



**Columbia Business School**  
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# Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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COLUMBIA STUDENT INVESTMENT  
MANAGEMENT ASSOCIATION

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**John Phelan**

## John Phelan of MSD Capital

Mr. Phelan is Co-Managing Partner of MSD and Co-Founder of the firm. Prior to forming MSD, he was a Principal from 1992 to 1997 at ESL Investments, a Greenwich, Connecticut based investment firm. At ESL, Mr. Phelan was responsible for ESL's Special Situation Investments and helped grow the firm from \$50 million to over \$2.0 billion in assets under management. Prior to ESL, Mr. Phelan was Vice President in charge of Acquisitions (Western Region) for the Zell-Merrill Lynch Real Estate Opportunity Funds. Mr. Phelan began his career at Goldman, Sachs & Co. where he

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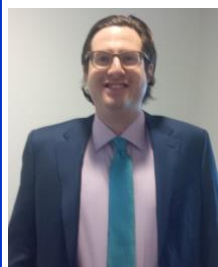
**Alex Magaro**

## Alex Magaro of Meritage Group

Alex Magaro is a Co-President of Meritage Group, a fundamentally-oriented

investment firm, managing approximately \$10B primarily on

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**Adam Wyden**

## Adam Wyden '10 of ADW Capital

Adam Wyden founded ADW Capital in January 2011 and acts as sole portfolio manager to the Fund. The Fund is focused on maintaining a concentrated portfolio of high-quality and high-

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**Marc Cohodes**

## Marc Cohodes formerly of Rocker Partners/Copper River

Marc Cohodes is a former General Partner of Rocker Partners/ Copper River from 1985-2009. He began his career at the Northern Trust Company in 1982 after graduating Babson College with a BS in Finance. He has been profiled in the books; Reckless Endangerment, Selling America Short, The Most Dangerous Trade. He was the subject of a Harvard Business School Case study on his efforts to expose Mortgage Fraud at Novastar. He resides in Cotati, California, where he runs Alder Lane Farm.

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## Welcome to Graham & Doddsville



Meredith Trivedi, the Heilbrunn Center Director. Meredith 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 Co-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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INVESTING



We are pleased to bring you the 27th edition of *Graham & Doddsville*. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA).

In this issue, we were fortunate to speak with four investors who offer a range of perspectives based on their unique paths to and careers in investing.

**John Phelan** of MSD Capital discusses lessons learned over decades of investing with mentors such as Richard Rainwater, Sam Zell, Eddie Lampert, and Michael Dell. John offers insights into the development of MSD Capital as well as his own development as an investor and PM, while shedding light on challenges he sees today in the investment management industry.

**Alex Magaro** of Meritage Group discusses his many experiences, from running a business as an owner-operator to investing in early stage companies, which led him to co-manage Meritage Group. Alex talks to G&D about long-term invest-

ment horizons across asset classes and the return potential of businesses with durable competitive advantages.

**Adam Wyden '10** of ADW Capital discusses the influence of an entrepreneurial spirit on his firm and investment process. Adam walks through past ideas such as IDT and Imvescor Restaurant Group (IRG.TO) as well as current theses on Ferrari (RACE) and Fiat (BIT:FCA).

**Mark Cohodes** shares his experiences from a lifetime of short-selling. He offers his perspective on the discipline and temperament required as well as the intellectual rewards of a career in short-selling. Marc discusses ideas such as Home Capital Group (HCG) and Tempur Sealy (TPX).

This issue also highlights photos from the 19th annual CSIMA Conference as well as the 9th annual Pershing Square Challenge.

Lastly, we are proud to include in this issue finalist pitches from current students at CBS who competed in this year's Pershing Square Challenge.

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 sought 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 Brandon Cheong '17, Eric Laidlow '17, and Ben Ostrow '17. We want to thank Brandon, Eric, and Ben for their commitment and dedication to Graham & Doddsville over the last year.

As always, we thank our interviewees for contributing their time and insights not only to us, but also to the investment community as a whole, and we thank you for reading.

