 2009 rolled around, I decided to launch my own fund. My thinking was that the best time to start a hedge fund is when nobody wants to start a hedge fund. That was the situation in 2001 and I saw a very similar landscape in 2009.

We started out in July of that year. We really could not raise any institutional money, but it was a fantastic time to be involved in the market. There were a number of very compelling investment opportunities and we had an excellent year. We have been able to perform in years following 2009 as well.

G&D: You focus on industries where things can change quickly, and that challenge is compounded as you often look at international businesses where you are not necessarily on the ground next to the management team. How did that approach evolve?

JR: Upon joining Fox in 1997, I had the privilege of working for Rupert Murdoch. He viewed everything as a global opportunity. Fox probably generated around 60% of revenue and earnings from international markets. This was at a time when most media companies were very US-centric. Many of them continue to be very US-centric.

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Every time he would see something work in one market, he would try to capitalize on that opportunity in other parts of the world. Satellite television is one obvious example. He launched Sky in the UK and in Latin America. He also worked on satellite in the US before ultimately deciding that the US market was a different market structure because of the presence of cable.

Another example is the National Geographic Channel. We recognized that the competitive landscape in the US was very difficult due to the presence of Discovery Communications, but in international markets, National Geographic had an open-ended opportunity. We had satellite distribution in markets around the world and could immediately put National Geographic in all of these homes and create a tremendous amount of value.

I adopted that way of thinking. For example, when we started our fund, we had 15% of our capital in Australia. I know from my time at Fox that Australia is normally an expensive media market. When we were launching in 2009, a number of investors were talking about Australia as the next housing bubble to burst. All these funds were short everything in Australia. I flew to Australia and met the media companies. Business was going great and executives didn't see any weakness at all. We made a big bet that we thought was asymmetric and it worked out well for us

Also, one of our best performing stocks this year has

been VimpelCom (VIP). People call us crazy for owning a Russian telecom, but when people take a broad brush approach to a market that has nothing to do with the company's fundamentals, that creates opportunity. More than half of VIP's operations are outside of Russia and the Ukraine, but the stock traded with near perfect correlation to the Russian index last year, which created an opportunity for us.

G&D: You mentioned the lesson of a global and opportunistic approach from your time at Fox. Were there any other lessons from your time at an operating business?

“...when people take a broad brush approach to a market that has nothing to do with the company's fundamentals, that creates opportunity.”

JR: Definitely. I would say probably the single most important variable for us when we're looking at companies is assessing management, and an operational background certainly helps for that. One of the best investments I had in my career was Pixar. We first started buying Pixar in 2002 when the whole world was short the stock. Everyone talked about how they only released one movie every two

years, and the multiple was too high. At the time, all the IP was owned by Disney, and the bears thought that Disney would pull the plug on Pixar if they made a bad movie, wiping out the stock. That was the general consensus. But Pixar just kept putting out amazing movies one after another.

We spent a lot of time with the management team at Pixar's headquarters, and we realized these people were very smart and disciplined, and that they had an excellent process for making movies. We made a big bet on the company. The bears just didn't appreciate how important the DNA of that company was, and how that DNA was going to create so much value. In the media world, there are not that many examples of companies creating new and valuable intellectual property over the last 20 years, but the Pixar team was among the few that could consistently accomplish this feat.

I firmly believe the management and culture of companies are underappreciated. I'm willing to pay premium multiples to own great businesses managed by great management teams. These are the investments that outperform and generate higher returns on capital. I'm rarely drawn to the cheaper companies on a relative basis.

When I worked at Fox, I noticed that it was very difficult to motivate tens of thousands of employees. It is a very challenging task, and companies that can implement the processes and the procedures to motivate people, to align their goals with

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creating value for the business, these are the companies that will reward their shareholders over time.

G&D: Do you have to meet with management before making an investment, particularly if a business is based outside the US?

JR: Typically, meeting management is required before we make a meaningful decision. There are some exceptions. We have a position in Amazon (AMZN) right now. I'm very unlikely to get access to Jeff Bezos; he does one investor meeting a year. In situations where you aren't able to meet management, you have to just to figure out what the variables are and what makes you think it's a great stock.

You never get to travel as much as you want. If it was up to me, I'd be out of the office 300 days a year. I'd just go and visit companies all around the world. It's not practical to do that from a personal or professional standpoint, but I try to get out and talk to people.

In the previous example, visiting Australia was important to finalizing the thesis. If you don't travel, you don't get that crystallization of the idea in your head. Company visits also give insight into the personalities of the employees and other underappreciated elements that can help you. When you're looking at it from your computer in New York, you see it in a different way than when you are meeting the company in their offices.

G&D: Staying on the topic of your AMZN position, how do

you gain conviction on valuation, considering their lack of profitability is always such a vigorous debate?

JR: We have watched AMZN for a long time. Jeff Bezos has been very focused on the long term, and has continued investing in the business at the expense of margin improvement. He also hasn't offered Wall Street much in the way of transparency. Last year, with the negative sentiment toward internet companies, AMZN declined around 25%. We think that precipitated a change in AMZN's behavior.

"I firmly believe the management and culture of companies are underappreciated. I'm willing to pay premium multiples to own great businesses managed by great management teams."

One thing that people may not appreciate with AMZN is that the highest paid employee there draws \$165k in cash salary; most compensation is stock-based. Employees at Amazon are told to expect that the stock will return 15% per year on average and to use that estimate to determine total compensation.

As we approached the end of last year with the stock

struggling, we spoke to a handful of employees at Amazon who said, "I love working at Amazon, but I'm not paying to work at a company." So we realized that AMZN would need to change to retain these incredible employees. When they reported 4Q results in February, not only did they exceed earnings estimates by 100%, but they also disclosed that they were going to be releasing separate financials for their Amazon Web Services ("AWS") business in the next earnings report.

The alarm went off for us. It became clear that AMZN does care about the share price. And if they actually do care about the share price, it will increase significantly.

Improved transparency will also showcase that AMZN's retail business is actually quite profitable. A lot of investors I speak to think Amazon's retail business is break-even to loss-making. But AMZN now sells nearly 45% of units via its 3rd party marketplace, which we think is extremely high margin. Also, our research suggests that AWS runs at negative 10-20% EBIT margins, which implies much higher EBIT margins than people realize.

Basically, we see the market moving to value in AMZN in three components: First, core retail business in the US; second, AWS; and third, the international ecommerce business.

With AWS, we think it could be spun off as a separate public entity. As the leader in the cloud, it could fetch a revenue multiple given the growth rate

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Professor Greenwald provides introductions at the Amici Capital Prize for Excellence in Value Investing.

and the potential future margin structure. With US ecommerce, we have an idea of long term margin potential and apply a multiple to that. On International ecommerce, we estimate that it may lose roughly \$1 billion in China. We have heard through our relationships that AMZN is changing how it views the China opportunity. We are amazed that there is still not a single example of a US internet company building a successful business on its own in China. We don't think Amazon is going to be the first. Based on our conversations, we think AMZN is likely to fold its China operations into JD.com in exchange for an equity stake, which should meaningfully improve the margin profile of the international business.

G&D: Would you like AMZN to do that in India as well with Flipkart?

JR: No, I think it's possible to build a business in India. It's challenging, but it's not like China. India is more of a free market for international competition and there is Western-based rule of law. I don't know if they will be successful in India, but it's a much higher probability of success than in China where we think their probabilities are less than 5%.

G&D: And the video business?

JR: Our approach essentially gives negative value for the video business, which we think is quite conservative. We estimate they are losing between \$1.5-\$2 billion from content spending this year, and we don't add these costs back

in our valuation. There is essentially no video revenue. Some of the value of the video business does get captured in the retail business because video helps drive Prime subscriptions to some degree.

G&D: Speaking of content, do you have a view on CBS?

JR: The multiple gap has narrowed considerably compared to peer media companies over the last few years. It's been a phenomenal performing stock and I think that really speaks to the strength of the management team led by Leslie Moonves. With CBS, we think the whole business revolves around the television ecosystem staying intact, and I have some concerns. If you simply look at last year's expectations and today's reality for the US TV ad market, you would definitely see some underperformance. Digital media seems to be capturing some of the TV ad spend. There was a 200 basis point movement from television into digital media. I don't see any counteracting forces that would stop that trend. When you look at the consumption patterns of the demographics that really matter for advertisers, they're all watching YouTube and Netflix. They're consuming video in very different ways compared to the average 54-year-old CBS viewer.

CBS still provides a tremendous amount of value to the ecosystem. If you compare share of affiliate fee revenue to share of ratings, you see CBS is valuable to distributors. That gap will continue to narrow, which will

be great for CBS. We're not involved. If the stock really got hammered, we would be very interested in it, but right now the valuation seems well-balanced relative to the risks.

G&D: In the past, you have talked about how we will eventually see differentiation between the real strategic assets and the more marginal content in the US media landscape. What do you think are the great strategic assets for US media?

JR: That's a good question. I don't really know that we have a great play in US media right now. I think the greatest strategic asset in US media is Instagram, which we own through Facebook (FB). The valuation of Instagram could be really incredible if FB had not purchased them. When they start to advertise on Instagram, it's going to be a massively valuable company.

G&D: Speaking of these technology companies, some valuations are off the charts. How do you think about valuing these technology companies?

JR: It depends. To me, FB is not an expensive stock. Next year, we have FB earning above \$3 and the stock today is at \$79. They have assets like Instagram and WhatsApp, both of which have not been monetized in a significant way, so they're not captured in the multiple. They have yet to press the accelerator on video ads, which could be a huge, multiple-billion dollar opportunity for them.

FB is in a similar situation to what I referenced earlier: we

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are looking for situations where people are painting with a broad brush. There clearly are some stocks, especially in the private market, which are trading at aggressive valuations. We think FB is a massive share taker in the media world, and we think that is going to continue for a while.

G&D: There has been some discussion that WhatsApp is making a strategic error by not trying to build a more robust mobile ecosystem and mobile platform, and they are ceding the opportunity to Snapchat and others. Do you have a view?

JR: Maybe. I think they're both in very different situations. WhatsApp, as a subsidiary of FB, has the luxury of not feeling monetization pressure. The user growth of WhatsApp is astonishing, so I don't know how you can criticize that. FB seems to be focused on building engagement first and focusing on monetization after.

Some of these companies have built such loyal user bases that ads can easily be incorporated. Another example is Tencent (700.HK), one of our largest positions in the fund. We believe Tencent is a very exciting and interesting stock, and on our numbers for next year, we believe Tencent will be trading in the teens. That's with accelerating revenue growth, and much of that revenue will be coming from advertising, which is a higher-margin revenue stream compared to mobile gaming. We estimate the monetization potential on Tencent's platform for next year could be RMB 7 billion, while Wall Street currently expects

around RMB 4 billion.

G&D: How do you generate your ideas?

JR: We are always looking for interesting companies, and when we find them, we track them over time. Sometimes our knowledge and perspective allows us to spot great opportunities.

“If you don't travel, you don't get that crystallization of the idea in your head. Company visits also give insight into the personalities of the employees and other underappreciated elements that can help you.”

One example is our biggest winner last year, MercadoLibre (MELI). It has historically been known as the eBay of Latin America. I actually met their team while I was in the VC industry. The founder of MELI, Marcos Galperin, went to Penn undergrad, worked as an investment banker in the TMT group at JPMorgan, and later attended Stanford Business School where he came up with

the idea for the company.

He saw how successful eBay was in the US and he basically said, "I can create that business in Latin America," and so they raised venture capital money. It was probably a \$20 million valuation when we passed on it in my prior job. I watched that company over time dominate ecommerce in Latin America despite a very complex ecommerce landscape.

The fixed broadband network penetration is low and the quality is terrible, wireless smart phone penetration is very low, there are entrenched retailers that have the ability to spend tons of money, and consumers are oriented toward making purchases via installment plans.

These guys have just persevered, and they have built a phenomenal business. From what I can tell, they're the only company in Latin America that actually makes money in ecommerce.

The question has always been, when do you initiate a position given valuation is usually challenging? Last summer, we ended up getting a great opportunity to enter. Around 23% of its revenue came from Venezuela and the exchange rate in the black market was diverging significantly from the official rate. According to the accounting principles, it had to record the revenues and the profits based on the stated market rate, not the black market rate.

As a result, the Street developed a short case of how MELI's earnings are going to take a massive hit when they

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have to move to the new translation rate for the Venezuelan bolivar. Secondly, another one of its large markets is Argentina, where there is also a gap between the stated market rate and black market rate for pesos.

The stock's short interest built, and the stock price performance was fairly weak. The share price got to the mid \$80's. Then the company ripped off the Band-Aid. It went from translating the bolivar at 8 to 1, to 50 to 1. These currency translation adjustments had a massive optical impact on earnings. The stock went down, and that was when we started buying.

G&D: How did you think about valuation for MELI?

JR: We weren't valuing the company on trailing earnings. To me, the enterprise value is \$4 billion. How does that compare to the opportunity? There is a huge addressable market for this company over many years. They have a population of 520 million people to address in regions where ecommerce penetration today is under 2%. And I think that they are the winners. I have visited them multiple times in Buenos Aires. The management team is best in class, and they have done a fantastic job of building a great durable culture. Employee turnover is very low and everyone seems smart and social. Most of the team is US-educated.

There are real barriers to entry from international players. If eBay wants to build a business in LATAM, it will have to get its employees to

move down to Sao Paulo or Rio. To that we say: good luck. They're not relocating their families down there and if they're doing it, you have to pay them some godly amount of money per year.

We built the position while every Wall Street analyst discussed how expensive it was. The stock went from as low as \$82 to \$130 today, trampling the bears in the process. We have reduced our position somewhat as the share price continued to increase.

G&D: From what we understand, your EPS expectations for MELI were 7% above consensus on a forward basis. We wouldn't characterize that as a massively variant view. Do you attribute your edge to the ability to think about the long-term opportunity and your willingness to look out farther than some other analysts?

JR: Yes, that's part of it. It's also our understanding of the strategic value of the company. We think MELI is slightly misperceived as a structural loser because of its association as the eBay of Latin America. We actually think it is more similar to Alibaba's business model considering it's a fixed price marketplace without any auction format. And MELI was launching a business similar to T-Mall. They were onboarding big brands to sell on their platform. That aspect of their business had grown dramatically over the first six months of last year and we were excited about that. I thought the association would change upon Alibaba's IPO.

G&D: Do they face any first-party competition, from more of an Amazon-type model?

JR: Yes, the largest first party competitor is B2W, which is a division of a very large retailer in Brazil. They have had some impact, but MELI has done a good job innovating to stay ahead. MELI has built its own shipping network, MercadoEnvios, so you aren't receiving product from sellers just shipping everything on their own.

Also, in some cases, we are very comfortable owning a position without a differentiated view on near term EPS expectations. Our differentiated view might simply come from a willingness to apply a different multiple. This was certainly the case in our positions in Moody's and McGraw-Hill a few years ago.

It was very well known by the market that the Department of Justice and Congress had been evaluating the credit rating agencies and assessing a potential fine for them as a result of their ratings on CDOs issued during that 2004 to 2007 time period. Eric Holder openly discussed what bad actors they had been during this time period. McGraw Hill was fined \$5 billion, and both stocks were down about 45% in the next week.

Some very prominent hedge fund managers were on CNBC discussing how the credit rating agencies were going to have their equity values wiped out and the companies would be put into receivership. A number of investors were using words we like to hear:

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“open-ended legal risk”, “wiped out”, “unknowable”. We looked at the business and thought they would earn \$4 a share, which implied very low valuations at the time. That can work for us.

G&D: You just talked about selling. What caused you to trim MELI?

JR: The stock has had a pretty big move which reduces the asymmetry of risk/reward. Venezuela also likely needs another round of currency revaluation, so we have to assess what exactly is priced in. And then this past quarter, they had a blow-out on the top line, but they lost ten points of margin on the bottom line due to investments in marketing and logistics. That took our earnings expectations down for the year, reducing our differentiation versus consensus.

In general, we like investment opportunities where earnings are going to increase or outperform consensus expectations by 25% or 30%, and we can assume a constant or lower multiple. We don't like relying on multiple expansion as much, but it can work for us.

G&D: Given your TMT focus, have you been active at all in the late stage, pre-IPO market?

JR: We haven't invested in those types of companies. From my experience in venture investing, you spend an incredible amount of time on one single investment opportunity. As a manager of a public market portfolio of equities, it would be very challenging to spend the

appropriate amount of time and attention on the private market investments. Also, having the appropriate fund structure right is very important. There are funds that have private investment arms entirely separate from the public team. I think that is the right approach.

One challenge for public funds is the illiquidity of the investments. In 2008, we saw the challenges illiquid side-pockets can pose for investors in the public markets. That's another consideration.

“A number of investors were using words we like to hear: “open-ended legal risk”, “wiped out”, “unknowable”. We looked at the business [of Moody’s] and thought they would earn \$4 a share, which implied very low valuations at the time. That can work for us.”

G&D: It appears a number of your best ideas were contrarian to some degree. How do you go about building conviction in your ideas?

JR: In many cases, it's the cumulative experience with those companies over a long

period of time, as we mentioned earlier. In other rare cases, we get conviction from doing more research and analysis than other investors. That can definitely be a source of conviction and comfort on the short side. That might have been the case in our largest overall winner in 2012 with Groupon (GRPN). We made 450 basis points of fund attribution on the GRPN short and our success was helped by the amount of work we had done on the company before it listed publicly.

Our research helped us clearly see that the story management was spinning to Wall Street was wildly different from reality. Upon going public, GRPN gave 12-month forward guidance of \$1 billion in EBITDA. 70% of that was coming from international markets, and based on our research, we thought the international operations were in real trouble. Our estimate for the whole company using generous assumptions was for \$350 million in EBITDA. It ended up being \$300 million. We're always trying to find situations where we know things that the market does not. That is the greatest challenge in this business.

G&D: To what would you attribute your success in being able to do that?

JR: I think that the biggest driver for me is humility. By that, I mean that I constantly question my thinking on a stock. I am not wed to any particular view. I am not going to be arrogant and say that I'm right and the market is wrong without constantly reassessing what the market is concerned

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about.

Of course, sometimes we are very wrong. We were short BlackBerry (BBRY) in 2013. John Chen had joined as CEO, and if you look at his background, you can tell this is not a guy you want to short. He was on the board of Wells Fargo, Disney, and Cal Tech. He had executed multiple successful turnarounds. However, it was pretty clear that there was a ton of imagination in between the current state of affairs and what they talked about as their goals. We had conviction that they would miss the quarter and the long term expectations for the stock would be reset.

Part of that thesis came to fruition, after they reported earnings in December. The stock opened down 10%, but then amazingly finished the day up 22%.

I thought about it all weekend. We were right, but we lost a lot of money. When I looked at the calendar, I realized BBRY was going to be able to present at CES and meet a ton of investors. John Chen would definitely impress everyone and convince them the turnaround strategy was winnable. We know from past turnarounds that managers typically get a 6 or 12-month honeymoon period. Investors will just ignore the numbers and give the CEO credit for whatever turnaround plan he plans to implement. I got in on Monday, covered the whole short and we actually went long. It was one of our largest winners last year. We always thought it would be very challenging to deliver the results over the long term that

BBRY presented, but we just felt like it was going to be this period of time where investors are going to focus on the story and Chen's background.