- G&Dsville Editors



**Howard Marks from Oaktree, pictured here giving the keynote talk at the CSIMA Conference in January 2016**



**Columbia Business School students help at registration for the 19th Annual CSIMA Conference**

## Columbia Business School Events: CSIMA Conference and Pershing Square Challenge



**Keith Meister of Corvex Management LP delivers his keynote address at the 19th Annual CSIMA Conference**



**Howard Marks of Oaktree with Bruce Greenwald after their keynote interview at the 19th Annual CSIMA Conference**



**1st Place Finalists Joanna Vu '17, Melody Li '17, and Thais Fernandes '16 pitch Alimentation Couche-Tard at the 9th Annual Pershing Square Challenge**



**Paul Hilal '92 and Bill Ackman listen and judge student pitches at the 9th Annual Pershing Square Challenge**



**Judges deliberate at the 9th Annual Pershing Square Challenge**



**Bill Ackman and the winning team at the 9th Annual Pershing Square Challenge**

## John Phelan

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John Phelan

**worked as an Analyst in the Investment Banking Division.**

**Mr. Phelan received his M.B.A. from Harvard Business School and graduated cum laude with distinction and Phi Beta Kappa from Southern Methodist University with a B.A. in Economics and Political Science. Mr. Phelan also holds a General Course degree with an emphasis in Economics and International Relations from the London School of Economics.**

**Graham & Doddsville (G&D):** To start off, talk about your background and your path to investing, including mentors and influences along the way.

**John Phelan (JP):** My mother was a very big influence on my development as an investor. My father was a doctor and, like most doctors unfortunately, not a very good investor. My mother, on the other hand, came from a real estate background and focused very much on cash flow. My parents gave me a Disney stock certificate for a birthday present when I was five years old. That got me hooked—I was fascinated by numbers and seeing something trade every day. That's what got me into stocks.

I initially went into real estate, where my mother taught me quite a bit, including two principles: make sure you can always pay your bills and debt service and the importance of free cash flow for levered assets like real estate. She also

encouraged me to go find good mentors. She said one of the things about good mentors is you can learn on someone else's nickel. It's something you don't realize when you're younger. But it struck me at a very early age to try to go find people that were the best in their particular businesses, and I think my mother pushed me towards that.

In my real first job, I worked with an uncle rehabbing apartments in New York. I was doing that during college. That was an eye-opening experience that forced me to focus on cash flow every minute of the day. It was a very tough business and I was doing a number of different things. The work ranged from running the numbers to actually doing construction work. That teaches you a lot. I also learned I didn't want to break my back doing that for my entire career.

I was fortunate enough to get a job with Goldman Sachs, which was really the first big company I worked for. At the time, Goldman was still a private partnership. I learned a ton and I had a number of great mentors at Goldman Sachs. I worked with truly exceptional people there.

As great as my experience at Goldman was, it did make me realize that I did not want a career in investment banking. Instead of being the person who is on call 24/7 to serve my client I wanted to be the client. I preferred being a principal as opposed to an advisor. I decided to attend business school and was accepted into Harvard Business School. The summer between my first and

second years at business school I worked for Richard Rainwater, and that's where I met Eddie Lampert. Richard introduced me to Eddie. Of those ten weeks that summer, I spent about three or four with Richard and the rest with Eddie.

**G&D:** How did you connect with Richard?

**JP:** I had been hoping to get back to Texas after business school and I wrote Richard a letter. In that letter I told him I would be willing to work for free and one of my professors at Southern Methodist University had suggested I contact him. I told him I just wanted to learn from one of the best and was willing to invest in myself.

Richard called me on a Friday at like 4:00pm. He said "Hey John, this is Richard Rainwater." I thought it was one of my classmates playing a joke on me. I used a curse word I shouldn't have and just hung up the phone. A minute later the phone rang again: "I think we got disconnected." I'm thinking, "Oh my God, this is Richard Rainwater. I cannot believe I just hung up on this guy." I said, "I'm really sorry, but my classmates have been playing jokes on each other, and I thought you were one of them." "Oh that's a pretty good one," he laughed—he was very good about it.

I flew down to Fort Worth on my own dime and met with Richard. He said, "Meet with these different guys. You can work with me for a bit and see if one of them will take you as well." I met with Eddie and a couple of other guys who were

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## John Phelan

with Richard at the time. I didn't know a lot about risk arbitrage, but I knew they were analyzing stocks and that was something I really wanted to do. It was a tremendous learning experience. I really enjoyed working with Richard and Eddie that summer, and I fell in love with the risk arbitrage business. One of the things you have to be good at in the risk arbitrage business is valuation: you need to be able to understand your downside.

I graduated in 1990—not a very good year to graduate from business school, as you can imagine. The markets were bad, the RTC/bank crisis was accelerating and most money managers were having a bad year. It was a rough year. Eddie said, “Listen, I don't know if I'm going to be in business much less have a job for you. It's not clear. You should go find something.”

**G&D:** Did you end up working with Eddie?

**JP:** I actually graduated without a job. It was depressing because I didn't expect to be jobless, in debt, and living at home with my parents after graduating from Harvard Business School. I knew I did not want to go back to banking, so I did not do that. Luckily a couple of the guys I had worked with at Goldman in Chicago left the firm to go work for Sam Zell. Bob Lurie had died and he was really Sam's right-hand man—they were partners. Sam hired Randy Rowe, who was the main person I worked with at Goldman in Chicago. Randy was kind enough to offer me a job. Sam had just raised his second distressed real estate

investment fund and was one of the few people who had capital. It was a good time to have capital. The RTC was formed after a number of S&L's failed, there were a lot of distressed loans, the trading market for loans was just starting to develop, and the illiquidity was incredible. Having capital at that time and being a liquidity provider to the banks was a unique and good place to be.

**“...my mother taught me quite a bit, including two principles: make sure you can always pay your bills and debt service and the importance of free cash flow for levered assets like real estate. She also encouraged me to go find good mentors.”**

If you go back and study the great investors throughout history—the Medicis, the Morgans, the Rothschilds, and recently Buffett—these great investors with terrific records share a common trait: they were always in a position to be liquidity providers. Each was willing to hold cash until someone was in distress or under duress, and they could provide liquidity at very attractive prices. We have run

our firm without leverage and have only been 100% invested once in our 18 year history, the first quarter 2009. I actually consider cash to be an asset class.

About nine months into the job, Zell through his Zell-Chilmark fund started taking a hard look at Executive Life, which had a large junk bond portfolio. I was asked to work on credits that had large real estate components: RiteAid (RAD), Carson Pirie Scott, Charter Medical—any company that had a big real estate component to it. We were trying to value both the real estate and going concern value as that was what the debt was secured by and the real estate provided your downside protection. We lost the Executive Life auction to Apollo. It was a fascinating experience and I really learned a lot. I remember looking at Charter Medical debt which was secured by a large number of hospitals. I called Chase Manhattan and said, “Hey, we see you guys are the lead bank on this.” They said, “We've got plenty of debt for sale, we can sell you at 20-30 cents on the dollar.” We came to the conclusion we could've sold four or five hospitals and gotten all our money back at that price. That's how bad and illiquid the market was.

Understanding where you are in terms of seniority in the capital structure and identifying the fulcrum security was critical, so I started auditing a bankruptcy class at University of Chicago because I wanted to learn bankruptcy law. I thought it was an important aspect of the work I was doing. I put together a business plan

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## John Phelan



Pershing Square Challenge runners-up with Paul Hilal '92 (from left to right: Chris Andreola '16, Brandon Cohen '16, Paul Hilal '92, and Daniel Rudyak '17)

on the side, while I was still working at Zell. I pitched Sam on the idea of setting up a junk bond operation to buy the debt of distressed companies. We had done a lot of work on over 100 companies. Exec Life owned only pieces of the debt, so there was a big opportunity to make a lot of money. Sam got up and slapped me on the back and said, "You know what, congratulations. I wish you a lot of luck—this is a fantastic idea. I think this is great." I asked, "Did I just get fired?" He said, "No, you don't have to leave. But you're going to leave. I already know it. This is a great idea. I don't want to do this because I want to own and control companies. I'm not interested in owning pieces of companies anymore. I actually want to buy and control them. But you've got a great idea and I think you should go pursue it."