G&D: Are there any additional favorite ideas that you would be willing to discuss?

JR: One of our favorite stocks is Telecom Italia (TI). It is tied to two different themes we have been working on, which is the consolidation of the European and Brazilian telecom industries. Interestingly, because of Telecom Italia's 67% ownership of the Brazilian subsidiary TIM Participações, we actually think Telecom Italia is one of the better ways to play Brazilian consolidation.

Historically, Europe telecoms have been viewed as a public good. These companies have continually been required to buy spectrum from the government and pay higher taxes on certain revenue items. The response from the operators has been to avoid investment in their networks. But now we are at a point where you need to go to a café to access a Wi-Fi network, and the speeds will be really slow. The network quality dramatically lags the networks in other regions.

German Chancellor Angela Merkel gave a speech last summer where she noted that there are 1.3 billion people in China with three telecom operators, 300 million people in the United States with four telecom operators, and 350 million in Europe with 28 telecom operators. Slowly but surely, we will see market

consolidation. In Austria, Ireland, and Germany, the market has already shrunk from four players to three. A recent development was the CEO of Orange mentioning in the Wall Street Journal that he was open to acquiring Telecom Italia. That raises the possibility of cross border consolidation. That's really exciting for Telecom Italia, especially since everything we have learned about the company suggests the Italian government is not wed to having Telecom Italia as an independent operator.

Telecom Italia company could generate M&A interest from Deutsche Telekom, Orange, or Telefónica. This is a hugely strategic asset yet it trades at a big discount to where other operators in Europe trade. One of the reasons it trades at a discount has been the leverage, and concerns around its ability to access the capital markets. Last month, the company borrowed at 3.3% so I don't think that is a legitimate concern.

There is also the potential for mobile consolidation in Italy. The #3 and #4 operators (Hutchinson and WIND) are in discussions. Mobile ARPU have fallen by so much that in order to return to the average ARPU of the other European markets, ARPU would have to increase 40% from here. All of which would be high margin revenue.

In the fixed line business, Italy is one of the only markets in Europe that doesn't have cable. Additionally, a government initiative to spur economic growth is providing financial assistance for fiber deployment

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around the country which Telecom Italia will own. So you can imagine them owning the whole enterprise market and most of the residential market in Italy.

Finally, we think its 67% stake in TIM Participações in Brazil will be very valuable upon consolidation. We think consolidation is inevitable, but it has been delayed by Oi's financial situation. When Brazil goes from four players to three, it will be a bonanza because it's a 200 million person country with low smart phone penetration, low data related revenue, and a population of people who love to talk and access the internet.

Telecom Italia's stock today is €1.08. We think it's worth at least €1.50, and with certain consolidation scenarios, it could be worth €1.80 or more.

G&D: One of the most aggressive consolidators in Europe has been Patrick Drahi. He seems to fit a number of the characteristics of what you'd like to see in managers. Have you spent time on Numericable or Altice?

JR: I think that's the biggest regret I have with our European investments over the last year. We should have owned Altice or Numericable. In our meetings with their team, we were very impressed. Sometimes you've just got to go with your gut about these people. Their recent deal to buyback Vivendi's Numericable stake for 19% below the current market price is incredible. It's a great illustration that if you back a great CEO and management

team, you'll constantly be positively surprised by the smart things that they do. When you back the bad management teams, you're constantly negatively surprised by the stupid things that they do.

G&D: Many of our readers are students interested in becoming professional investors. Can you share any advice on how to enter the field, and to remain successful over the long term?

JR: The best way to enter the field is to meet with as many people as possible and hone in on specific ideas that you have, along with supporting materials. You really want to demonstrate that you are extremely committed to a career in investment management and have been risking your personal capital for years. In my opinion, the most successful investors are the individuals who really love what they do. You need to be thinking constantly about where you might be wrong with your thesis and how you can verify that you aren't missing anything. The market is very smart and you have to respect it and continually reconfirm what you know about a situation that the market doesn't appreciate.

G&D: Thank you for your time, Josh.

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founding Firebird, he was a clerk on the U.S. Court of Appeals and an M&A specialist at the law firm of Wachtell, Lipton. Harvey is a graduate of Columbia University (*magna cum laude*) and Harvard Law School (*laude*), where he was an editor of the Harvard Law Review. He is a member of the New York State Bar. Harvey serves on the board of PR Foods (Estonia) and is a Trustee of Churchill School and a member of the Visiting Committee of the Department of Photographs of the Metropolitan Museum of Art.

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

Harvey Sawikin (HS): I was an M&A lawyer at the firm Wachtell Lipton for five years. I always had an interest in investing. When I left Wachtell, one of the partners gave me a copy of *The Intelligent Investor* and said, "This is what you should read if you want to be a serious investor." I read it and I thought, "This seems pretty easy. I could do this."

I started doing research on stocks. In those days (1992), I had to go up to Columbia Business School; there was no Internet back then, so I sifted through these big Value Line books for stock ideas. I started buying value stocks according to Benjamin Graham's principles. One of his main principles was that you could

tell if the US stock market was a good buy or not if the earnings yield was double the bond yield. At that time, it wasn't even close. But still, if you were American, you should have 25% of your net worth in US stocks even if the market valuation was not particularly attractive. So, I put 25% of my money in stocks, and said, "I'll wait until the earnings yield is double the bond yield," which actually took 16 years because it didn't actually reach that relationship until 2008-2009.

I was at the library at Columbia and I ran into a guy named Dan Cloud, who's now Geoffrey Batt's partner at Euphrates Advisors, a hedge fund focused on investing in Iraq. Dan had just come back from Asia where he had been working for a brokerage. He said, "If you want to talk about value, you need to look at emerging markets. That's where real deep value is found." He convinced me to start a little friends-and-family partnership called Morningside Capital in October 1993, in which we invested in emerging markets.

In December 1993, Yeltsin disbanded the parliament and began a mass voucher privatization program in Russia. Dan, Ian Hague (our third partner), and I thought this would be a major investible opportunity. We looked at the program, and realized that they were going to be privatizing this vast economy of resources. Based on the low valuation the Russian people were attributing to the vouchers, companies could be selling for one cent on the dollar. So we put all of our

money into the voucher auction program in Russia.

Our first voucher investment was into an oil and gas company called Surgutneftegas ("Surgut") in January 1994. We knew very little about it. The only available information was on one sheet of paper. Surgut had the same amount of oil reserves as Mobil. At the time, we calculated that its implied market capitalization in the voucher auction would be about \$40 million, versus \$40 billion for Mobil. We said, "Look. It doesn't have to be as good as Mobil. It only has to be a little less bad than Mobil, and we could make 2x or 3x our money." In fact, at the peak, Surgut actually had a market cap above \$40 billion.

People often ask me, "Weren't you scared when you invested in Russia? You took a big risk." At that moment, I was pretty sure we were going to make a fortune. How could it be any more obvious than when you're buying something for one cent on the dollar? When we visited Russia in January 1994 I saw with my own eyes that it was a real country. It wasn't nice, it didn't smell good and there was no food, but it was a real country. In the course of my investing career, I've had three or four of these big revelations where I just was absolutely overwhelmed by something. Russia was the first one I ever had. So that's how I got started.

There were four of us who got together and launched Firebird. We were all from different backgrounds. I was a lawyer. Ian was a political scientist. Dan Cloud had

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emerging markets experience. The fourth partner who joined, Brom Keifetz, had just finished an MBA.

The fact that none of us had much mainstream professional investing experience was a benefit at that time, because we didn't have any preconceptions; if you required good financials to invest in a name, you would never have touched the stocks we looked at. In fact, you probably wouldn't have touched it for ten years, because it really didn't start looking like that until about 2004-2005, but by then, a lot of the money had been made. Because we were very green, but we had some big ideas, it was a benefit to us.

G&D: What were your other major revelations?

HS: We started investing in Kazakhstan in 1997 because it was a repeat of Russia, in a way.

We started a private equity fund for the Baltic States in 2002. I was very excited about that. With U.S. stocks in 2009, I was not as excited as I had been about Russia in 1994, but I felt that, finally, Benjamin Graham's requirements were met – I had been waiting for it for 16 years. It was then that I finally added a decent weighting in U.S. equities.

There have been other times when I thought I had it, and it hasn't worked out. We have a fund dedicated to Mongolia run by my partner James Passin. When he first showed that to me in 2010, I thought that was another amazing opportunity. So far, it hasn't really broken

out yet – it's still struggling, but that's typical with the frontier markets.

I have never invested in a frontier market that didn't have those growing pains in the first few years. It's always the same: they start out amazing and everybody gets very excited. Then, something goes wrong and you go into the wilderness. The first time we went to the wilderness in Russia was in late 1994 until about the third quarter of 1996, before it started to work again.

“People often ask me, ‘Weren't you scared when you invested in Russia? You took a big risk.’ At that moment, I was pretty sure we were going to make a fortune. How could it be any more obvious than when you're buying something for one cent on the dollar?”

G&D: You've obviously expanded since investing in Russia. What statistics or data points do you look for to help you determine what country to invest in next?

HS: In the early stages, we're looking for a few things. First, is the political environment: you want a country that has

been through political change that has made things more stable. For example, Russia had come out of a period of chaos, and Yeltsin finally established more personal control and installed a prime minister who could make things happen. We've seen this many times, in Georgia in 2004, and Mongolia. Second is macroeconomic stabilization. If you have a government that is determined to stabilize the economy, it's often after a period of high inflation or when they've lost a war and everything is in chaos. Someone comes in and manages to get control of the economy, and bring the inflation rate down. Third, we look for a functioning capital market that should have a few investible stocks. It doesn't have to have a lot. You can make a lot of money on just one stock, which is what we did in Georgia where we made 10x our money on Bank of Georgia.

G&D: If you talk to a number of emerging market managers, they call Russia un-investible. They worry that the rule of law is murky, that there is corruption. That said, you've clearly managed quite well there. What would you say to those investors who consider it an un-investible country?

HS: People have been saying that for the last 20 years. I think it's always required careful management, but the opportunities in Russia were, and are, huge. I think it's actually gone through periods where it was more investible than it is now. Now, it's more was akin to the early days where you really had to be a stock picker. I don't think the ETFs are a good way to play

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Russia and they haven't been since 2008.

In general, ETFs have proven to be a poor way to invest in emerging markets. Institutional investors who want low fees and that have played emerging markets through ETFs are starting to realize that it may not be suitable, and there's a reason why: ETFs are market cap-weighted. Market caps tend to be the largest in state owned or state-influenced companies, which generally tend not to be managed for the benefit of minority shareholders. The top five stocks in the MSCI Russia constitute 60% of the index. You're missing out on all these amazing companies that have smaller market caps.

So Russia is investible, but our required return is higher now than it has been at times in the past because the macro risks are so high, and because there is more government influence on private property.

Ukraine was different. Ukraine was a country where you couldn't even find managements that were aligned with shareholders at all. In Russia, there are a lot of companies where the companies are controlled by majority shareholders who, a long time ago, determined that they were going to get value from the company through share ownership, not through theft.

At a lot of these Russian companies, the corporate governance is equivalent to an average company in Europe. In Ukraine, there have been almost no such companies. That's what un-investible

means to me: I consider any country "investible" where there are liquid listed companies run by managements that are aligned with shareholders.

G&D: Could you talk about your investment process when it comes to looking at these early stage macro and political catalysts? Can you also discuss the transition from these early stage opportunities to the later stages where you can start to look at the fundamentals and the reporting becomes better?

“Generally speaking, once companies become well-accepted and start to see the big mutual funds in the shareholder base, that's usually a time to start taking profits.”

HS: In emerging markets investing, the dream is to buy an early stage frontier stock and hold it all the way until it becomes a NYSE-listed stock that's highly regarded. That has occurred in a number of our investments. For example, the Bank of Georgia, which we first bought in 2004. Georgia had just changed its government. They had a new,

very pro-Western government with a radical reform program. They called us, looking for somebody to buy shares from the old management. The EBRD (European Bank for Reconstruction and Development), which was involved with recapitalizing the bank, suggested Firebird, because they knew we had been interested in Georgia. We wound up buying 20% of the bank in two transactions. At that point, it didn't have much earnings. We knew that the book value was overstated, and that much of the loan book was worthless. But we had acquired 20% of the bank for less than \$10 million.

Over the next ten years, the bank cleaned itself up, cleaned up its balance sheet, and did capital raises at higher prices with good institutions, which diluted us down. Bank of Georgia eventually listed on the London Stock Exchange, which is where they are now. It now has an \$800 million market cap with a blue chip investor base.

In 2003, we bought a stock in Russia called Uralkali, which was a potash producer. It was not a profitable company. Any the profits were being hidden, but we noticed one quarter when things started to change. So, we started buying stock at five cents a share; we also did a little bit of research and concluded that there was a potential structural supply deficit in potash, so we were bullish on the resource.

The management was trying to convince us not to buy it, because they were buying it themselves! This was something we called the

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"Scooby Doo" where they try to scare you to go away. You know that's what they're doing, because usually they end that by saying, "By the way, if you have any shares, we'll buy them from you because we're nice guys... but you shouldn't buy them."

We were also right about potash, and the stock went from five cents, which was our first purchase, eventually peaking above \$12, so it was a huge win.

G&D: In the example that you just went through, with the Bank of Georgia shedding its non-performing loans, improving corporate governance, etc., what if something politically or economically adverse happens? How do you determine the risk-reward profile?

HS: Generally speaking, once companies become well-accepted and start to see the big mutual funds in the shareholder base, that's usually a time to start taking profits. For example, with Uralkali, we were reducing exposure as it went up. Of course, the risk-reward starts to shift a little bit. Now, you start to have things priced for growth.

But there's another element in what you said, which is what happens if something goes wrong. In my 20 years of doing this, I've seen a lot of things blow up that people thought were unassailable, such as Yukos. There is only one solution to that problem, which is diversification; because everybody thinks that they are going to know to get out before somebody says something about re-

nationalization or something. These things happen all of a sudden. Also, the liquidity disappears very quickly. Investors get in trouble when they are over-concentrated. I believe that an emerging markets fund should not be over-concentrated; it's a big mistake.

"The first thing you learn as a value investor is if your stock goes down you should be buying more. In an emerging market, very often, that first leg down is just the beginning of a total meltdown because of some major change that's happened at the macro level."

When you're over 10% in a single stock, alarm bells should start ringing. If you want to be over 10%, you should be aware that you're taking a very aggressive view. Generally speaking, our position size for something that is a great value, is liquid, and has good management and a good macro situation, is somewhere between 4% and 6%. That's pretty much it. If any of those elements is less, then it would be less. If it's got all these great things, great value, great management, etc., but the liquidity isn't so good, then

maybe you're talking about 2% to 3%.

I remember in 2003, Yukos was almost 30% of the Russian index. We were taking heat from investors because we were 2/3rds underweight in Yukos and underperforming as a result. I kept saying, "Well, we don't think it's as safe as everybody else seems to think." Then the arrest of Khodorkovsky (then-CEO of Yukos) occurred and we heavily outperformed the index in 2004.

G&D: How do you think about geographical diversification?

HS: We have Russia funds and Eastern European regional funds. Even our Russia funds are fairly diversified. For example, our Firebird New Russia Fund is about 57% Russia. That's on the lower end of what it's been and that's because of the geopolitical situation. Even at the peak, it was no more than 90% Russia. The rest consisted of our best ideas from Eastern Europe.

Studies have shown that even a small amount of diversification enhances expected return significantly. Our regional funds are about 25% Russia and very diversified.

On the other hand, personally, I'm not a big fan of global emerging markets equity funds. I think fixed income and currencies funds are different. But I know how hard it is to feel that we keep an edge in just the 12 markets that we're currently active in, much less having to follow what's going on in Indonesia and Egypt and everywhere else.

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At the same time, I think a single country fund is problematic because it's very hard if the country is not doing well to just go to 100% cash. What if you're wrong? Your investors would be very angry if you were wrong and the market continued rallying and you missed the whole thing if you're calling yourself say a "Russia fund".

Our regional funds are free to exit a country if it's not working. Last year, after the events in the Crimea, we reduced Russia in our regional funds by a third very quickly. We felt no compunction about doing that; we reallocated the proceeds partly into Romania and Estonia, which we thought would have a better year, and they did.

G&D: A lot of funds categorize themselves as being bottoms-up, fundamental investors. Given your firm's EM focus, does it necessitate a top-down approach? Does it require an assessment of what's going on politically and any geopolitical risk?

HS: All of our investing is hybrid top-down and bottom-up because every company that we invest in has to operate within the context of a dynamic macro situation. Obviously, there is no way you could invest in Russia just running models on Sberbank and Lukoil without understanding what was going on in Ukraine, and what was going on in the oil industry.

We spent a lot of time on the macro over the last year. It comes and goes in waves. Between 2010 and 2013, we were really focused on the

bottom-up. The macro was relatively stable in our region and geopolitics was relatively calm, so it was easier to just focus on stocks.

This is one of the pitfalls of being a value investor in emerging markets. The first thing you learn as a value investor is if your stock goes down you should be buying more. In an emerging market, very often, that first leg down is just the beginning of a total meltdown because of some major change that's happened at the macro level.

“...the day that I feel that oil bottomed was the day in early January when Goldman Sachs put out this piece of research that said that oil was going to be low forever.”

I've found that with all fund managers, both in EM and in the developed markets, people are always fighting the last war. For example, right now, everybody is a macro person thinking about the oil price and the Euro. All the things that blew up on people last year, everyone's focusing on that when maybe now is the time they should just be picking their favorite stocks and buying value.

That was why in 2009, most people failed to get back invested at the bottom, because they kept thinking about what they should have done in 2008. In emerging markets, certainly, it's always a blend.

G&D: In our interview with Geoffrey Batt last year, he talked about the delta between perception and reality in emerging markets. In that context, when you think about Russia and Ukraine and some of these other countries, what do you see as the perception versus reality there?

HS: In the Ukraine, there is a perception that this new government is the same old thing. I think some of this is actually disinformation. In fact, the new government in Ukraine really is trying to do something new and different.

In Russia right now, I don't see a huge gap between perception and reality. People perceive that Russia's motives toward Ukraine are not particularly benign. We tend to see it the same way, which is why we reduced Russian exposure. There are specific trends that people may not understand. For example, everybody thinks that because oil prices are down, they've taken down the prices of Russian oil stocks by 30%. But Russian oil companies are not that much less profitable with oil at \$60 than they were at \$80.

The reason is that the ruble is highly correlated to the oil price. When the ruble goes down, the companies' costs do as well, since their costs are largely denominated in rubles. At the same time, the tax

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regime in Russia is set up in a way that as oil goes down, the tax burden gets lower, and as oil goes up, they tax away a lot of the profit. That's something the market may not fully perceive.

The delta between perception and reality is greater in frontier markets than it is in more developed emerging markets. There are a lot of investors doing a lot of research on Russia. Maybe we have some insights they don't have, but generally speaking, investors understand Russia more or less.

Some of our smaller markets may be different. Kazakhstan is a country where people who don't specialize really have very little understanding about how things work there. The more "frontier" a country is, the greater the inefficiencies in terms of understanding the macro, and in stock-picking.

G&D: You said that Russian oil companies are not significantly less profitable at \$60 a barrel partly because of the tax. How low can oil prices go such that these companies are only just breaking even?

HS: I think \$40 is a level that I've seen Russian oil companies mention as a level where they would have to re-think a lot of their projects. By the way, here is something I noticed about oil. Everybody focuses on the fact that oil got down to \$35 in 2008, and on why we might get back to those levels. We did get there, when you adjust for inflation. When oil hit \$45 in January, it was like we were back to those levels – so we got there. I may be proven totally wrong, but the

day I feel that oil bottomed was the day in early January when Goldman Sachs put out this piece of research that said that oil was going to be low forever. The piece of research got a lot of attention. They talked about it on CNBC. I and a few other people who think a lot about oil found it to be full of holes. My thought about it was that this was the kind of research that Goldman puts out is when they're ready to cover their shorts.

“In frontier markets...you’re betting not on current profitability, but on what it could earn if it became a normal country and a normal company, and the management does the right thing.”

I think we've seen the lows. Pricing is pretty solid at these levels in spite of production still rising. Maybe that has to do with the financial buyers of oil now pulling forward the better supply/demand picture that we'll have in the second half of the year. Just as in the fourth quarter of last year, investors pulled forward the bad supply/demand picture

into the fourth quarter and drove oil down in advance.

G&D: How does Firebird get comfortable investing in frontier markets given the limited information available and/or the opacity of the data?

HS: In frontier markets, you're never going to get the kind of full information that you like. You don't necessarily buy stocks on that basis. You're buying franchises, large assets trading at 10% of replacement cost. You're betting not on current profitability, but on what it could earn if it became a normal country and a normal company, and the management does the right thing. You're looking for a management that's competent and incentivized properly. You're looking for a world-class franchise or a company that is a dominant player in its market. Also, you want to find the right sectors within a country. When we first came to Russia, we chose to buy oil stocks. Not everybody did that. In hindsight, it seems so obvious, but at that time, a lot of people were focusing on retailers, which were terrible retailers at the time, or consumer goods companies that could never survive.

Each country has a different sector that's attractive. It's a comparative advantage question. In Mongolia, it's coal; they are the Saudi Arabia of coal. When we came to the Baltic States, it was about banking and retail, because they were a trading entrepôt between Russia and the West. If you're requiring perfect financials, you're not going to get the deep discounts.

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Harvey Sawikin



Rick Gerson of Falcon Edge Capital responds to a question from the audience at the 2015 CSIMA Conference.

G&D: Do you find yourself investing in certain sectors more than others?

HS: We invest in banks and resource companies much more than others. If you believe in the economy of a country, buying the bank is a leveraged play on the growth of that economy. That could work both ways; when things go wrong, it's the banks that take the biggest hit. You have to be careful and take profits.

Also with banks, particularly if they're systemic banks, they are generally going to be more regulated and less prone to theft. Take Sberbank for example – it's too dominant. They hold half of Russia's deposits. Of all the listed banks in Russia, here's one that you feel is going to have to be under a microscope and it's going to be pretty clean.

In Kazakhstan there are some resource companies that are huge and have unique assets. If you could find them in a developed market, you'd be paying 2x the multiple, at least. We're always trying to achieve sector diversification, which is a challenge.

There aren't a lot of listed consumer products companies. Over the years, there have been a few, but they keep getting taken over. Over the years, we had Wimm-Bill-Dann, which was a dairy that was acquired by PepsiCo. We had Baltika Beer, which was acquired by Carlsberg. It's very difficult to find listed consumer companies because they are often logical takeover targets for the big international players.

G&D: We've talked about a number of names so far. Can you share any other ideas with us?

HS: I mentioned Bank of Georgia. When I look out five years and I look at the portfolio and I try to figure out which stocks I have a pretty high degree of confidence in, that's one that I focus on just because Georgia is growing anywhere from 3% to 5% sustainably.

“Long-term, I'm bullish on fertilizer, because I don't see any major substitutes on the horizon. It's not like oil with electric cars and alternatives. The population of the world keeps growing, so crop yields have got to be high.”

Bank of Georgia has a 40% market share and the best management in the country. They not only have their bank business, they also now have the largest healthcare business and one of the best real estate developers. It's sort of a play on the whole country now, not just the banking side. It's not dirt cheap. It trades at about 1.4x book, but I feel like that's something that I have confidence is going to go up over time.

Among oil companies, we like Lukoil, which trades at about a 5% dividend yield. They have transitioned into a company that runs efficiently and pays big dividends.

In Russia, we also own Gazpromneft. It's a subsidiary of Gazprom. I actually presented it in 2013 at two value investment conferences. It's a company that has a portfolio of more mature and newer assets, generates a lot of cash flow and pays a large dividend. Because they are a subsidiary of Gazprom, they were allowed to acquire a lot of young oil fields from Gazprom. They were a preferred buyer. And they have a very good management team, which is unusual for a state-owned company. The quality of management is the main reason that they're allowed to be independent and not fully absorbed into Gazprom, because they add so much value. If they had poor management and were inefficient, they would have no justification for staying independent.

Uralkali is an interesting case study. When potash prices came down over the last two years, this was actually an exercise in cartel behavior. They have to protect the cartel long-term by deterring a few major projects. They did so successfully. Now, gradually, they're raising their prices again. This company took a double hit because of not only the potash prices and Russia problems, but they had an accident with one of their mines that knocked out 20% of their capacity. The stock is down 65% from where it was two years ago. The

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Harvey Sawikin

management is probably among the highest quality in Russia in terms of transparency and corporate governance. This is one of the stocks that was considered investible by the big institutions. I think it still is, although some of them got scared off because of the macro situation in Russia. I still like Uralkali, and we've been buying it back.

Long-term, I'm bullish on fertilizer, because I don't see any major substitutes on the horizon. It's not like oil with electric cars and alternatives. The population of the world keeps growing, so crop yields have got to be high.

G&D: Are both of Gazpromneft's assets relatively well positioned on the cost curve such that they can still produce profit if the price of oil declines further?

HS: Yes. In Russia, even though costs have gone up, particularly at the older fields, the lifting costs are still much lower than a lot of other mature assets. Because of the tax regime I mentioned, they still generate a lot of free cash flow even with oil at \$60. Even with oil at \$50 they are still profitable.

G&D: Do you have any advice for people wanting to specifically invest in emerging, developing, and frontier markets?

HS: There are two paths. One path is to go to work at a company like ours. We've hired a lot of people out of Columbia's Value Investing Program. Going to be an analyst at a buy side fund or emerging markets brokerage I

think is a perfectly good way to get in the business.

The other way to get into the business, which is totally different, is to do it the way I did, which is just basically figure out something that other people haven't noticed and just go and do it. If somebody noticed that some country in Africa was developing a great capital market, went there, made contacts, tested it out with their own money, and figured out what was good, and then came to New York, they would find lots of doors open to them. Everybody wants to hear about a new idea.

Even though the Firebird team all really came out of nowhere, because we had a great idea, doors were opened to us quickly. That's the other way to get into the business, which is riskier, but ultimately can be more rewarding if you're right.

G&D: This has been really fascinating. Thank you very much for your time.

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Eric Yip & Mark Unferth

estate, gaming/lodging/leisure, and was lead analyst in a multi-billion dollar portfolio of commercial mortgage backed securities (CMBS). From 2006-2009, Eric was a principal at Columbus Hill Capital Management where he invested in credit and equity across a variety of industries. From 2004-2006, Eric was an Investment Analyst at Icahn Associates, where he focused on activist equities and distressed credit investments. Prior to joining Icahn Associates, Eric worked at Franklin Mutual Series, Stanfield Capital, and Mellon Bank. He graduated in 1997 with a B.S. in Accountancy from Villanova University.

Mark Unferth is a Managing Partner, and Co-Portfolio Manager at Alder Hill Management. Prior to founding Alder Hill, Mark spent five years as Head of Distressed Strategies at CQS, where he managed \$400 million in a number of investment vehicles. From 2007-2008, Mark was a principal (with Eric Yip) at Columbus Hill Capital Management, responsible for making credit and equity investment recommendations. From 1998-2002, Mark served as Managing Director/Co-head of Distressed Research on the Distressed Bond Trading Desk at Credit Suisse/Donaldson, Lufkin & Jenrette. Prior to DLJ, Mark worked at Metropolitan West Asset Management, in Loan Sales & Trading for Citibank, and at the Federal Reserve in the International Finance Division.

Mark received a B.A. in Economics from the University of North Carolina at Chapel Hill in 1990 and an M.B.A. in Finance from the University of Rochester in 1995.

Graham & Doddsville (G&D): Let's start by talking about your backgrounds and how you got your starts as cross-capital structure investors.

Eric Yip (EY): As far as I know, I am the only investor to have worked for both David Tepper and Carl Icahn, two legends who are in the investing Hall of Fame. But by today's standards, I got my start in a very non-traditional way.

In terms of background, I'm always reading profiles of great investors where people talk about being born to invest, and it seems their whole life was planned with that goal in mind. It was quite the opposite for me. I grew up in a lower middle class immigrant family, and that path was never obvious. I studied business at Villanova and when I graduated in 1997 I was unsure what to do next. I knew I wasn't going to get into the pedigreed Wall Street programs. I wasn't interested in working for one of the big accounting firms. So the best opportunity at the time was a job with Mellon Bank in Philadelphia.

I worked in the asset-based lending group as an analyst, not doing anything glamorous, but learning the nuts and bolts of commercial lending. Early on in the training program, there was a lot of reading, particularly lending agreement documentation regarding covenants,

terms, etc. Those documents force you to understand your protections and rights as a lender. I might not have recognized the skills that I was acquiring at that point, but they turned out to be very important to what we do today. I also participated in field exams, which entailed meeting clients, evaluating financials, and kicking the tires on collateral. As an asset-based lender, you have limited upside in getting your money back with interest while your downside is a real diminution of capital, so understanding asset value is critically important. This experience also helped shape my value investing philosophy and intense focus on risk and downside minimization.

After a few years in Philadelphia, I wanted to move to New York. I joined Stanfield Capital in their CDO group. The early years were spent working with the senior analysts, attending bank meetings and high-yield road shows, and learning the business and applying some of the lessons from my time at Mellon.

After about a year and a half, the fund hired a PM from the outside to start their distressed hedge fund. He saw the work ethic that I had, appreciated my first in-last out mentality and preached the importance of taking advantage of your opportunities. Once I joined his team, I got a taste of what I found to be the real fun stuff - distressed debt and deep value equities. That's when I started connecting the dots as an investor.

After that PM left, I went to work for Franklin Mutual Series, which was among the first

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funds to invest across the capital structure. I wanted to join a traditional value shop that was agnostic about where in the capital structure to invest, as well as to work for one of the most respected distressed groups on the Street (led by Mike Embler and Shawn Tumulty, both of whom are still good friends and mentors).

We had several billion dollars of capital to allocate to distressed at the time and were very active in some of the largest opportunities, particularly companies like Adelphia, NTL, and WorldCom. I focused primarily on utilities and IPPs, where what mattered were replacement values and the power markets themselves. Names like Calpine, NRG, and Dynegy ended up working out well for us.

Mark Unferth (MU): After finishing school in 1990, I went to work at the Federal Reserve Board in Washington, D.C. for three years as an economist building large econometric models. I thought I'd end up getting my PhD in Economics but ultimately decided that wasn't for me and moved to Wall Street.

When I joined Citibank in 1995, I started in a group that was structuring loans. My first introduction to the bankruptcy code and process was from structuring DIP facilities. I did that for about a year and then moved over to the trading desk. Loans were an infrequently traded asset back in the mid-1990s, but this was the early stages of when distressed loan trading was about to become a big thing. I worked as a desk analyst for three years before moving over to DLJ

where I eventually became Co-head of Distressed Research for the bond trading desk.

In those seven years of working on the sell-side, I had an opportunity to interface with a lot of very large distressed investors. In observing the different styles and approaches those investors took, I started to assimilate what I thought were the best ways to approach distressed and value investing. At the same time, I was putting it into practice by investing capital for the desk, which at the time was run by Bennett Goodman, Tripp Smith and Doug Ostrover who later went on to start GSO Capital Partners.

I moved over to the buy side in 2002 when I joined Metropolitan West Asset Management (now TCW) and it was there that I had my first chance to manage capital during a distressed cycle as a PM. I ended up working on quite a number of bankruptcies during that timeframe. The most salient experiences for me were Finova, Worldcom and Conseco where I sat on official or ad hoc creditors' committees. I loved that. It was an opportunity to provide insight into investments that are off-market. Distressed investments don't have the same characteristics that you find in a large-cap equity that is well-followed by the Street. A lot of these things are very situational. There is quite a bit of game theory that's involved and it's very analytical.

Eric and I met at Columbus Hill Capital in 2006, where we were principals responsible for generating investment ideas across the capital structure,

both debt and equity. We worked closely together in 2007 and 2008, which was the opportunity of a lifetime to invest in distressed situations, and our teamwork in that volatile time is the bedrock for Alder Hill now. I left Columbus Hill in 2009 to become the head of the Distressed and Special Situations group at CQS, a London-based \$15 billion hedge fund, where I built a five-year track record investing across US and European markets. I left CQS to reunite with Eric and form Alder Hill.

G&D: Eric, tell us about the transition to working for Carl Icahn and David Tepper.

EY: While I was still at Mutual Series, I built a working relationship with some of the team at Icahn. After a while, the appeal of working for Carl Icahn was hard to resist. He is an iconic figure and I couldn't say no to the opportunity. I always found activist investing to be very interesting and I still believe in the value it can create in the right situation. Everyone knows Carl as an activist, but what people don't often appreciate is how successful he has been at making money in the area of distressed debt. He can take very large stakes in companies in the hopes of restructuring them and controlling them when they exit bankruptcy. It's all about understanding the process. For Carl, activism in distressed debt and equity activism are not that different. When you look at investors today, there are very few people who can succeed in both of those areas.

I primarily worked on activist

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Luke Tashie '15 receives the 1st place prize from Paul Orlin at the 2015 Amici Capital Competition.

equity investments in both the US and internationally due to fewer distressed companies at that point in the cycle. That's the benefit of shops with a broad mandate and capabilities; it allows you to search a wider area for the very best opportunities.

After a few years there, I had an opportunity to join Columbus Hill, which is where I met Mark. The fund was founded by Kevin Eng and Howard Kaminsky, who, prior to starting it, had been managing domestic and international credit investments at Duquesne for Stan Druckenmiller and had also worked with David Tepper at Appaloosa. What I did at Columbus Hill is very similar to what we do here at Alder Hill, which is investing across the capital structure, looking for event catalysts, and searching out ideas anywhere in the world. I was with the fund from 2006-2009, which encapsulated some of the best times in the market and also some of the worst. In the aftermath of the housing market collapse, I worked on some high profile real estate bankruptcies and near-bankruptcies.

G&D: And Appaloosa came after Columbus Hill?

EY: That's right, and after joining, David I had two main duties. The first one was helping build out a multi-billion dollar CMBS portfolio. David was well-known as a distressed debt guy, but what he did, which makes him brilliant, was recognize opportunity in other areas and pursue it. He made big investments in equities during the financial crisis when he wasn't thought of as part of the equity community. Based

on what he has done since, people might even consider him a macro guy. But he wanted to start investing in structured products, mainly CMBS, even though he wasn't really known for having expertise in that area. That's why it is hard to define him.

“As an investor, you have to ask some important questions. What are the cash flows? What's the replacement value? Does it generate enough cash to pay fixed charges? While most people were running away, we were digging into a new situation that was ultimately not too different from corporate securities.”

CMBS is really just a portfolio of first lien debt. If I had you look at CDOs, it would typically be a portfolio of first lien syndicated bank loans for corporates. This was not different except it's backed by real estate properties. You still have to analyze it. The massive growth in CMBS issuance prior to the downturn, like many things at the time, was very artificial. They were purchased by investors who did not really

understand what they were buying. As an investor, you have to ask some important questions. What are the cash flows? What's the replacement value? Does it generate enough cash to pay fixed charges? While most people were running away, we were digging into a new situation that was ultimately not too different from corporate securities.

At Appaloosa, I also worked on the fund's gaming/lodging/leisure sector coverage as well as everything real estate-related on the corporate side. That includes both debt and equity investments. At Appaloosa, you are taught to be both a value investor and an opportunist, which requires moving around to where the opportunities are.

G&D: Talk about some of the key lessons from working with those two investors and how they've shaped your philosophy or process over time.

EY: From Carl, the first lesson was thinking about investments with an ownership mentality. And this wasn't simply a theoretical exercise, because in the right situation he really could buy the entire business, so I had to apply that same rigor consistently in my analysis. Secondly, Carl is also great at understanding his rights as a shareholder and creditor, and knowing both the business side and the legal side of his investments. A third lesson was the importance of understanding management's motivations and incentives. Carl has an amazing capacity to understand human nature. Lastly, Carl built a great organization and I had the pleasure to work with incredibly talented colleagues.

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Vince Intrieri, who is still with Icahn, and Keith Meister, who has gone on to start his own very successful firm Corvex, were instrumental in my development.

As for David, I've never seen anyone who is so great at so many disciplines, yet is also very generous and humble. As a CIO, as a PM, as a trader, as an analyst, and as an economist, he can hold his own with anyone. I have seen him do all those things at Appaloosa, and across a broad range of investing styles. He's also not afraid to take risks or invest in a situation where everyone else is running away. In my opinion, that's where he's the absolute best. He can connect the dots on a theme or idea better than anyone, and that has influenced my way of thinking today. Everybody is focused on E&P and energy services right now, and that's fine, but now my mind goes to, what about the car dealership chain in Canada that might have got really beat up because they had significant exposure to the Alberta region? How about that bank or hotel company with exposure in Texas? Are there opportunities there that might be more interesting as second or third derivative ideas from the fallout in oil prices? It's that type of non-traditional thinking that we're still very influenced by today.

G&D: What did you learn from him in terms of getting comfortable with making big contrarian bets?

EY: He has been able to do that because there is exhaustive research backing up the ideas. At Alder Hill, we won't make an investment without

first doing the hard work, so that we're ready to defend our position and stick with that conviction if the market goes against us.

G&D: How influential were they in how you thought about setting up Alder Hill?

EY: Very few hedge fund managers would do this, but early in our process of setting up the fund, David sat down with Mark and me on numerous occasions. He knew that we could invest so he wasn't concerned with that part. What he really emphasized was the im-

“What [David Tepper] really emphasized was the importance of building the business the right way - creating the infrastructure, hiring the right team, finding the right investor base.”

portance of building the business the right way - creating the infrastructure, hiring the right team, finding the right investor base. And these issues are especially important for a fund that may invest in esoteric products or require the flexibility to run toward the ugly

and underappreciated situations.