I called Richard, but he had also taken a run at Executive Life and already had a team in house. So I called Eddie. I sat down with Eddie and gave him my business plan and pitch. He said, "Well why don't you come on in and do it." I did that with Eddie and ended up working with him a little over seven years. I started off basically doing distressed, risk arbitrage—all special situation-type of investing. Then I got involved in the emerging markets debt crisis in 1994. I did quite a bit in that area with Eddie. That's how I earned my stripes.

I've been very fortunate to have really great mentors at Goldman, as well as Sam, Eddie, and Michael Dell, whose private investment firm I now co-manage with my partner

Glenn Fuhrman. All those guys have been very influential for me. And they all have very different approaches. They all go about things very differently, but I've tried to take nuggets from each one of them and incorporate what I've learned from each of them into my thinking process.

***"If you go back and study the great investors throughout history—the Medicis, the Morgans, the Rothschilds, and recently Buffett—these great investors with terrific records share a common trait: they were always in a position to be liquidity providers. Each was willing to hold cash until someone was in distress or under duress, and they could provide liquidity at very attractive prices."***

**G&D:** Could you talk more about working with Sam Zell through the real estate cycle? How has he been able to avoid mistakes and be opportunistic when others can't?

**JP:** I think Sam is one of the

really great macro thinkers out there. He's very good at looking at excesses and thinking through the implications of them before they happen, when they happen, and then after. He's really adept at connecting the dots. He's a much more top-down guy than someone like Eddie, who also has a great nose for investments but is more bottoms up.

I have a funny story with Sam. He spoke during my first year at the Goldman real estate conference. He looked in the room and said, "I want all you to know that, within three years, half of you will no longer be working in this department. There is going to be a major blow up." This was in the summer of 1987. He was dead on the money. Sam is very good that way. He's also a very smart deal structurer. He understands leverage points and knows how to negotiate very well particularly in complex situations. He's a consummate deal maker.

**G&D:** When did you start thinking about launching your own fund? Why did you ultimately decide to join Michael Dell instead?

**JP:** In late 1997, I decided to leave ESL. It was a personal decision. My mother had passed away very unexpectedly. It was a very tough thing for me, and it was especially difficult on my dad. I decided to take some time off. I'd been working like a machine with Eddie, those seven years were like dog years. He was a demanding guy to work for but also a very smart guy. I enjoyed it, and learned an incredible amount,

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## John Phelan

but I needed some balance and I needed to help my father. After a few months, I started getting itchy trying to figure out what I was going to do. At the same time, I'd made a decent amount of money and didn't feel rushed to have to do anything.

I decided I was going to write a business plan for a multi-strategy investment firm, similar to ESL. I met with a number of different successful investment people. Some of them I knew. Some of them I did not. I said, "I just want 30 minutes of your time, and I have just one simple question. Tell me why you've been successful and how do you sustain it?" Richard as well as David Bonderman were two of the people kind enough to indulge me. I basically interviewed different successful hedge fund and private equity managers. From those interviews I came away with what I call the three Cs, which is what I thought were really the keys to success in the investment business: Capital, Connections, and Culture.

These were the drivers I was able to identify. They're probably drivers in just about any business. I was out raising my own fund and had raised a decent amount of money. While I was raising the fund both Dan Stern and Richard Rainwater gave me a call and said, "You should go meet with Michael Dell." I said, "Michael's an investor of Eddie's. I don't know that I really want to do that." Richard and Dan both said, "Just shut up and go do it."

I met with Michael and he asked me what I was trying to

build. I walked him through my business plan and he said, "That's interesting. I'm trying to hire a guy similar to Richard to do something like that for me. Would that be of interest to you?" I said, "No, probably not. I've got some good investors and I am not sure I want another partner at this time." He said, "I got it, okay no problem." I said, "By the way, I'm happy to give you my business plan. It might help you think through what you want for your investment office."

***"I came away with what I call the three Cs, which is what I thought were really the keys to success in the investment business: Capital, Connections, and Culture. These were the drivers I was able to identify. They're probably drivers in just about any business."***

I gave him my business plan. He called me about a week later and said, "You know, I was reading through your business plan, and I have a question for you. I'm just puzzling on it. I'm curious how you're better off under the three Cs by yourself than you are with me. I have capital. I'm pretty connected. And you get to build the culture." That

stopped me in my tracks and I said, "Now that's an interesting question. I didn't really think about that." He said, "I'd like you to think about that." I met with Michael a few more times. At the end of the day it was trust on both of our parts, and it worked. He's been a phenomenal partner. I'd make the same decision again anytime. It's been a great partnership with him and Glenn.

Michael was the one that introduced me to my partner, Glenn Fuhrman. He was very good at matching us up. It was a hard thing for me to do because Michael was partnering me up with somebody I didn't know. Although we both came from Goldman—and were there at the same time—we didn't know each other. It became very apparent when Glenn and I first met that we had very complementary skill sets which is really important to a successful partnership. We both came from the same Goldman mold: teamwork, hard work, intelligent, humble and ethical behavior. It just worked. I think, to his credit, Michael saw that it was going to work and he knew, unbeknownst to us, that this was probably going to be bigger than what we thought it was going to be when we first started. Glenn has been a tremendous partner and friend and we owe this to Michael.

**G&D:** Could you talk about the evolution of MSD as an investment firm as well as the evolution of your role?

**JP:** It definitely has evolved a lot. I used to jokingly say that we'd never be more than 15

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## John Phelan

people. Then when we got to 20, and I'd said, "There's no way we're going to more than 30 people." Today we're 124 people. Initially, when it was just the two of us, Glenn and I were involved in every decision. The firm evolved by us working closely with our PMs before we really let them loose. Distinguishing a good PM from a good analyst is not that easy. We were on top of them in the beginning and over time we established enough confidence in them that we could step back. We knew that they were quite capable. They didn't need the same sort of continued oversight, and we wanted them to focus on building the business just as we were.

We felt that creating diversification by strategy and having people who were focused on their individual businesses was the right way to build our overall business. If you look at why most managers get frustrated in the investment industry it's because, as you get bigger and as you scale, you move from picking securities to running the business. That can end up taking 30% - 40% of your time. Guys like us, who like to look at stocks and companies, don't like reviewing the HR policy, the vacation policy, compensation system, etc. But those are all things you have to deal with: your interviewing policy, your training policy, and all those operational issues. Today with all the regulation and compliance it can be a full time job in its own right.

We want to find really good investors and remove the distraction of running the business from them, so all they

have to do is focus on the investment side. That's really what we've tried to create at the firm today. I would say our roles have evolved to more of a chief risk officer/chief investment officer. We oversee the portfolios, we oversee the teams, but they're really running independent businesses, and they're making the decisions to buy and sell. If there's something in there we don't like we will have a call. I'm happy to pick up the phone and say, "Walk me through this and tell me why we've got this position and what's there," because we're trying to risk manage the firm, so we're kind of a second layer of risk management to their own risk management.

***"It all depends on your own DNA. Self-awareness is a really important quality to have, as is humility."***

Today we have ten strategies. We sit on the investment committees for our private equity and real estate strategies. Any illiquid-type investments need to go through an investment committee process. We spend a lot of time today on our investment research process and how to improve it. How do we improve our decision making? How do we do better with data management? What's going on in the markets right now and how are we positioned for it? Are we too exposed in one sector? Are

there any hedge overlays we should put on? What do we see across our platform that is concerning? We have a great vantage point because we get to see everything across the firm.

I'm not as deep in the weeds as I was when we started. That's partly due to the fact that we have highly capable people who don't need my direct oversight. We do still have very robust conversations around investments and process. We focus a lot on our process. I would say I probably spend more time now on culture building and on trying to develop the firm and our next generation of talent. In reality, for a firm to be successful you have to create these virtuous circles. We're very disciplined. We have a good team. We have good culture. We have great investors. We've been investing for the long term. All this stuff has been built up over time, and it's self-reinforcing. But you also have to adapt constantly.