We were very thoughtful about the team. Our current group is made up of senior people. That dynamic is important because our strategy requires the dexterity and variety of talent to switch, for example, from evaluating foreign sovereign debt, to levered equities, to REIT arbitrage, to high yield credit, to M&A situations and other special situations like equity spinoffs. We require people who are able to do all those types of things, and in order to do that, we needed to hire people who were experienced and were trained in cross-capital structure fundamental investing.

Mark and I have a rule that we always want our entire investment team to be able to fit around a conference room table. If they can't, then we know we've grown too large. We want to go back to the ways of the old-school hedge funds, in that we're going to run a little more concentrated portfolio, and with a large degree of collaboration and respect for our team's opinions. We sit around the table and critically review every investment idea as a team. What that means is you're going to really know your investments, properly create a margin of safety, and develop the conviction needed to succeed.

G&D: Have there been other influences in how you've thought about the culture at Alder Hill?

MU: Make no mistake, you have to work really, really hard in this business. That will be true wherever you go, but one

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thing we learned at Columbus Hill was its culture of collaboration. We've tried to bring that to Alder Hill.

We wanted a close-knit group where everyone can collaborate and where we value people's thoughts and participation. Our view is that the more eyeballs you have looking at something, the more likely you get to the right answer. When we have meetings, one of the things that we picked up over the years at different spots that we worked was to allow people to take a contrarian position. It's okay to express it if you have a different view, because at the end of the day the most important thing is we get to the right answer for our investors.

G&D: How would you describe yourselves as investors?

MU: I am really a distressed investor. I lean toward the situations that have an element of active involvement, where I'm rolling up my sleeves and getting involved in the restructuring, working on ad hoc committees, or maybe a litigation situation in bankruptcy like Six Flags or Visteon in the last cycle.

I would say that's the side of investing that I particularly enjoy because it's a bit like putting together a really complicated puzzle. There are often times these things take a little gestation to work themselves out and for the pieces to fall in place and you decipher all of that, but that's the kind of work that, generally speaking, and this is not to knock the sell side, but that's not the kind of stuff that they do. Very often when things

become special situations in that manner, they lose coverage. They become less followed and it gives you a real opportunity to invest, and that's what really appeals to me as an investor.

EY: I'm opportunistic in my

“It's not just identifying the idiosyncratic value situations, because anyone can run a spreadsheet, but you need to understand the process and catalysts to realizing full value.”

ideas, and I consider myself an old-school Munger geek, particularly his passions for reading, retrospective/contrarian thinking and psychological self-awareness. I also enjoy the Buffett-ism of buying dollars for fifty cents, which increases upside while also minimizing downside. Since value oscillates across cycles, you need to have the tools to invest in both equity and credit to find those fifty-cent dollars. And lastly, it's not just identifying the idiosyncratic value situations, because anyone can run a spreadsheet, but you need to understand the process and catalysts to realizing full value. When I was growing up, Macy's would have their big annual sale and the dream was to buy that elusive thing that never went on sale, like a white Polo shirt, for 50%

off. So, I guess from an early age that is what really appealed to me.

MU: The other thing that really stands out is that we are both value investors that can move around the capital structure. Eric and I have been through several cycles, and given that we were initially both credit-trained but have also extensively invested in equities, we really understand upside/downside and where things can move around.

G&D: Some people view credit investing and equity investing as being quite distinct. You don't run into that many people that have very successful at both. Is that false logic or why do you think that is the case?

EY: What we're trying to do is to find assets that we think are trading at a deep discount to intrinsic value. They could be credit or equity. If our mandate was to be a cross-capital structure fund and I started telling you about our equity investments in growth companies that trade at 10x revenue or 50x P/E, or that we invested in investment grade, low yielding paper trading at par, then I'd agree that would be a strange mix.

What we're investing in for credit and equities is actually quite similar. I will give you one historical example: MGM Mirage is the type of company we would typically look at. It has high yield debt and levered equity. During the 2008-2009 downturn, MGM had senior bonds that were trading in the 30s and 40s. As the company started to fix its balance sheet and the market was improving in the 2010-2011 period, the

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Brian Waterhouse '15 receives the 2nd place prize from Paul Orlin at the 2015 Amici Capital Competition.

equity became a play on the continued repair of the balance sheet, continued repair of the fundamentals, and with upside optionality from a normalization of industry growth. On top of that, you had an opco/propco element that you were seeing elsewhere. It's that type of situation that we focus on at Alder Hill - one day it's the equity we'll invest in, but then in the next downturn, we may invest in the credit of the same company and vice versa, depending on the cycle. When you stick to value-based situations like that, the credit vs. equity dynamic is not really an issue. The question for us is consistently, what is the fulcrum security which creates the most value based on our analysis? That could be debt, or equity, or debt that might one day be converted into equity. Covering that whole range of outcomes gives us an advantage over funds with restricted mandates.

G&D: Can you give us another example where your debt expertise helped you identify an interesting equity opportunity or vice versus?

EY: I'll give you an example without giving you the company's name. There was a gaming company we invested in that was trading at 7x EV/EBITDA and the leverage was 5x EBITDA. As we all know, that is clearly a levered equity. It's a high-yield issuer, and when we put on our credit hats, we noticed the most junior debt was trading at a 6.5% yield. The high-yield markets appeared to be comfortable with the leverage.

Meanwhile, the free cash flow yield on the equity was around

20%, so there was some disconnect in how the two markets were looking at it. Yes, it is levered and that's part of why the FCF yield was so high, but this is the type of stuff where we start off by asking "what is the credit market view?" and, in this scenario, it seemed different than the equity market. The credit metrics

"[Equity investors will] come across something like this, see that it's 5x levered, and get scared off. It is not for the faint of heart but this is our bread and butter, where we get to apply our credit expertise into understanding the equity."

were solid. They were generating free cash flow and using all of it to de-lever. We thought the equity was especially interesting because we didn't feel like there were any knockouts for the credit - no liquidity issues, no near-term maturities to worry about; interest coverage was fine.

This is the type of investment where we feel like we have an edge over the typical equity investor, because those investors may not know or even look where the debt trades. They'll come across something like this, see that it's 5x lev-

ered, and get scared off. It is not for the faint of heart but this is our bread and butter, where we get to apply our credit expertise into understanding the equity. The added benefit in this particular investment is that it came from an industry that I had been covering for over ten years so I knew the fundamentals very well and understood there were multiple other ways to win.

MU: The Holy Grail of investing is finding a situation with an asymmetric upside/downside ratio. Part and parcel with that is how you can get there, what are the paths to realization. If we had to add one other thing that we've taken from our prior jobs that applies here, it would be the idea that when you're investing, if you can find a number of different paths that you can go down for value realization, all of which can get you where you need to be, the more the better.

EY: When we started looking at this situation, we had a starting point that even if nothing else happens, you're getting a 20% levered FCF yield and you're already trading at a significant valuation discount to the 10x EBITDA deals that were getting done in the market. So if valuation remains the same and they use the FCF to keep paying down debt, the stock should go up 20% one year from now. And then you still had other sources of potential upside that we didn't think we were paying for. If the valuation gap closed, if the company explored an opco/propco structure, or if a buyer acquired them, all of which seemed like reasonable possibilities, then we had meaningful

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upside potential.

G&D: What are the dynamics you see in the market today? Where are you seeing the most interesting opportunities?

MU: There are various points in time where credit is cheap to the borrower. Out of that comes a lot of very interesting transactions, and thus event-driven investment opportunities. That is the type of market we see today. Managements and boards feel compelled to do something for shareholders and there are a number of tools by way of cheap credit that they accomplish that. How do we capitalize on it? Part of it comes from Eric's experience working for Carl Icahn and knowing the activist playbook so we can spot where these transactions are likely to occur and start investing in advance.

EY: You have two things. With this cheap credit, it is very hard for a credit investor because the risk/reward is not attractive. But of course that means it's a great time to be a borrower. The other thing we know is that topline growth has been very elusive, and companies have cleaned up their balance sheets and have the firepower and credit market support to put on leverage to manufacture growth. The M&A space will be very active given how cheap it is to finance these deals.

Activist investors have raised tons of capital. But they also have two other positives going for them. One is that corporate management teams have been more receptive to listening to them. It doesn't mean they'll agree with their ideas

but there seems to have been a shift in the paradigm in their willingness to listen. The other thing is that the large mutual funds are feeling pressure from low-cost ETFs, so they are looking to find alpha in these types of situations. In the past, it was a lot harder to get a blue chip mutual fund to support you. Nowadays they are much more willing to. In fact, I have heard that a lot of times they are actually suggesting certain names to the activists.

We think all of this is leading

“Just because [a security] has traded down doesn't mean it's cheap, as there has been a distinct bifurcation between high quality and low quality companies, and you can't fix bad hard assets.”

to a golden age of event-driven opportunities. For us, it is really about focusing on these types of situations - companies that we think are going to acquire, get acquired, break up, do recaps, convert to a REIT or MLP, etc. Those types of ideas are a large portion of our current portfolio.

G&D: How much time are you spending on the energy sector?

MU: Energy is another hot topic. In the last seven or eight

years, there was around \$1 trillion of debt issued in the E&P space. There are probably \$150 billion of bonds still outstanding, which is around 20% of the high-yield space. A fair number of these companies are not going to make it without a significant amount of capital that will come in and either subordinate everybody in the debt stack or dilute the existing equity.

EY: But it's not clear to us yet how compelling the opportunity is at today's valuations. Yes, some of these energy names that now trade in the 50s or 60s with double-digit yields traded at par and had 5% yield to maturity a few months ago when oil was much higher, but it doesn't necessarily mean they're cheap. Just because it's traded down doesn't mean it's cheap, as there has been a distinct bifurcation between high quality and low quality companies, and you can't fix bad hard assets. Our concern is that some of these names are going to have liquidity issues and because the docs have covenants with holes you could drive a truck through. So like Mark said, you're going to see a lot of issuance of first and second lien debt that will layer the rest of the stack.

We're focused on that area, but today our limited energy exposure is in companies that are secondarily connected to oil prices and where the valuation overhang is inconsistent with oil's impact on the fundamental business. For example, we have a position in a \$10 billion market cap MLP which is the subsidiary of a high profile energy company. Its revenues are completely contracted, yet it trades at a 25% dis-

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count to NAV, with a strong current dividend yield. All of the headline issues which are worries for the parent are only sources of further upside for the MLP. Many of our energy positions today are similar in that they are in companies that have sold off for no good fundamental reason, have great upside if oil recovers (and good upside even if not), but for whatever reason aren't trafficked so thoroughly by the sell side and conventional hedge funds.

G&D: Can you talk about your idea generation process in more detail? Do you take a macro view, or a bottoms-up approach?

MU: We're a bottoms-up shop. We do think you need to be aware of the top-down risks that are going to potentially affect fundamentals. It helps inform us in how we manage the portfolio and think about risk management. Most of our ideas are internally generated. We prefer dislocations, disruptive change, anything that complicates the analysis and lessens sell-side coverage. Think of Eric's earlier example in CMBS. Then we use our 35 years of experience to act quickly in identifying key drivers to valuation, the catalysts to unlock that value and the process to get there.

G&D: There has been a lot of talk about "Outsider" CEOs recently since the book was published in 2012. How do you think about the importance of management teams in the companies you invest in?

EY: With distressed, a lot of times you are unfortunately dealing with very weak man-

agement teams and you have to be able to get comfortable with that. Ideally, we would love to invest behind somebody like a John Malone or a Bill Stiritz, but you won't find these kinds of super value generators in most of our names. Interestingly though, we did invest in a spinoff of a larger company in which a well-respected CEO was involved. We originally invested in it because it was trading at what we thought was a 50% discount to intrinsic value. It was a portfolio of private equity investments. When you see these big discounts, however, you have to look at the man-

"We're a bottoms-up shop. We do think you need to be aware of the top-down risks that are going to potentially affect fundamentals. It helps inform us in how we manage the portfolio and think about risk management."

agement team to say, "Are they going to unlock this value?" What made this one interesting was management was announcing value-enhancing catalysts – they were spinning off various assets, giving cash back to shareholders – while the stock price was declining. It really was an orphaned

stock.

Again, this is the type of situation where we would invest because it had the classic spin-off dynamics. It was barely covered on the Street. At less than \$5 billion market cap, you just have less eyeballs looking at the names. You won't find this type of opportunity on screens. We found it just from following all of the spinoffs that are happening and then doing the work to get comfortable they would unlock value.

G&D: Are there any other ideas or themes you would be willing to share?

EY: One area that we're spending a lot of time on now is what I would call "broken IPOs."

These are situations where a private equity sponsor still owns a large stake, and where the current price is something like 25% below where the IPO priced within the last year. With the sponsor overhang reducing liquidity, these companies tend to be a little smaller so again they don't get the same attention.

We've invested in a ski company that trades at a substantial discount to its peers and has a hidden real estate angle to it. If you back out the real estate, we think we're buying it around 7x EBITDA when its main peers trades for 10-11x. It was a busted IPO that we like for a few reasons. The valuation discount is one. It's also generating a double-digit free cash flow yield and its balance sheet is fine. It's 4x levered with just a term loan and 4-5% cost of debt. It generates around \$115 million of

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EBITDA.

I think all of the companies that have hidden real estate will eventually be forced to do something with it because of the massive arbitrage. In this particular company, that's optionality. Now they probably won't do it because they would have \$1 billion plus of NOLs so there is no tax arbitrage from doing that, but somewhere down the line it will make sense. But given they're not going to pay taxes anytime soon, what are they going to do? They're going to buy stuff.

The sponsor is smart and certainly understands financial engineering so you would think there would be optionality in monetizing that NOL, but we're not assigning value to it in our own valuation. We're also not giving full credit to the land value – we have it at 50% of its 2006-2007 book value. It used to be \$300 million of value that we are assuming is \$150 million in our model. The land could be used to develop condos and time shares - there is value there.

I don't think it should trade at 1x, but 9x wouldn't be unreasonable. If you mark it to our numbers, you're looking at a stock that could easily end up being a double, but it's because it's still majority-owned by a private equity sponsor, so you have this overhang and with a sub-\$1 billion market cap, investors just aren't going to be focused on it. That allows a fund like us who isn't afraid of companies that are a little hairy to get involved.

We are also spending time on potential activist targets, either

by our fund or another firm. We're currently looking at a \$1 billion market cap company with an extremely inefficient capital structure. The company has no debt, but a comparable business was recently taken private with leverage equivalent to the entire EV / EBITDA multiple of this company. So there is opportunity for 20% accretive share buybacks, an LBO at a 50% premium, or a merger with the #1 player in their market, which could also work at a 50% premium. As always, we're remaining flexible and trying to find those 50 cent dollars in underappreciated places.

G&D: Thanks to you both for taking the time to talk with us.

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he was a Research Analyst at Donald Smith & Co., a deep value asset manager. He received an MBA from Columbia Business School and a BA from the University of Michigan.

Graham & Doddsville

(G&D): To start off, can you take us through your background and what led you to Breithorn?

Rolf Heitmeyer '06 (RH): I arrived at value investing in an unusual way. Coming out of college, I wanted to be an investor, but I didn't have a great understanding of value. My first buy-side job was at a publicly traded venture capital firm. It was 2000, and this company was the poster child for the internet bubble. It made investments in startups at ridiculous valuations based on clicks and eyeballs, and all sorts of other non-GAAP metrics. Predictably, that imploded a year after I joined, which was a very formative investing experience. It really forced me to think about the meaning of intrinsic value and margin of safety. Watching a company collapse like that probably also sparked my interest in short selling.

That's when I started reading value investing classics like Graham's *The Intelligent Investor*. Subsequently, I got to explore value investing in-depth through the Value Investing Program at Columbia Business School, and that was definitely the best academic experience of my life. After that I worked for eight years at Donald Smith and Co., a traditional Graham and Dodd-style asset manager that has outperformed the stock

market over a 30 year period. There, I learned how to pick deep value stocks but also gained experience short selling.

I've always wanted to build my own business, so I left Donald Smith and Co. last year to become a co-portfolio manager, along with Benner Ulrich, at Breithorn Capital Management. Benner is a like-minded value investor who was formerly a med-tech analyst at UBS and a Director

“We always try to determine if management has a clearly articulated capital allocation plan based on appropriate metrics like ROIC. We greatly prefer companies that have a specific quantitative return hurdle as opposed to qualitative goals that are open to interpretation.”

of Research at an activist hedge fund, Oliver Press Partners. He and his brother, Adrian Ulrich, a CBS classmate of mine, were exploring ways to expand the long-only business they had been running at Breithorn since 2009. We decided a partnership made sense. Currently, we manage \$190 million and recently launched an alternative mutual fund called Breithorn Long/

Short Fund.

G&D: Could you tell us more about the long/short fund and why it was the time to do that?

RH: We conceived the idea by asking ourselves a simple question: what kind of fund would we personally want to invest in to maximize our long-term absolute returns? That determined both the investment strategy and the vehicle we chose. Regarding our strategy, first and foremost we believe that making relatively concentrated investments with a statistically disciplined value approach is the best way to generate outperformance over the long-term. Second, we believe in being significantly net long, between 50% and 100%, to take advantage of the long-term appreciation of the stock market. Third, we believe in short selling to expand our universe of alpha generation opportunities, and to provide downside protection in market declines. Our typical exposure might be 110% gross long, 30% gross short, and therefore 80% net long. However, that will fluctuate based on the number and quality of ideas we find on both the long and short side. We believe this structure enables us to enhance absolute returns if our shorts significantly underperform our longs. That's important to us.

G&D: Do you have any limits on portfolio construction since you have a mutual fund structure?

RH: Given our strategy, it is not a constraint. For example, with a mutual fund you can't go over 150% long on a gross basis, but that is not an issue

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for us because we don't plan to go over 130% under normal market conditions.

The reason we chose a mutual fund vehicle is because we think it is appealing from an investor's perspective. First of all, we charge a management fee of 1.5% instead of the 2% and 20% charged by traditional hedge funds. We think traditional hedge funds have underperformed the stock market partially because of their fee structure. Second, we believe the convenience of mutual funds is attractive. They have daily liquidity and daily price transparency, and there is typically less paperwork.

As we looked at the existing long/short mutual funds out there we noticed something interesting. We think the vast majority of these funds are geared towards minimizing volatility rather than generating superior absolute returns. They tend to have consistently low net exposures which we believe is a drag on absolute returns in the long-term. They also tend to be highly diversified and have low gross exposure, which makes it hard to generate alpha in our opinion. We saw a void in the market for relatively concentrated long/short funds focused on generating superior absolute returns, and that's why we launched our fund.

G&D: Is daily liquidity an impediment to long-term value investing?

The most important thing is cultivating an investor base that understands your long-term perspective and is willing to stick with you for that time horizon. At the end of the day,

the difference between daily liquidity and quarterly liquidity isn't that drastic. Traditional hedge funds can and do get big redemptions at inopportune times. It just happens at the end of the quarter instead of during the week. To discourage short-term investors, we do have a redemption fee of 2% for investments held less than 90 days. From an investor's perspective, I don't want to be locked up for a long time, and I think that's why those structures are becoming increasingly rare.

G&D: Can you give us an idea of how you construct the portfolio?