I look at the markets today and I look at the sheer amount of information that's thrown at us. I look at all this algorithmic trading and the impact that has on the market. You better be very aware of what's going on and how it's going to change and what the implications are for you and your business. Those are issues we talk about a great deal.

**G&D:** One element of the MSD philosophy that comes through in a lot of your interviews and writings is a certain contrarian streak. Are there sectors or areas of the investment world where you

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## John Phelan

feel like you have a contrarian view currently?

**JP:** I like to call it independent thinking as opposed to contrarianism. We really try to be as independent in our thought as possible. I don't want to get into a lot of specific investments and what we're doing right now—that is for paying customers—but we try to look for big dislocations. We try to look for places that other people are running from or people don't like. Zell used to always say, “I like to look for trouble.” I think that's something we try to do, as well.

We try to think about the long term implications of things and how they're going to turn out. That's something that we spend a lot of time on. Take, for example, the sustainability of a company or business model. Today, competitive moats are getting smaller and smaller and competition tougher and tougher. Trying to find really good businesses that can continue to compound at high levels is really hard. You have to really think through all the risks out there and their implications. That's what I mean by independent thinking. Is there a company or business immune from technology risk? Maybe railroads, cement? Think about it.

I think there could be some pretty good opportunities in energy as that is a space which has been decimated. We have been analyzing debt securities in a number of energy, metals, and mining companies. We're also trying to understand the knock-on effects of the energy downturn. In energy-heavy markets you're going to see

real estate get hit. What will be the flow through in office, multi-family, and industrial? You want to look into where there's a lack of liquidity or mispricing. Is part of the recent equity market volatility due to Middle East Sovereign Wealth Funds taking their money out of equities?

**G&D:** On the topic of good businesses, when Rainwater asked you what was the best business you'd ever seen you answered parking garages in New York City. With the benefit of 20-plus years of investing now, would you change your answer?

**JP:** Well at that time I didn't know a lot about companies and businesses. I just hadn't looked at that many. But it's really not that hard of a business when you think about it. It's pretty defensible and you get the benefit of an increased value in real estate over time, similar to car dealers, for example. There's a lot of inherent value in the real estate there. I would probably answer the same way again. I've seen some other great businesses, but when you're put on the spot like that you have to think on your feet pretty quickly, and that's the one that occurred to me at that time.

**G&D:** Could you talk about investments that you've been involved with at MSD that would qualify?

**JP:** We've had a number of investments that have gone extremely well. Because I am a big believer in pattern recognition and we have made investments in the same company multiple times over

different years. Let me focus on a private deal we did. We're one of the big investors in IndyMac Bank now called OneWest which was recently sold to CIT (CIT). In 1990, when I was with Zell, we were looking at RTC banks, and I remember the Besses made a fortune on American Savings. IndyMac/OneWest was an investment we did phenomenally well on, and I think that was a combination of good underwriting, good management, and a compelling risk/reward. Buying a bank in the first quarter of 2009 was not a really easy thing to do. We're looking for very good businesses with strong management teams and very defensible moats.

**G&D:** Eddie Lampert is famous for using case studies and studying historically successful investments to develop pattern recognition. Were you part of this effort at ESL and did any investments that you made rely on this pattern recognition?

**JP:** Yes, I was. Pattern recognition can mean different things to different people. The bottom line is this: good companies, just like managers, have to experiment. You have to constantly test new things. Sometimes that 30% probability case shows up and you lose \$0.25 of earnings or you make a bad investment and people just kill the stock. It doesn't mean your business or the company is dead or that it's a bad business. When I was at ESL I can think of four or five companies that we bought two or three times over the years. Kmart was something that originally came out of a distressed investment we

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## John Phelan

made. We made a big investment in their mortgage bonds when they were in bankruptcy the first time. We modeled out every single store and even had a plan for alternative uses of the spaces. That was a company we did a lot of work on before Eddie ended up buying it.

When Dominos first introduced thin crust pizza the market did not react well which presented a good opportunity as our research indicated this would be very successful. I think that history and understanding why companies are successful is really important. I think you can learn different things about different businesses and apply them really well to other situations. That's something we were able to do.