RH: One of the biggest takeaways from my experience in the CBS Value Investing Program was an appreciation for the different flavors of value investing. Several different styles work, but not always at the same time. Realizing that, we opportunistically allocate our portfolio into three buckets. Our deep value bucket consists of average quality businesses trading at very cheap valuations. Our compounder bucket consists of high quality businesses trading at slightly higher multiples. Finally, our special situations bucket consists of catalyst-oriented investments that may or may not screen cheaply, but are none-the-less cheap on a pro-forma or sum-of-parts basis. We'll usually have something in every bucket, but the amount depends on the quantity and quality of opportunities that we're seeing in each area.

Our average long position size

is typically between 3% and 5%. Our goal is to limit positions to a maximum of 10%, because unexpected things always happen, and we don't want to be overly concentrated. On the short side average position sizes are generally smaller, usually 1% to 3%, because of the inherently asymmetric risk profile.

Currently, I think the deep value bucket is a point of differentiation for us. In general, I think the traditional Graham and Dodd approach is overlooked right now. Like everyone else, we like to buy exceptional businesses at a discount. The problem is that by definition there aren't a lot of exceptional businesses. Also, I think there are more people chasing those opportunities than ever before because you have multiple generations of Buffett disciples on Wall Street - enough to fill a stadium in Omaha every year. Most value investors say they're looking for high ROE businesses with wide moats. However, let's assume there's an average quality business that we expect to earn an ROE that is merely equivalent to its cost of equity, say 10%. If we can buy that business at half of stated book value, then we'll earn 20% on our investment at market value of equity, which is very attractive. The difference is we won't hold it forever like a compounder. We'll sell it when it appreciates to fair value. That is what my experience at Donald Smith & Co. taught me.

Keep in mind that while Buffett is best known for his investments in compounders, he started off as a "cigar butt" investor. In his most recent

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letter, Buffett says that in the 1950's when he was investing in "cigar butts", he generated by far the best returns of his life, both on a relative and absolute basis. He can't invest that way anymore because he manages too much money, but luckily we can, and that is where we spend a fair amount of our time.

We also believe strongly in maintaining a statistical value discipline. In aggregate, we expect our longs to trade at a discount to the market and our shorts to trade at a premium on numerous valuation metrics. In our opinion, this provides a strong long-term tailwind. Take something as simple as price to earnings ratios. We have observed that over the past 50 years through 2014, stocks in the lowest decile of P/E ratios returned roughly 16% annually versus 12% for the market as a whole. Conversely, the highest decile returned roughly 7%. Despite this, people are reluctant to invest in statistically cheap stocks because they aren't "high quality" enough. This is why the opportunity persists. Our goal is to profit off of this spread through long/short investing. We make decisions based on a lot more than valuation alone, but we think maintaining a valuation discipline is important.

G&D: How do you think about scaling the fund longer term? How do you offset potential size with still finding actionable deep value opportunities?

RH: We're figuring it out. I've spent most of my career picking stocks as opposed to capital raising, so there's a

learning curve. I think we have identified an underserved part of the market that we think rational investors will gravitate towards. In general, I think the alternative mutual fund structure is attractive and will eventually transform the hedge fund industry. Given our current size we are nowhere near the point of limiting our opportunity set. I'm not sure when that would happen, but my guess is north of \$1 billion.

"Catalysts are a higher priority for shorts because time is generally not on our side given that the stock market goes up longer-term."

G&D: Can you explain how your assessment of management teams factors into your investment process?

RH: We prefer not to rely too much on our ability to assess management teams because they are usually good salespeople and have the ability to mislead. We're far more comfortable basing our investment ideas on historical financial data, which usually doesn't lie. We also try not to rely on management's ability to add value. This is particularly true in deep value situations where there usually aren't

exceptional managers running the show. Our primary goal is to find managers that will do no harm.

There are many ways that managers can do harm. Our biggest concern is usually capital misallocation. We always remind ourselves that a DCF valuation is only valid if the free cash flow is returned to us or reinvested at a decent rate, which is often not the case. We always try to determine if management has a clearly articulated capital allocation plan based on appropriate metrics like ROIC. We greatly prefer companies that have a specific quantitative return hurdle as opposed to qualitative goals that are open to interpretation. Then we evaluate if their past actions are consistent with their stated principles. For example, have they made bad acquisitions in the past? In general, the fewer acquisitions the better. By analyzing their past behavior and incentive structures, we also try to determine whether managers are looking to enrich themselves or shareholders.

G&D: How do you incorporate macro analysis into your investment process?

RH: As bottom-up investors, we would love to ignore macro. However, we live in an environment where government intervention in financial markets is so extreme that our investments will be heavily influenced by macro factors, so it's not something we can ignore. The way we approach macro is to focus on big things that could go wrong.

At the top of my list is the likelihood of unintended

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consequences related to rampant money printing by central banks around the world. Economics is a dismal science because it's more of an art than a science. However, central bankers conduct business with a false aura of scientific precision, and I think people have too much trust in their abilities. Also, there's rarely a free lunch in economics, and I think the market may not be considering the ultimate cost of all the stimulus it has enjoyed.

Another thing I worry about is a hard landing in China. The debt fueled investment binge that has powered growth in that country could end very badly. I see returns on fixed asset investments drastically diminishing. In my opinion, there is overcapacity in a lot of industries, so they don't need to build more factories. They don't need to build more residential or office buildings because of the high vacancy rates we are seeing. The day of reckoning has been delayed because of government stimulus programs, and because China has a closed and manipulated financial system. However, there may be signs that things are starting to unravel. For example, housing starts and housing prices have started to decline significantly in recent months. The property sector accounts for 15% of GDP, so that's a problem. I think that there is a big risk that China misses its 7% growth targets.

As an example, our short thesis on Hermès International (RMS.FP) incorporates our macro view. An estimated 50% of all luxury industry sales are to Chinese nationals. That's up

from 30% five years ago. China is a big reason why Hermès has grown sales at a 16% CAGR over the last five years. Obviously \$8,000 handbags are highly discretionary, so if the Chinese economy weakens, that could have a big negative impact on this business.

From a valuation standpoint Hermès has significant downside risk. The company trades at 35x 2015 consensus earnings estimates, which are projected to be an all-time high. It's clear to us that investors are extrapolating past revenue and margin growth trends into the future, and we believe that they could be disappointed.

There is also a technical catalyst here. Last year LVMH tried to take over Hermès, and in the process, shrank an already small free share float. This caused a big run-up in the stock price. Hermès family members fought back by pooling their shares into a vehicle that controls 51% of the company, greatly reducing the likelihood of a takeover. LVMH threw in the towel and agreed to divest the Hermès stake it acquired to its shareholders, so technical support for the shares has been reduced. Now if the company disappoints, its stock price could hit an air pocket.

G&D: How important are catalysts to you?

RH: All else being equal, we always prefer to have a reason why a cheap stock will appreciate and an expensive stock will decline in value. However, catalysts are a higher priority for shorts because time is generally not

on our side given that the stock market goes up longer-term. Occasionally we will short on valuation without a specific catalyst, but that can be risky because an excessive valuation can easily become more excessive. In those cases, there are two things that we like to do to mitigate our risk. First, we generally make the position sizes smaller. Second, we try to use the law of large numbers to our advantage. For example, if we're anticipating that a glamour stock's revenue growth will mean revert down, it's easier to do that with a company that has billions of dollars in sales facing natural deceleration. Also, from a market cap standpoint, it's a lot harder for a company with a \$45 billion market cap, like Salesforce.com, to double than it is for a company with a \$45 million market cap.

G&D: Could you give us an example of a management team who are poor capital allocators?

RH: We think a glaring recent example is Weight Watchers (WTW). In 2012, the company issued \$1.5 billion of debt to repurchase 25% of its outstanding shares at \$82 per share, near all-time highs. This happened right as secular challenges to their business model were starting to appear in the form of competition from free smartphone dieting apps and fitness bracelets. The shares were repurchased from a controlling shareholder, Artal Group, which serves as a cautionary tale of how conflicts of interest can lead to bad capital allocation. Now the stock trades at around \$8 and the company has leverage

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issues.

Without naming specific companies, on the short side, we are doing work on a few serial acquirers who we believe are playing unsustainable financial engineering games. These companies appear to be creating value by rolling up a lot of small companies at relatively low multiples. However, this eventually comes to an end when they have to keep making bigger and bigger acquisitions to move the needle. These are more expensive and have much higher integration risk.

One thing we try to do is back out organic growth from acquisition growth. If a company is touting big revenue growth, but it is all being purchased, then that is a red flag for us. We also try to determine if previous acquisitions delivered on promised expenses synergies, which are generally oversold by investment bankers. If there is no aggregate improvement in costs, that's also a red flag for us.

G&D: Could you explain your approach to sizing positions?

RH: Generally, we rank every idea on a scale of one to three, with one being the highest target position size and three being the lowest. The rank is based on our assessment of expected value versus downside risk. If something has big upside potential but is binary, we won't make it a large position.

G&D: We noticed that American International Group (AIG) and Bed Bath & Beyond

(BBBY) are two of your larger positions. Take us through your thought process there from an upside/downside perspective?

“There are several general types of value traps we look out for in our investment process. The first are companies in secular decline masquerading as companies in cyclical decline [...] A second type are management teams that destroy value, most commonly by misallocating capital. A third type are companies that chronically earn less than their cost of capital.”

RH: AIG is an example of a company in our deep value bucket. For us the main attraction is that it is very cheap, not that it is an exceptional business. Although, given its global scale, we believe it has the potential to be an above average business. The stock price is around \$54, while book value per share excluding accumulated other comprehensive income is \$70.

Comparable insurance companies trade at a big premium to book value. At a minimum, we believe AIG should trade at book value which provides a margin of safety.

G&D: Some shorts believe AIG trades at a discount because it's not earning its cost of capital. What levers could they pull to improve profitability?

RH: In 2014, AIG had an operating ROE of around 6% while comps earn greater than 10%. We think there is no reason why AIG won't close the gap based on several levers at their disposal. First, there is a lot of low hanging fruit for improvement in profit margins. Hank Greenberg cobbled this company together through a slew of acquisitions over a long period of time. We don't believe these were ever properly integrated, and there are significant cost saving opportunities from streamlining and consolidating operations. Historically, AIG also had poor underwriting discipline, and so we see a big opportunity to bring loss ratios down. Overall, we think AIG's property and casualty insurance combined ratio could move from around 100% towards the 90% range longer-term. Importantly, we're not expecting a miracle here, just mean reversion to comps.

I should note that we think underwriting discipline in the entire insurance industry has improved. It used to be that insurance companies deployed all of their capital to write new business, which contributed to poor pricing. Now, rather than write unprofitable business,

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companies are returning capital to shareholders. One reason for this is that it's harder for them to make money on their float given low interest rates, so they have to make money on underwriting instead.

AIG's other big lever for improving ROE is increasing its asset to equity ratio, which is currently lower than comps. AIG can do this by growing its business or returning capital to shareholders. It has been doing the latter through large buybacks. As AIG's ROE mean-reverts to industry averages and the stock trades at a premium to book value, we think the stock will be worth over \$100 per share. Bed Bath & Beyond (BBBY) is an example of an investment in our compounder bucket. We believe this is an exceptional business, with a leading position in the housewares retail category and a return on invested capital that is consistently above 20%. The company spins off a lot of cash and has returned it to shareholders in large amounts. Over the last ten years, BBBY has repurchased over \$7 billion of stock. The current market cap is under \$13 billion. The company recently upped the ante by issuing \$1.5 billion of inexpensive debt to accelerate the buyback. We believe BBBY has medium-term earnings power of approximately \$7 per share. Applying a 15x multiple to that, we arrive at a target price of \$105 per share compared to around \$75 today.

With over 1,500 stores, BBBY already has significant market penetration, so this probably won't be a high revenue growth story. However, that

isn't necessary for this to be a good compounder over time. We think share count reduction at attractive prices will drive EPS growth. I should mention that there is an embedded growth option in the form of BuyBuyBaby, one of the company's retail concepts which is growing rapidly but off of a small base.

Given the strength of the franchise, we believe the downside is pretty limited. We also take comfort in the macro backdrop. Lower oil prices are a big tailwind for U.S. consumer spending. We also think housing starts are below longer-term norms, and BBBY's houseware sales are correlated to the housing market.

G&D: [How big a threat is Amazon here?](#)

RH: We think that is the biggest overhang on the stock, and the main reason why it's cheap. Over the last few years, BBBY has maintained its market share, but margins have been pressured by competition from online retailers, primarily Amazon. BBBY has responded by investing a lot of money into ecommerce. They've totally revamped their web presence, invested in online analytics and marketing, and improved their ecommerce logistics. As a result, we think they are nearing an inflection point where they'll start to see the benefits of their investment and the expense tapers off. In the past, BBBY's products were priced at a premium to Amazon which was one of the drivers of margin declines. That price gap has now closed, and BBBY is actually cheaper in some categories. We think this

will reduce margin declines going forward.

G&D: [Could you take us through another deep value investment and how you came across it?](#)

RH: American Axle & Manufacturing (AXL) is one of our top holdings and a good example of a deep value investment. The company makes driveline systems for the auto industry. A majority of its products are used in light trucks, and 68% of sales were to General Motors in 2014. The company initially came to our attention through a high free cash flow yield screen. We think the stock trades at a discount for three main reasons. First, AXL is perceived to be a boring provider of commoditized products. Second, its high customer concentration is perceived as a weakness. Third, the company is seen as riskier than comps due to its higher leverage. We disagree with all of these perceptions.

To the first point, if you go to an auto supplier conference it seems like all anyone wants to talk about are hot themes like autonomous driving or infotainment systems. If you're a supplier in those segments, you'll probably have a standing room only audience. On the other hand, if you go to an AXL presentation, you may hear crickets chirping. We think AXL is not getting credit for the fact that it actually has innovative products. For example, they have a new lightweight, disconnecting axle that cuts off power to tires when it's not needed to increase fuel efficiency. This has enabled AXL to grow

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revenue faster and achieve higher operating margins than most comps.

To the second point, we think AXL's exposure to GM light trucks is actually a huge positive. In general, we think the US light truck segment is extremely attractive. U.S. pickup trucks are 13 years old on average, a record high, which we think provides a replacement cycle tailwind. Lower oil prices are a big positive for large vehicle sales, which is evident in recent increases in light truck market share. GM specifically is benefitting from a strong new product cycle. This is consistently GM's highest margin segment and suppliers share in the wealth. To the extent that high customer concentration is a concern, this should be resolved over time as AXL diversifies its customer base. The company has a large backlog of new business that should bring GM concentration to below 50% of sales over the next few years.

To the third point, we believe AXL's debt load is very manageable. Net debt currently stands at 2.5x EBITDA and is steadily declining. The company spins off about \$200 million in free cash flow a year which compares to \$1.3 billion of debt. AXL has an industry-leading free cash flow yield to equity of over 10%. We estimate AXL's earnings power to be approximately \$3 per share over the medium term. If you apply a low double digit multiple to that, say 12x, you get a target price of \$36 per share versus a current price of around \$25. We think that multiple is undemanding

on an absolute basis and it's a big discount to comps.

G&D: What's the nature of the commercial arrangement with GM? Can they come back next year and renegotiate it given how important they are to AXL?

"...my first preference is to buy stocks that are cheap based on asset value. The next best thing are stocks that are cheap on historical earnings power. Growth is something I don't pay for, although free options are nice."

RH: One nice thing about auto suppliers is that there is a lot of visibility into their sales and margins because agreements to supply any given car program are locked in for several years into the future. GM just rolled out its new light truck platform in 2014, so the current economics should be intact through the end of the decade at least. Also, these contracts tend to be very sticky. Upon renewal, AXL has negotiating leverage because it would be very disruptive for GM to take its business elsewhere. GM would also have to incentivize a competitor to build out the specialized, high-volume capacity necessary to fulfill such a contract.

G&D: How do you assess investment opportunities to protect against potential value traps?

RH: That's an essential question, particularly with deep value investments where cheap stocks are often cheap for a reason. There are several general types of value traps we look out for in our investment process. The first are companies in secular decline masquerading as companies in cyclical decline. Telling the two apart can be tricky. A second type are management teams that destroy value, most commonly by misallocating capital. A third type are companies that chronically earn less than their cost of capital. If a company doesn't earn its cost of equity, it mathematically deserves to trade below book value.

Another type would be companies with unsustainable balance sheets. For example, valuing a company on mid-cycle earnings power doesn't hold water if the company goes bankrupt at the trough of the cycle.

G&D: Can you talk about Energy, which obviously has been a tough sector? How do you analyze downside risk in this context? Some of the valuations are compelling, but many of these companies might not make it to the other side of the cycle given their balance sheets.

RH: Energy is difficult, because with commodities it's hard for us to determine intrinsic value. Theoretically, over the long-term, the price of oil should gravitate towards its full-cycle cost of production. However,

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in the near-term the floor on prices is determined by the half-cycle, or cash cost, of production, which is really low. Current valuations are definitely not pricing in a downside scenario of sustained oil below let's say \$50 a barrel. These cycles can last a long time, and given our lack of conviction, we haven't bought much during the decline. But that could change. There's a price at which almost anything becomes interesting.

Given the high debt levels of a lot of energy related companies, there's a possibility that equity value could be wiped out, so position sizing is important. We own two levered offshore drillers, and we have sized them according to our view that the outcome there is binary. They are effectively call options. We are comfortable making investments like that as long as the expected value is high and the position size is small.

G&D: Do you have any special situations you could take us through?

RH: I have a couple that demonstrate our approach. One is a company called Vectrus (VEC), a defense contractor that was spun out of Exelis in September 2014. Vectrus specializes in infrastructure asset management for U.S. military bases. This has some typical spin-off dynamics. There is selling pressure from Exelis shareholders who received one Vectrus share for every 18 Exelis shares. With a market cap below \$300 million, the company is underfollowed and has minimal analyst coverage. Its management is newly

incentivized with performance-based stock compensation.

We think Vectrus is a decent business given its low capital intensity and potential to generate a lot of cash. Its government contracts are sticky and provide good earnings visibility. The stock recently sold off when management issued disappointing guidance for 2015 due to lower than expected margins. We think that's a temporary problem partially due to the cost of ramping up some new contracts. Also, Vectrus will be renewing a lot of its existing contracts under a fixed price structure that we believe will give them the ability to profit from efficiency gains in the future. That should be margin expansive.

A potential positive catalyst relates to a big contract Vectrus has for managing the U.S. military base for operations in Afghanistan. This is projected to account for about 15% of the company's revenue in 2015, and has higher margins than the rest of the business. Due to a planned withdrawal of U.S. troops, this contract was assumed to be wound down by 2016. However, the government recently reversed course and extended the timeline for withdrawal. This is not baked into management's guidance or sell-models yet.

Vectrus also has a big pipeline of new business that it is competing for, which could provide upside. They recently had success winning a contract away from a competitor, Lockheed Martin. All in all, we think medium-term earnings

power is \$3 per share. We think a multiple of 13x earnings is very reasonable for a company like this, and a big discount to comps. That gets us to a target valuation close to \$40 per share compared to the current price of \$25.

Another special situation that illustrates our approach is Investors Bancorp (ISBC). This is a small regional bank with a footprint in New York, New Jersey and Pennsylvania. The bank recently demutualized in May of 2014, and is currently overcapitalized as a result of that transaction. This is depressing ROE, and the stock trades at 1.1x tangible book value. On average, comps trade at over 1.5x. We think Investors Bancorp will increase its ROE by growing its loan book and returning excess capital to shareholders. The company recently received approval from regulators to buy back stock earlier than anticipated.

Investors Bancorp has a track record of highly accretive acquisitions, and we think the company has generated a lot of value organically too. For example, they have increased their mix of low cost core deposits dramatically in recent years. The company is growing its loan book in the commercial and multi-family real estate segments, primarily in the New York region. Based on our analysis, we think their loan growth looks prudent.

The track record for bank demutualizations is generally very positive. There is frequently book value multiple expansion after they become public, and over half of them get acquired within three

(Continued on page 50)

Rolf Heitmeyer '06

years. We're not assuming the latter is going to happen, but that provides upside potential. Also, the company's largest shareholder is an activist fund, Blue Harbor Group. We think management allocates capital wisely, but it is nice to have an involved investor guarding the cash register, so to speak.

G&D: Given that you're an alumnus, can you go through how your experience at CBS helped develop you as an investor?

RH: The best thing that I got from CBS was a wide perspective on value investing. Learning about different approaches and why they work was fantastic. I also picked up some investing frameworks that I find very valuable. One in particular is Bruce Greenwald's "three sources of value". With that in mind, my first preference is to buy stocks that are cheap based on asset value. The next best thing are stocks that are cheap on historical earnings power. Growth is something I don't pay for, although free options are nice. I think about that all the time.

G&D: Lastly, do you have any advice for our readers who are looking to break into the investment industry?

RH: First of all, I would recommend experimenting with the different flavors of value because the temperament required for each is different, and you won't know what you're best at until you try it. Also, force yourself to find ideas in as many different industries as possible. I think appreciating absolute value is the key to being a

good value investor, and that requires a broad perspective. If you're considering a career in investing, be certain that you're doing it because you have a deep intellectual interest in it. If your idea of a good time is reading a 10-K and learning about a new business, that's a good sign. If you're doing it only because you want to make a lot of money, you probably won't be very good at it.

G&D: That is great advice – thank you for your time.



Brendan Dawson '16

Brendan is a first-year MBA student at Columbia Business School. Prior to CBS, Brendan was an investment analyst intern at Slate Path Capital after spending 4+ years as part of the investment team at the UVA Investment Management Company.



Patrick McDonald '16

Patrick is a first-year student at Columbia Business School. Prior to CBS, he spent 4 years working at JPMorgan's Private Bank. He holds a BA from Rice University.



Moiz Valji '16

Moiz is a first-year student at Columbia Business School. Prior to CBS, he worked for four years in investment banking at Macquarie Capital and in equity research at Jacob Securities, a Toronto-based investment bank, where he focused on power & infrastructure. He holds a BMath from the University of Waterloo.

Altice S.A (Euronext: ATC) - Long 1st Place - 2015 Pershing Square Challenge

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Investment Opportunity Summary

•Our 2018 base case target price of €180 (15.5x 2018 FCF of €11.59) represents nearly 80% upside. Bull scenarios involving in-market consolidation, mobile market repair, and further accretive M&A offer upside as high as 160%, representing an IRR of 30% over nearly 4 years.

Business Overview

- Altice S.A. (ATC), is a holding company for leading cable/telco businesses in 6 countries, with France and Portugal as the two key geographies.
- In each geography, ATC owns a high speed, high capacity fixed line network as well as a mobile network, enabling them to offer high quality quad-play services (premium cable TV, highspeed broadband, fixed line telephony, and mobile telephony and services)

Thesis Points

1) Patrick Drahi—A true Cable Cowboy: ATC Chairman and controlling shareholder Patrick Drahi is an incredible entrepreneur, capital allocator, and operator. He is 50% wealthier than John Malone despite being 20+ years his junior. In addition to being an excellent and opportunistic capital allocator (demonstrated through his successful rollop of the French cable industry starting in 2002), our references indicate Drahi and his team are lean operators, capable of achieving massive cost reductions at acquired companies. With Drahi holding a 60% stake in ATC, we love being aligned with such an impressive value creator.

2) A portfolio of differentiated, advantaged assets: In each geography, ATC has a network based competitive advantage. In France, they face minimal FTTH overlap and in Portugal, they own a fiber network passing 56% of homes. An excellent feature of ATC's current asset base is their relatively low broadband penetration across geographies. As data consumption grows secularly at 40+% per year, ATC will become a monopoly broadband provider in most markets. For instance, NUM-SFR has 80% market share among very-high-speed subscribers in France. This dynamic provides a long duration runway for market share gains. Additionally, the ownership of mobile networks will allow ATC to drive per-subscriber profitability higher through triple play and quad play bundles within their fixed line footprint.

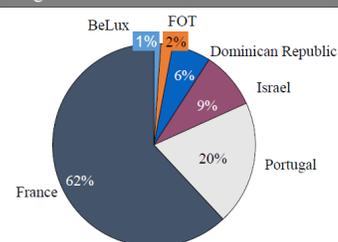
3) Investors are underestimating the magnitude of opex, capex, and NWC synergies at two recent significant acquisitions: In ATC's recent acquisitions of French #2 mobile provider SFR and Portugal's incumbent telco Portugal Telecom, we expect ATC to deliver improvements well beyond consensus expectations.

As of 4/19/2015, in EUR m except per share data

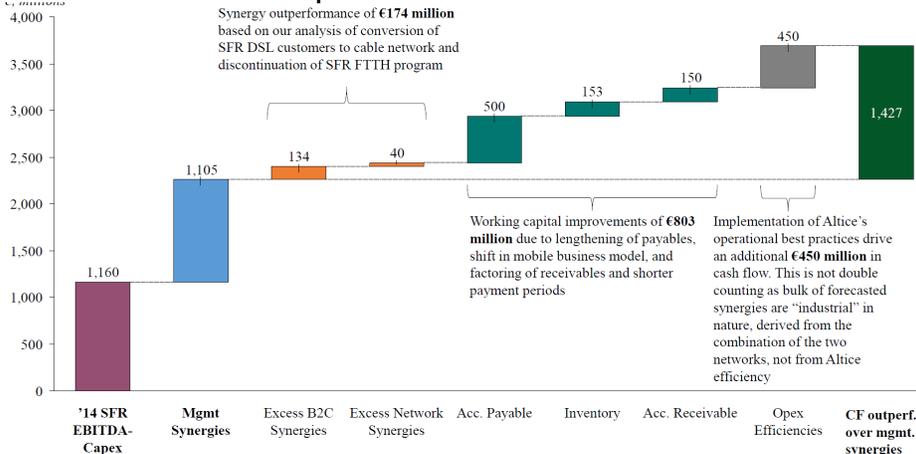
Current Capitalization	
Stock Price	€100.65
Diluted Shares Outstanding	248.0
Market Cap	€24,961
Debt ¹	22,786
Deferred Purchase Consideration ²	1,950
Cash ¹	-1,437
Enterprise Value	€48,260

Trading Statistics	
52-Week Range	€36.00 - €111.15
Dividend Yield	0.0%
Avg. Daily Volume (M)	0.4

Regional Breakdown – 2015E EBITDA



Deconstruction of SFR FCF Improvement



Altice S.A. (ATC) - Long (Continued from previous page)

With SFR, we believe cost savings from migrating DSL subs to NUM's cable network as well as the capex savings from ending SFR's FTTH program and a redundant B2B DSL network will deliver synergy outperformance. Additionally, we expect €450 million in opex cuts beyond synergies, a number in line with savings achieved at past ATC acquisitions. With PT, the incumbent telco had 33% of industry revenue yet 75% of headcount, a discrepancy highlighting the inefficient nature of the previous management which we expect ATC to rectify.

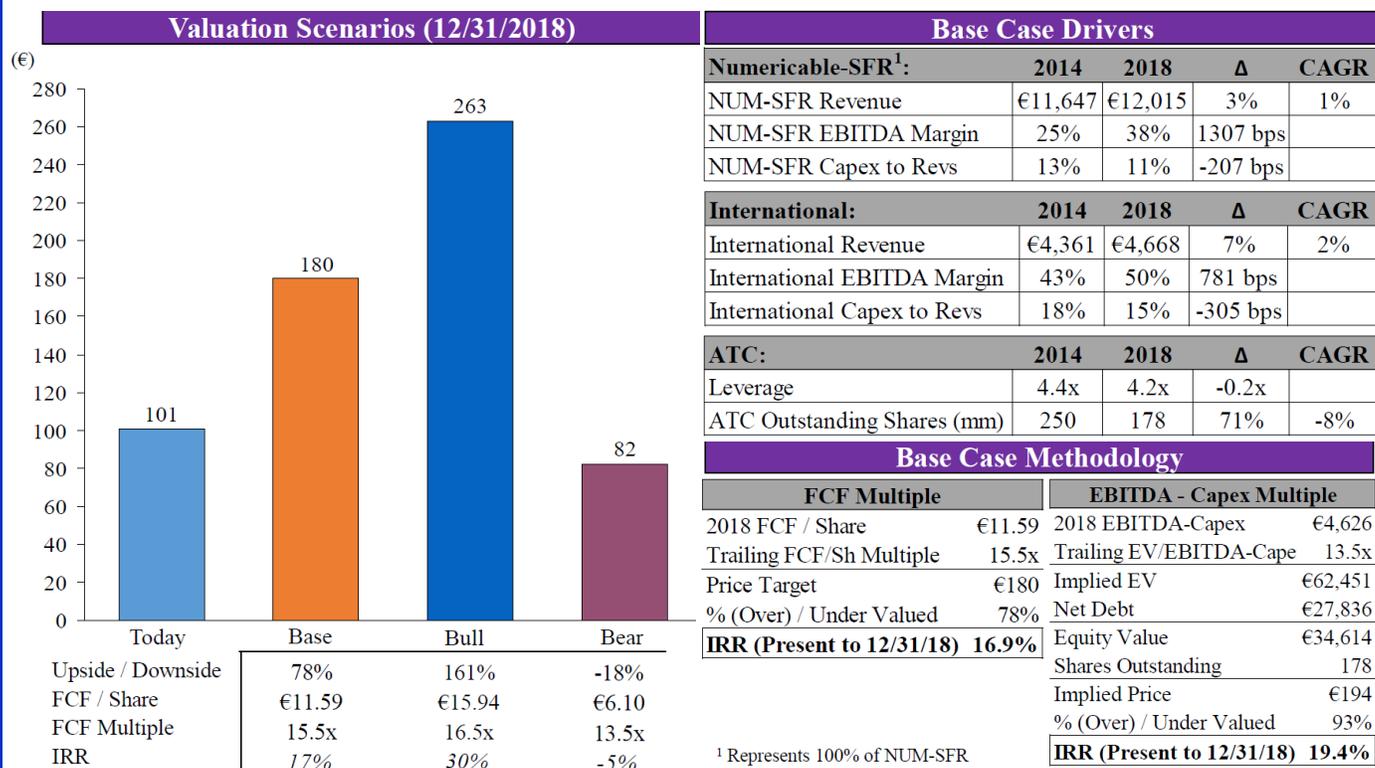
4) The need for consolidation in European telecoms provides a long M&A runway to an excellent management team: We think there is a big game to be played in the consolidation of the European telco industry. There is total industry revenue of >€340 billion and 35 cable/telco operators with greater than \$250m in revenue. The large universe of potential targets provides a great setting and opportunity for ATC. Of the companies we have evaluated, they are one of the best positioned to serve as a consolidator in the industry. The compounding in ATC's core business from broadband combined with the opportunity to deploy significant capital in consolidating acquisitions bears many similarities to great wealth creating companies such as Capital Cities, John Malone's TCI, Constellation Software in Canada, and Ambev under 3G.

Key Risks and Mitigants

- *Advantaged fiber and cable providers could face an aggressive regulatory regime in Europe*
 - ◇ The current regulatory regime across Europe is positive and in favor of consolidation. With average broadband speeds badly lagging other developed economies, we do not foresee a significant change in the regulatory outlook in the near term.
- *The Eurozone faces serious macroeconomic issues which could impair operations in France and Portugal*
 - ◇ The secular growth of data demand will occur independently of macro outcomes, benefiting high speed broadband providers.
 - ◇ The recurring nature of revenue streams creates some predictability and stability
- *The increase exposure to the mobile business is not a good thing, especially in a competitive market like France*
 - ◇ French mobile pricing is some of the lowest in Europe and has shown recent signs of stabilization
 - ◇ 50% of the post-2011 ARPU decline is due to regulatory cuts of MTRs. With MTRs below 1c, the headwind is largely exhausted
 - ◇ #3 mobile provider Bouygues Telecom is EBITDA-Capex breakeven, limiting their ability to withstand further ARPU declines
 - ◇ Price disruptor Iliad's MVNO agreement with Orange expires in 2017. We think a renewal at existing terms is unlikely.
- *Given ATC's high financial leverage, rising interest rates may adversely impact profitability, FCF conversion, and financial flexibility*
 - ◇ The maturity profile of ATC's debt, with the first significant maturities occurring in 2019, reduces financial risk

Valuation

- We value ATC on 2018 FCF. A composite of well managed European cable peers, incumbent telcos, and other cable businesses trade at roughly 20x FCF. We believe our 15.5x exit multiple embeds our expected IRR with conservatism. In fact, our exit multiple is at a discount to all comparable companies within the composite except for one incumbent telco.





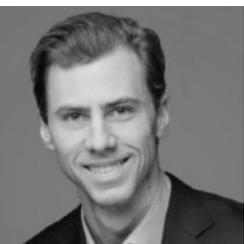
Brandon Cohen '16

Brandon is a first-year student at Columbia Business School and is Managing Partner of Abrika Capital Management, LP, a long biased, value oriented investment management company established in 2008. He graduated from Washington University *summa cum laude* with degrees in finance, economics, and accounting.



Christopher Crawford '16

Christopher is a first-year student at Columbia Business School. Prior to Columbia, Christopher was a Corporate Finance Associate at Gerson Lehrman Group, where he was responsible for its capital structure. Prior to GLG, Christopher founded Lockett, a consumer mobile advertising company. He graduated from UC Irvine, where he studied psychology and finance.



Tyler Boone '16

Tyler is a first-year student at Columbia Business School. Prior to Columbia, Tyler was a private equity associate at American Capital, where he focused on middle-market leveraged buyouts. He graduated Southern Methodist University with a BA & MS in Accounting, and is a CFA Charterholder.

Fiat Chrysler Automobiles NV (NYSE: FCAU) - Long 2nd Place - 2015 Pershing Square Challenge

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Thesis

The market misunderstands Fiat Chrysler Automotive's business and industry. Despite its name, Fiat Chrysler generates no profitability from either Fiat or Chrysler. It would be better suited with a name change to Ferrari Jeep Ram Maserati Automotive. Those brands alone are worth well in excess of the current market cap. Ferrari could be worth €15-25/share in 2018, compared to a total price for the whole business of €14.94/share today. The ex-Ferrari stub has normalized earnings power of ~€1.5/share but will be generating €4+/share in 2018, with no net debt and a fully funded pension, if management successfully executes its five-year plan. At 10x earnings, plus €15-20/share for Ferrari, Fiat should be worth €30-60/share in 2018, 2-4x the current price. With Ferrari as the margin of safety, there is very limited downside.

Fundamentally Better Industry

During the financial crisis, fixed costs were reduced, labor was brought down to ~5% of the price of a car, capacity was reduced, and dealerships were closed. These factors create a much more rational competitive environment. GM used to require industry volumes of 16 million vehicles in the U.S. to break even; but that number is now only 10 million, which is lower than the lowest volume posted during the financial crisis. Because of this, GM recently announced a 20% ROIC target, as compared to the old days when managers wore lapel pins that said "29", symbolizing the need to maintain 29% market share. Ability to break-even at lower volumes will make for a much more rational pricing environment.

Excellent Management

Fiat's CEO, Sergio Marchionne, has compounded shareholder wealth by ~22%/year for 17 years over three separate company turnarounds. Had one invested \$1 with Marchionne in 1996 when he became CEO of Alusuisse, it would be worth ~\$32 today. He has ~€200 million personally invested in Fiat and all of his stock compensation is tied to hitting his five-year plan targets. He retires in 2018 and is intensely focused on creating value for shareholders.

Marchionne reports to Fiat's Chairman, John Elkann, Chairman & CEO of Exor, a holding company controlled by the Agnelli family that owns 31% of Fiat. Elkann attends the annual Berkshire Hathaway meeting in Omaha every year, and has proven to be a very successful capital allocator who buys low and sells high. The combination of an incredible operator in Marchionne and an incredible capital allocator in Elkann is hard to beat.

Ferrari - The Margin of Safety

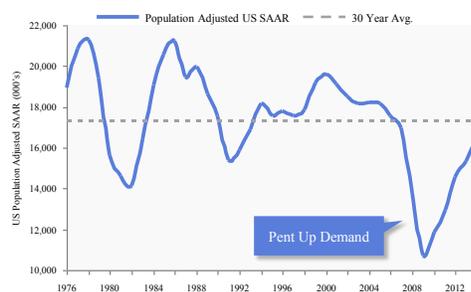
The market misunderstands Ferrari's brand potential and the capital intensity of its business. Its F1 racing budget is not disclosed, but estimates are in the range of €300 million and this spending does not need to scale with additional production. More importantly, it has the ability to produce 10,000 units per year without additional capex, but has voluntarily capped production at 7,000 units per year. Marchionne fired long time Ferrari CEO Luca di Montezemolo last year over a disagreement about the production cap and immediately raised the cap by 5%. He has also publicly stated that by scaling to 10,000 units per year, Ferrari would generate EBITDA "well in excess of €1 billion" and that growth in the number of high net worth individuals will warrant raising the cap. In its Form F-1, Fiat discloses Ferrari Cost of Goods Sold, which shows that incremental margins for an additional Ferrari are in excess of 55%, but EBIT margins for Ferrari are currently only 15%, so additional production will significantly increase Ferrari margins. The Form F-1 also discloses cash flow from investing activities for Ferrari, which was €314 million in 2013, almost exactly equal to depreciation and amortization. Therefore, EBIT margins are a very good proxy for free cash flow for Ferrari. And since ~50% of revenue is in USD or USD linked currencies, but costs are entirely in EUR, Ferrari margins will increase significantly in 2016 when its currency hedges roll off.

At a 1.08 EUR and 10,000 units per year, Ferrari EBIT margins would double to 30% and EBIT would increase to €1,159 million. To put that in perspective, Hermes EBIT margins are 32%. If Ferrari could increase prices by 5%/year, consistent with increases over the past decade, EBIT margins would grow to 42%, and EBIT would increase to €1,919 million. Ferrari only appears to be a capital-intensive business because it is underutilizing its capacity; but, as it scales to 10,000 units per year, its capital intensity will fall dramatically.

(€ in Millions)

Key Statistics

Capitalization	
Share Price (as of 4/17/15)	€ 14.94
Fully-Diluted Shares Out.	1,507
Market Capitalization	€ 22,515
Plus: Net Industrial Debt	7,654
Enterprise Value	€ 30,169



Fiat Chrysler Automobiles NV (FCAU) - Long (Continued from previous page)

Hermes trades at 22x EBIT. At that multiple, assuming it takes four years to scale to 10,000 units, Ferrari would be worth between €25,498 million and €42,218 million in 2018, depending on the level of annual price increases.

Five Year Plan

Management's publicly stated five-year plan would have the ex-Ferrari stub earning in excess of €4/share in 2018 driven primarily by globalizing the Jeep brand, producing luxury products for export using excess Italian capacity, and rationalizing competition between Chrysler and Dodge.

Jeep - Annual volumes will grow from 1 million units to 1.9 million units, driven primarily by local production in China and Brazil, as well as two new models to compete at the high and low end. Jeep has de minimis market share in China and Brazil due to 25-30% import tariffs. Local production will finally make Jeep pricing competitive. Its Brazil facility will have 20%+ EBIT margins due to government handouts and the introduction of the Renegade, Jeep's smallest model ever, will result in significant growth in Europe, where Jeep also has de minimis market share.

Premium Brands – Development of the Alfa Romeo and Maserati brands will enable Fiat to utilize excess European capacity, resulting in very high incremental margins. Maserati volumes will double, driven primarily by the launch of its first SUV, which will increase its coverage of the luxury market from 50% to 100%. Alfa Romeo will be relaunched in the U.S. with eight new models designed by two former heads of Ferrari design with a €5 billion budget.

Chrysler/Dodge – Chrysler has suffered from underinvestment and internal competition with Dodge, but Dodge is being repositioned as a performance brand, and Chrysler's lineup will see a significant refresh and expansion to address 65% of the market by segment, compared to only 25% today.

Architecture Convergence – Fiat and Chrysler integration will have 1 million vehicles on its three principal platforms. This substantially reduces R&D and capex per vehicle, lifting margins to competitive levels.

Normalized Earnings Power

When Fiat purchased Chrysler, Chrysler had outstanding debt that ring-fenced Chrysler's cash. This debt has been uneconomical to repay to date, but the first of the two bonds was just recently prepaid and the second will be prepaid next year. Because Chrysler cash was ring-fenced, management had to borrow on the Fiat side to invest in its plan. It has therefore been intentionally carrying excess liquidity, the release of which will reduce interest expense by €1 billion, or €0.46/share after tax. Its earnings are also currently depressed by elevated recalls and elevated incentives to clear old inventory in anticipation of significant refreshes. After accounting for these factors, 2015 normalized earnings power would be ~€1.5/share.

Auto Industry Consolidation Kickstarter

Marchionne has publicly stated many times over the last few years his belief that the industry needs consolidation. In the last month, he has elevated the rhetoric and announced his intent to release an analysis on the potential savings that could be generated through consolidation. He has also publicly stated that he wants to close another big deal before he retires in 2018, and has said he has an "ideal partner in mind" and a merger with Ford or GM would be "technically feasible." There could be massive synergies on R&D, as the major OEMs are spending billions of dollars on duplicative research. We believe a merger with GM could create in excess of €4 billion per year in synergies.

The major roadblock to consolidation has historically been manager self-interest. There can only be one CEO in a merger, and as Marchionne has said, "One of the most difficult things to do is to get the turkey to invite himself to Thanksgiving dinner." But because Marchionne plans to retire in 2018, he could potentially overcome this hurdle, as he could be the "interim" CEO of a larger MergeCo to facilitate the integration, since he has experience integrating two large automakers, with plans to hand over the reigns to a much larger more profitable company in 2018 to the acquired CEO.

Fiat is the seventh largest automaker and will produce ~5 million vehicles this year. The top seven automakers control about 75% of the market, but there are more than fifteen automakers that sell more than 1 million vehicles per year. A large merger between Fiat and one of its larger competitors could initiate an industry wide domino effect. Fiat/GM MergeCo, for example, would produce ~15 million vehicles, compared to Toyota which would be the new #2 at ~10 million vehicles. Toyota, Volkswagen, Renault-Nissan, Hyundai-Kia, and Ford would then find themselves in need of a partner to compete with the scale of Fiat/GM MergeCo. Through a round of mergers, the top seven could become the top four. Then the remaining small automakers would be so disadvantaged that they would likely be purchased in smaller add-on mergers. The industry could end up with only four or five players in five to ten years, which could lead to much more rational competition and higher multiples, as it did for the airlines.

Key Risks

Macro – Fiat is an operationally and financially leveraged business, a major macro shock could cause material downside; however, Ferrari provides a margin of safety. Ferrari revenue only dropped ~8% in 2009 and completely recovered in 2010.

Unions – Unions could claw back concessions made during the crisis. However, right to work laws in Michigan and Indiana, as well as two-tier wage system, reduce the power of unions. Reasonable wage increases can be passed on through price. A 20% increase in wages would only require a 1% increase in prices to maintain margins.

Uber – Uber could reduce demand for second cars, which would reduce U.S. SAAR; however, Jeep, Ram, Ferrari, and Maserati are worth well in excess of the entire current market cap. Ram, Ferrari, and Maserati are completely unaffected by Uber, and Jeep benefits from a secular mix shift towards SUVs, which will offset any reduction in long term U.S. SAAR from car sharing.



Damian Creber '16

Damian is a first-year student at Columbia Business School. He is also Co-President of the Columbia Student Investment Management Association. Prior to CBS, Damian spent two years as an Associate in the private equity group at Onex Partners.

Damian is a CFA Charterholder and graduated from the University of Toronto with a Bachelor of Commerce.



Michael Herman '16

Michael is a first-year student at Columbia Business School. He is also Co-President of the Columbia Student Investment Management Association. Prior to CBS, Michael spent three years as an Investment Analyst at East West Investment Management.

Michael is a CFA Charterholder and graduated from the University of Western Ontario with a degree in Software Engineering, as well as an HBA from the Richard Ivey School of Business.

HCA Holdings Inc. (NYSE: HCA) - Long 3rd Place, 2015 Pershing Square Challenge

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Opportunity

The market is presenting the opportunity to buy HCA at less than 10x 2017E earnings. Demographic trends and healthcare reform will provide a meaningful tailwind to profitability, while the regulatory overhang will dissipate in June. In addition, HCA owns all of its real estate which, if monetized, would unlock significant equity value, and the Company has enough firepower to buy back 35% of its shares.

We believe the shares have ~75% upside over the next three years as earnings will accelerate meaningfully. Our view is that the shares have ~25% downside over the same period, implying a 3:1 upside/downside ratio.

Company Overview

HCA is the largest hospital operator in the US with 166 hospitals and 113 freestanding surgery centers.

Investment Thesis

1) Structural Competitive Advantage

HCA's market position (#1 or #2 in each of its local markets) gives it significant leverage when negotiating with commercial insurers. HCA owns between 20% and 60% of the beds in each of its markets, which drives a 30% price premium. Additionally, HCA's scale allows it to negotiate meaningfully lower costs on purchases. HCA's margins allow the Company to earn returns on invested capital that would not be possible by a new entrant – creating a meaningful barrier to entry.

2) Attractive Capital Deployment Opportunities

HCA's management team is very shareholder friendly and has continued to deploy capital into highly attractive projects (>50% incremental ROICs since 2007). HCA is currently pursuing an ambulatory surgery center (ASC) development strategy whereby they look to place ASCs in a hub-and-spoke format around their urban hospitals (ASCs have ~18% ROICs). While acquisitions have not been a large part of the story, management has continued to evaluate opportunities and completed acquisitions have had attractive returns.

3) Significant Free Cash Flow and Debt Capacity

HCA's management – having been through two private equity buyouts – understands the attractiveness of repurchasing shares opportunistically. The strong and stable free cash flow profile of HCA allows the Company to constantly re-lever to return capital to shareholders. HCA management has returned a total of \$7 billion back to shareholders – this compares to the IPO market cap of less than \$13 billion.

4) Meaningful Industry Tailwinds

The Medicare eligible population (65+) will grow at a CAGR of ~3.0% a year over the next 20 years. Simply shifting today's aging population forward 10 years illustrates that HCA is going to benefit from a significant tailwind regarding the aging population. Incremental EBITDA margins per admission are in the range of 40-50% and we estimate that EBITDA will increase by ~75% from the aging demographic alone. In addition, health care reform will drive a meaningful reduction in highly unprofitable uninsured patients which we believe will drive an incremental \$1 billion of EBITDA through the system over the next two years.

Capitalization Summary (\$MM)		Valuation (Base Case)	
Share Price	\$78.04		Multiple
Shares O/S	439.6	Price / LTM EPS	18.7x
Market Cap.	\$34,306	Price / 2015 EPS	11.8x
		Price / 2016 EPS	10.4x
		Price / 2017 EPS	9.1x
plus: debt	\$29,645	EV / LTM EBITDA	8.8x
plus: minority int.	1,396	EV / 2015 EBITDA	7.7x
less: cash	(566)	EV / 2016 EBITDA	7.3x
Enterprise Value	\$64,781	EV / 2017 EBITDA	7.0x

Name	Average EBITDA Margins		
	1- Year	3- Year	5- Year
Community Health Systems	15%	15%	15%
LifePoint Hospitals	13%	14%	15%
Tenet Healthcare	12%	12%	12%
Mean	13%	14%	14%
Median	13%	14%	15%

HCA	20%	20%	20%
HCA Advantage (vs. Median)	713 bps	577 bps	474 bps

Current ASC Revenue (mm)	\$1,000
Number of ASCs	113
Revenue Per ASC (mm)	\$8.85
EBITDA Margin Per ASC (@ 30%)	\$2.65
Cost To Build	\$15.00
Existing ASC ROIC	17.7%

Component 1 (Current Cash)

Cash on Balance Sheet	\$566
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Component 2 (Debt Capacity)

Additional Debt (@ 4.0x)	\$5,999
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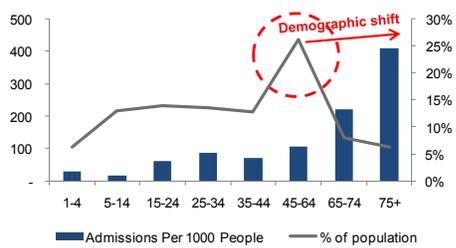
Component 3 (Free Cash Flow)

Cumulative Free Cash Flow	\$5,782
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Total Cash Available to Shareholders	\$12,347
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Current Market Cap	34,306
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% of Mkt. Cap. Returned (2 Years)	36%
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Source: Morgan Stanley, company financials, US census

HCA Holdings Inc. (HCA) - Long (Continued from previous page)

5) Hidden Real Estate Value

HCA owns all of the real estate under its hospitals and freestanding surgery centers. By spinning its owned land and buildings into a PropCo, HCA shareholders could capture the hidden value associated with the real estate. Healthcare REITs trade between 16x and 25x EBITDA (and the recent Ardent transaction was completed at 14x), whereas HCA trades at ~8.5x EBITDA.

Value of OpCo		Value of PropCo	
Adjusted EBITDA	\$4,979	Triple-Net Rental Income	\$2,406
EBITDA Multiple	8.8x	less: REIT management	(60)
OpCo Enterprise Value	\$43,816	Funds From Operations (FFO)	\$2,346
less: debt	(21,163)	FFO Multiple	14.0x
less: minority interest	(1,396)	OpCo Enterprise Value	\$32,841
plus: cash	566	less: PropCo debt	(\$19,293)
OpCo Equity Value	\$21,823	PropCo Equity Value	\$13,548
Equity Value (OpCo + PropCo)	\$35,371	PropCo Coverage Ratio	2.0x
plus: special dividend	10,811	Implied Interest Expense	\$1,173
Total Equity Value	\$46,182	Effective Interest Rate	6.1%
Shares O/S	439.6	PropCo Debt	\$19,293
Per Share	\$105.05		
% upside	34.6%		

Risks and Mitigants

Risk / Street View	Our View
There is currently a large overhang on the stock as the market is worried about King v. Burwell	<ul style="list-style-type: none"> The King v. Burwell ruling, which will occur in June, will decide whether plans purchased on federally-run healthcare exchanges are eligible for ACA subsidies The impact of a negative ruling would only be temporal vs. structural as states would create their own exchanges "There is not a single Republican governor in the United States that is cheering for a King victory – we all understand this will fall squarely on our shoulders" - High-Ranking State Healthcare Official
The industry is looking to move towards a fee-for-value model and this may harm hospitals	<ul style="list-style-type: none"> Consensus remains concerned about the ambiguity of the shift from a fee-for-service model to a fee-for-value model We believe this threat is overblown as (i) the government has indicated the profit pool will remain flat through the conversion, and (ii) HCA's quality metrics are industry-leading "We currently have 30% of our patients on a capitation model and we are not making any less than we were under a fee-for-service model" - Partners HealthCare
There is concern that there will be significant reimbursement pressure going forward	<ul style="list-style-type: none"> ~30% of hospitals in the US have negative operating margins and average operating margins are ~5% – this leaves very little room for below-inflationary increases (let alone cuts) in reimbursement rates Historical market basket increases have never been below 2% on an annual basis, and have averaged closer to 3%, as the government understands the importance of offsetting rising costs of healthcare Hospitals employ more than 5.4 million people in the US today – the second largest private sector employer (very powerful voice)

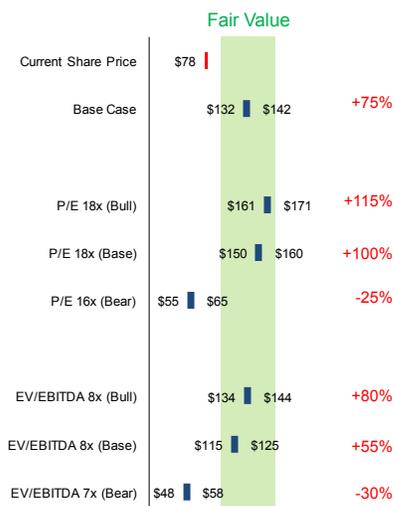
Valuation

Based on a variety of metrics, HCA appears meaningfully undervalued. We believe there is ~75% upside over the next three years under a probability-weighted scenario, which translates to a 21% IRR.

Our downside includes an adverse ruling on King v. Burwell, as well as associated multiple compression.

The shares represent an attractive risk-reward proposition with ~25% downside over the same period, representing a 3x upside / downside ratio. Value-creating catalysts / positive signposts include:

- 1) A reversion in trading multiples (to levels before the Supreme Court agreed to hear King v. Burwell) would result a 17% increase in the share price
- 2) Continued decline in uninsured patients
- 3) Monetization of the Company's real estate assets
- 4) Announcement of Medicaid expansion in Texas or Florida





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Genuine Parts Company (NYSE:GPC) - Long 2015 Pershing Square Challenge

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Recommendation

We recommend investors buy Genuine Parts Company (GPC) with a two year price target of \$127, representing a total return of 45%. There are three main points to our investment thesis:

- 1) Strength of the automotive parts segment as a pure play
- 2) Office segment Reverse Morris Trust merger transaction with United Stationers
- 3) Tax-free spin of the industrials and electrical parts segments

Business

- GPC is a conglomerate operating within three primary industries. The company's largest segment is its automotive parts group, which represents approximately 53% of sales and 55% of EBIT. GPC operated as an auto pure play until the mid-1970s when it acquired Motion Industries and S.P. Richards.
- Motion Industries is GPC's industrial products subsidiary, and it represents approximately 31% of sales and 29% of EBIT. Motion is a value-added distributor of replacement parts to factories across a number of different end markets. In a highly fragmented market, its main competitors are Applied Industrial Technologies (AIT), Kaman and DXP Enterprises.
- S.P. Richards is GPC's office supplies subsidiary, accounting for 11% of sales and EBIT. S.P. Richards is a national wholesaler of office products competing with \$1.6 billion United Stationers.
- The remaining 5% of sales and EBIT comes from GPC's electrical parts subsidiary, EIS.

Investment Thesis

Over the last 15 years, GPC has outperformed the broader market, as proxied by the S&P 500. However, over the same period of time, GPC has substantially underperformed its automotive peers. Since Advance Auto Parts went public in November 2001, GPC has underperformed O'Reilly, Advance Auto Parts and AutoZone by 2-3 times.

Our primary research indicates that GPC is a great business that is suffering from an unwieldy conglomerate structure and an overly conservative management team. As such, we believe GPC is ripe for an activist.

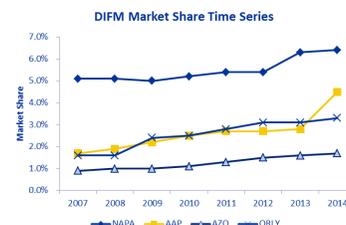
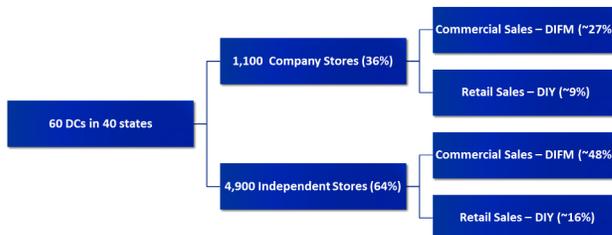
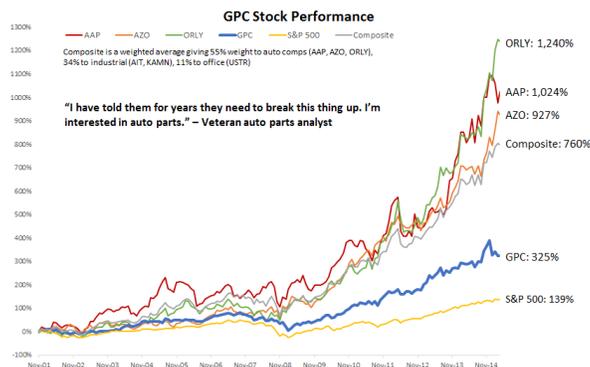
1) Strength as an automotive pure play

- GPC's automotive parts group operates under the NAPA brand name and sells nearly 500,000 parts including car batteries, brake pads and wiper blades. Within the space, GPC primarily competes with O'Reilly, Advance Auto Parts and AutoZone. In comparison to peers, NAPA sales are more skewed to the faster-growing commercial Do-It-For-Me market. Further, NAPA employs a capital-light model through its 4,900 independently owned stores.
- Within its commercial niche, NAPA has created a tremendous network effect and captive customer base through its 15,000 NAPA AutoCare locations. Local economies of scale within the space have created significant barriers to entry. Across the industry, the NAPA brand is known for its superior quality. We think NAPA is well-positioned to take market share from local and national competitors, particularly from Advance Auto Parts as the company has had difficulty integrating its newly acquired CARQUEST locations.
- The auto parts aftermarket has several significant tailwinds, including increased car complexity and an aging vehicle fleet. NAPA has also been making significant strides within the retail market, delivering year-over-year growth of 8% in 2014. Our primary research indicates much of this can be attributed to the group's president, Paul Donahue. During our channel checks, we learned Donahue has changed the culture within the automotive segment and has consistently improved execution. Donahue is widely considered to be the heir-apparent to the current 67 year-old CEO. As such, we think an activist campaign could help to expedite this transition.

Genuine Parts Company

Capital Structure

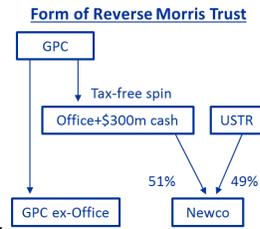
Stock price	\$91.67
Diluted shares	154.1
Market cap	\$14,125
- Cash	\$138
+ Debt	\$765
+ Pension (tax-effected)	\$210
+ Minority interest	\$11
Enterprise value	\$14,973



Genuine Parts Company (GPC) - Long (Continued from previous page)

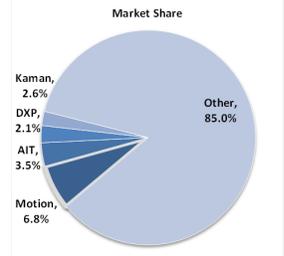
2) Office segment Reverse Morris Trust merger with United Stationers

- We propose that GPC spin off S.P. Richards and merge it with United Stationers via a tax-efficient Reverse Morris Trust transaction. We think a merger would allow the combined company to cut costs and halt margin-damaging price wars. We estimate synergies equal to 2% of the combined company's annual sales, a figure consistent with last year's merger of paper distributors xpedx and Unisource Worldwide. Subtracting restructuring costs and capitalizing the synergies at 10x would create new value of \$1.5 billion. Half of that would accrue to GPC shareholders, providing incremental value of approximately \$5 per share.
- Significant synergies were confirmed through our primary research. The founder of an ERP system used by office products distributors told us that United Stationers and S.P. Richards have duplicative warehouses that would be a clear source of cost savings in a merger. Our contact, who has decades of experience in the industry, told us that S.P. Richards had only won first call at Office Depot last year after the OfficeMax merger because S.P. Richards had bid extremely low on price.



3) Tax-free spin of the industrials and electrical parts segments

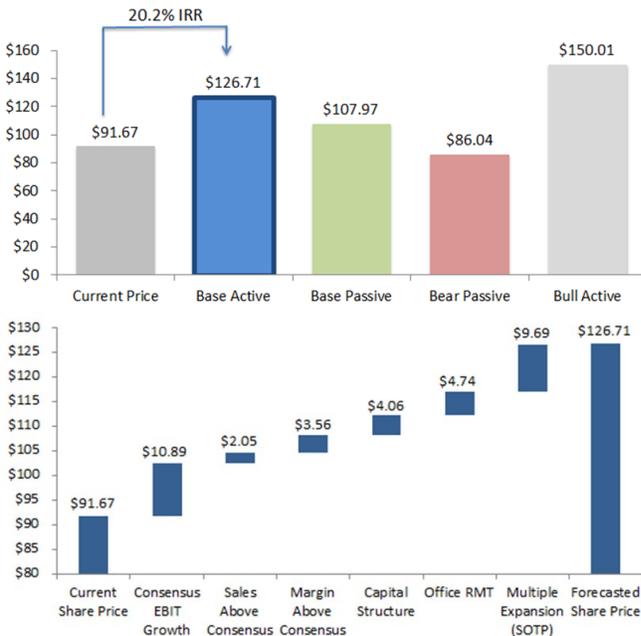
- Motion Industries is essentially a break/fix business—when a machine on an assembly line breaks, they sell the parts to fix that machine. The company is viewed as the best in the business, and several people across the industry think that Motion would be better as a standalone company. We are recommending a tax-free spin of the industrial and electrical parts segments for several reasons. First, Motion and EIS have no material synergies with auto or with office. When asked about synergies between the different segments, the company has told us that it's tough to see anything glaring since the businesses serve very different end markets. Further, the industry is highly fragmented. With a leading market position, management at the new, independently run company can better focus on growing share and realizing synergies through strategic acquisitions. We think an independent Motion could follow a roll-up strategy after the spin. While smaller targets are more feasible over the next 2-3 years, the company could eventually consider acquiring one of its larger competitors—DXP, Kaman or even AIT.



Valuation

- To properly value GPC, we used a sum-of-the-parts methodology. Adding up the value of each of GPC's segments, we calculated a two-year price target of \$127 for a total return of 45%. In estimating earnings, we started with industry revenue forecasts from the Auto Care Association. After speaking with the director of market intelligence at the industry group, as well as many other industry participants, we gained confidence that NAPA would continue to gain market share going forward, particularly from Advance Auto Parts and independent shops, bringing us to a revenue figure above consensus in our base case.
- For margins, we focused on the company's substantial operating leverage. A former NAPA supply chain executive told us that NAPA had far too much overhead at the distribution center level for the current volume, suggesting that incremental revenue would come with minimal SG&A increases.
- Because we wanted to evaluate how the company would fare without activist intervention, we've included four cases—a base active, a base passive, a bear passive and a bull active. Earnings estimates are the same for our base active and base passive, so you can see we believe an activist adds \$19 per share, the difference between base active and base passive.
- We will also note that while our base case provides a 45% return, we believe this is a long-term compounder as NAPA and Motion should each continue to consolidate and gain market share in fragmented markets where they are the market leader.

Key risks include 1) dividend-oriented shareholders may be reluctant to support an activist campaign, and 2) S.P. Richards and United Stationers may face anti-trust scrutiny.



	Target Price			
	Base Active	Base Passive	Bear Passive	Bull Active
(\$ millions except per share)				
2017 Estimates				
Automotive EBIT	\$844.2	\$844.2	\$768.6	\$886.0
Industrial EBIT	417.8	417.8	412.9	417.8
Office EBIT	151.9	151.9	150.0	151.9
Electrical EBIT	72.1	72.1	71.4	72.1
Corporate expenses/other	(72.4)	(72.4)	(72.9)	(72.4)
Consolidated EBIT	\$1,413.7	\$1,413.7	\$1,330.0	\$1,455.5
Consolidated EPS	\$5.72	\$5.72	\$5.35	\$5.93
Target Forward Multiples				
P/E		18.0x	15.0x	
EV/EBIT		12.0x	10.0x	
SOTP: Automotive	15.0x			16.5x
SOTP: Industrial	11.3x			12.4x
SOTP: Office	10.2x			11.2x
SOTP: Electrical	11.5x			12.7x
SOTP: Corporate expenses/other	10.0x			11.0x
Price per Share				
P/E		\$103.02	\$80.18	
EV/EBIT		\$112.02	\$86.49	
Levered DCF		\$108.87	\$91.44	
SOTP	\$121.97			\$143.95
Office RMT	\$4.74			\$4.74
Motion Roll-Up				\$1.32
Target Price	\$126.71	\$107.97	\$86.04	\$150.01
Upside (Downside)	38.2%	17.8%	(6.1%)	63.6%
IRR	17.6%	8.5%	(3.1%)	27.9%
2017 Dividend Yield	2.3%	2.7%	3.1%	2.0%
Return (dividends reinvested at IRR)	20.2%	11.4%	(0.1%)	30.5%



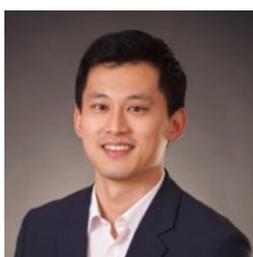
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Precision Castparts (NYSE: PCP) - Long 2015 Pershing Square Challenge

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Recommendation

We recommend a long position in Precision Castparts (PCP) with a two-year target price of \$300, representing ~50% upside. PCP is a long for four major reasons:

- 1) PCP is the market leader in an industry with meaningful barriers to entry.
- 2) PCP has a history of best-in-class FCF generation and capital allocation with further opportunities for accretive M&A and share buybacks.
- 3) PCP's end-markets benefit from strong secular tailwinds, providing confidence in near-to-midterm FCF generation.
- 4) The opportunity exists due to recent negative sentiment regarding potential market share loss, which we believe to be unfounded but has provided an attractive entry point.

Capitalization	
Current Share Price (4/17/15)	\$201.15
Shares Outstanding	141.8
Market Cap	\$28,517

Less: Cash	(\$430)
Plus: Debt	\$4,172
Enterprise Value	\$32,259

Other Metrics	
Short Interest	2.4%
52-Week Low/High	\$186 / \$275

EV / FY'15 EBITDA	10.5x
EV / FY'16 EBITDA	10.0x
Price / FY'15 Earnings	15.8x
Price / FY'16 Earnings	14.8x

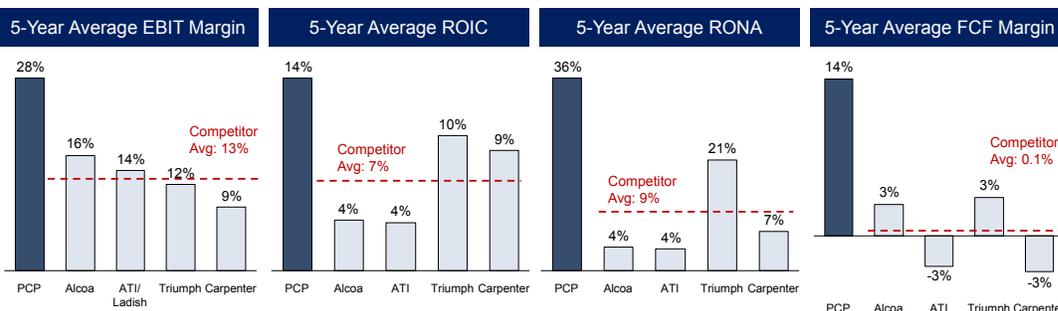
Business Description

Precision Castparts is the market leading provider of mission-critical metal components to the high-end aerospace market, which accounts for ~70% of sales, primarily to commercial aerospace. The company generates \$10 billion in annual revenue and over \$2.8 billion in operating income. It is a nearly \$30 billion market cap company with only ~\$3 billion in net debt. PCP produces highly engineered, high-value metal components that are found all over airplanes, especially in the engine, including nickel and titanium investment castings that go in the hot section of the engine, forgings that help encase the engine, and airframe products that go on the outside the plane, such as fasteners that hold the plane together.

Investment Thesis

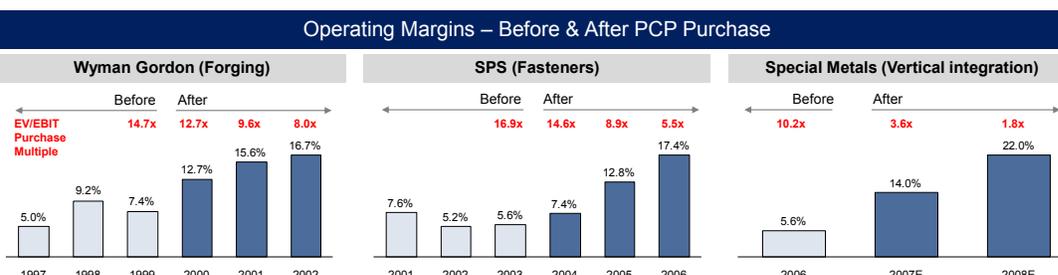
1) A formidable competitive moat

PCP has had significant success for over a decade due to the following three factors, which represent a formidable competitive moat. First, PCP is fully entrenched in its customers' ecosystems. The company supplies products to every major airplane platform, including the 787 and A380. It is extremely expensive and difficult to try to build an airplane engine without PCP. A new entrant would need to wait several years for regulatory and quality approvals and would incur a significant capital outlay to build scaled capacity. Second, PCP has dominant and stable market share, including 50% share in investment castings and the top market share in forgings. The company has maintained this position over the last decade-plus with a combination of sole-sourced products, for which it has unique manufacturing capabilities, and defined market share products, where it faces competition from other top players. Third, PCP is the low-cost leader in the space. The company has operated since WWII, and a combination of experience, a fanatical focus on cost reduction, and vertical integration helps it maintain this pole position. The numbers back up the durability of these advantages as PCP has been the leader in operating margin, ROIC, RONA and FCF margin over a sustained period of time.



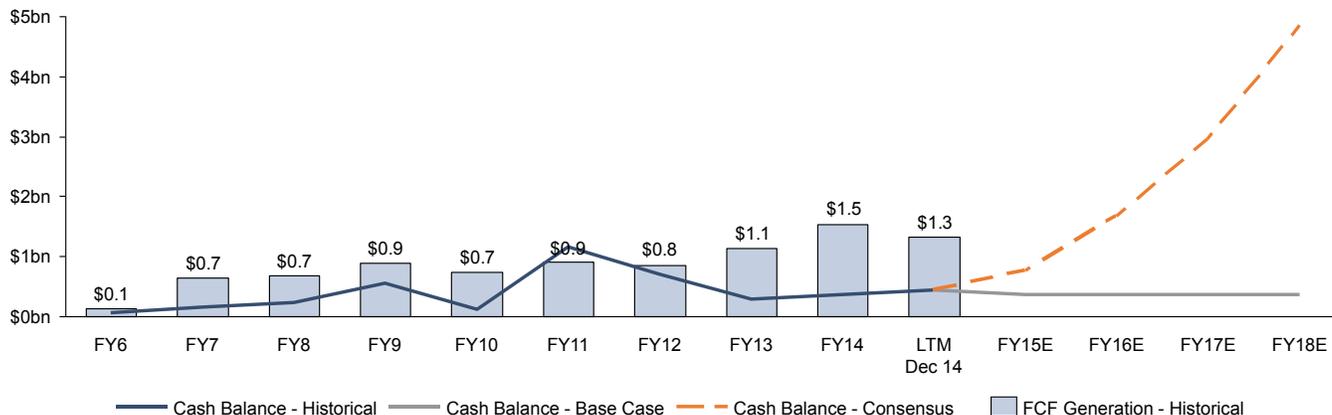
2) Best-in-class capital allocator

PCP has been a phenomenal capital allocator and we believe this will continue through both M&A and share buybacks. PCP has clearly demonstrated its ability to do accretive M&A in the past by leveraging its operating expertise to buy down purchase multiples to levels that were effectively one-half to one-third of the stated purchase price. PCP achieved this by driving significant synergies over a period of time that was often ahead of their original guidance.



Precision Castparts (PCP) - Long (Continued from previous page)

We feel that there is significant runway to continue to drive growth through M&A. Based on PCP's guidance, conversations with industry experts and bankers covering the space, the airframe structures market represents significant opportunity given its fragmentation. Another interesting area of potential is highly-engineered components in the hot section of the engine that would allow PCP to expand its capabilities in a critical part of the engine. Based on these opportunities, we believe PCP is well positioned to continue to grow through M&A. However, the sell-side severely misunderstands this capital allocation story. PCP generates significant cash flow and is very good at allocating that cash intelligently, but analysts are not modeling that in. For a company that has rarely had more than \$400mm of cash on the balance sheet, it is unlikely they're going to build \$2-6bn on the balance sheet going forward. We believe PCP will utilize their cash and use both M&A and buybacks to continue to drive meaningful EPS growth. Our conviction is further strengthened by investing behind CEO Mark Donegan, who is the driving force behind PCP's status as a best-in-class operator and capital allocator. Even competitors speak highly of him. Indicative of many conversations we had, one competitor told us that he was an "Outsider type CEO, hands down the best CEO in the space."



3) Strong secular tailwinds in key end-markets

The last leg of our thesis rests on the robust secular tailwinds in the commercial aerospace market, which give us confidence that PCP's FCF will continue to be strong. As discussed earlier, 70% of PCP's sales are tied to aircraft deliveries. Over the last 10 years, production backlogs at major commercial aircraft manufacturers have grown to all-time highs as orders have consistently outpaced deliveries to match rising global air travel demand. We see limited risk of a sharp pull back in deliveries, given the delivery cycle is much less volatile than the order cycle and deliveries as a percentage of the worldwide fleet are only at average levels historically.

4) Destocking misperception

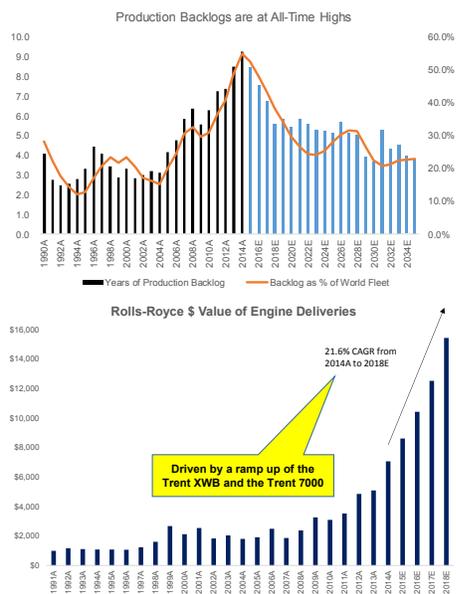
Despite these strong secular tailwinds, PCP shares have underperformed due to investor concern over slowing organic sales growth. Destocking further down the supply chain at Rolls-Royce, one of PCP's largest customers, is the primary reason behind the weak organic sales. The issue emerged two years ago and has not gone away. This, combined with the lack of a formal guidance program, has led to speculation among analysts about structural market share loss. Our diligence calls point firmly to destocking at Rolls, a poorly managed company, as the main culprit. Because of the complexity of the aerospace supply chain, it is possible that different parts of the supply chain will experience the end of Rolls' destocking at different times. Although there is some uncertainty as to when it might end, the fact that a smaller competitor (Allegheny Technologies) indicated on its most recent earnings call that destocking was no longer an issue might be a positive sign that it could be over soon for PCP as well. To be clear, calling the end of destocking is not critical to our core thesis. The strong trend of rising Rolls-Royce engine deliveries will more than offset any ongoing destocking impact.

Valuation

PCP currently trades at a forward P/E of 14.8x versus a historical average of 17.4x. At today's price, PCP is valued at 10.4x our F18 EPS estimate of \$19.30 in our base case. We value the existing business at \$287 based on 15.7x F18 EPS. Additionally, we ascribe \$13 of value to acquisitions done over the next five years, assuming PCP is able to close \$750 million worth of deals annually at 10.5x EV/EBITDA. Our SOTP price target of \$300 in our base case implies a P/E of 15.6x, a very reasonable below market multiple to pay given the quality of the business. In addition to a bull case with 79% upside and a bear case with 10% downside, we believe there is a leveraged recap opportunity that offers 87% upside. PCP has always maintained leverage at modest levels, but given the company's steady mix shift towards aerospace, an industry with great sales visibility, we believe it can take a more aggressive approach to its balance sheet. We view this opportunity as an embedded lottery ticket and estimate that a leveraged recap could result in over 20% accretion to F18 EPS.

Key Risks

We've identified several risks to our thesis but believe the overall risk profile is manageable. The emergence of another viable competitor could negatively impact PCP's market share. Engine OEMs have tried to develop smaller competitors into suppliers of scale. These efforts have largely failed however due to poor yields and difficulty moving down the cost curve. A second major risk involves a push-out of aircraft delivery schedules due to a cyclical downturn, which would negatively impact sales; however, as mentioned previously, our analysis indicates that deliveries are much less volatile than orders. As an example, deliveries kept up through 9/11 even when orders cratered.



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Graham & Doddsville Editors 2014-2015



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