**G&D:** It seems like part of building your own moat as an investment firm, to build up your own intellectual capital and property.

**JP:** That's what you're trying to do. We are very focused on process, as I believe you should focus on process not outcomes. Process is the key to proper risk management. There is a big difference between a wrong decision and a bad decision. A wrong decision is picking door #1 when the prize is actually behind door #2. It's a lousy result but the fault lies with method. A bad decision is launching the space shuttle Challenger when the engineers predicted a nearly 100% chance of catastrophe. The distinction is important because it separates outcomes which you can't control from process which you can.

**G&D:** What are your thoughts on the broader hedge fund industry, what the future may hold, and whether or not it's a good place to start a career these days?

**JP:** If you applied Porter's Five Forces to the hedge fund industry right now, I'm not sure that analysis would suggest you should go running in. You've got massive fee pressure, so revenues are

***"We are very focused on process, as I believe you should focus on process not outcomes. Process is the key to proper risk management. There is a big difference between a wrong decision and a bad decision."***

coming down. You have huge regulatory costs and burdens plus IT expenses which seem to go up every year, so your costs are going up. You could argue the barriers have gotten bigger because of the expense of starting, but when you look at the number of hedge funds each year that seem to start and go out of business, even post-2008, you would have thought there would be a significant drop in the number of firms and assets. But we did not see that. When I compare the number of firms today run by smart people compared to

when I started, it is mindboggling. I also think you have a massive asset-liability mismatch caused by institutional investors, making it that much harder to succeed long term. If you look at what investors want today I call it the Holy Grail: liquidity, transparency, high returns, low volatility, and group validation. The question is this: Is this goal achievable? Does it make sense? The only person I can think of who consistently gave you this is Madoff.

Today it's hard to scale. Unless you become a large firm fast, you're not going to get proper service from any of the banks. Unless you're going to be a big client, it's going to be really hard for you. I could argue that running less money may be an advantage, candidly, but it definitely makes it harder right now. There are a lot of trends going on now that make the business very tough. You've had a lot of smart people come into it, making it much harder to find opportunities. You need to determine what your real competitive advantage is. When I look at the industry—and we look at it from a lot of different ways—I've not found a lot of people who make money shorting. I think long/short is to some extent just a way to run leverage long. I think that it's a tough business.

With the advent of electronic, HFT, and algorithmic trading, many smart people believe machines are going to put guys like me and firms like ours out of business. It's going to be machine to machine. My own view is the machines are going to put the machines out of business. But the question is when. This may last for a very

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long time. We're seeing a lot of interesting anomalies in trading. We're seeing interesting things in stocks that get beat up. I think this whole movement to passive and ETFs combined with the electronic trading and the "Holy Grail" I mentioned earlier that investors want today is making it really hard to invest actively on fundamentals. When you look at stocks like we do as owners of a business as opposed to pieces of paper to be traded, it's a difficult environment today.

That doesn't mean you shouldn't go into the business, but the attractiveness of the industry has declined significantly from when I started. If you're an incumbent and you've got a lot of assets, you're in a pretty good place. If you think about how much risk a new manager needs to take to really make it, it's quite high. They may make it, but even then all it takes is one bad quarter or a bad year. If you don't have five to ten years under your belt, if you have a bad quarter, the fund will see significant redemptions. With pension funds and institutional investors—the whole ecosystem, really—moving to passive, you're going to see this big movement to quantitative trading, and, if that lasts for a long time, I think long-biased guys like us are going to be very challenged in that type of environment. You've got to make sure you've got the capital, the wherewithal, the strategy, and the ability to wait for that to end, because I do think it will end. I don't think it's going to end in a pleasant fashion. But hopefully it'll be a good opportunity.

For a student, the amazing thing today is the number of new companies that are starting up. The barriers to starting a new company today are so much lower. Google is what, a 15 year old company? It took Coca Cola over 100 years to have the brand recognition Google has. Think about it. You can become a global brand in ten years or less. That's unbelievable. I think that unless you're really passionate about this business, unless this is what you want to do every day, you're better off starting a business today. Find a dislocation and start a business.

**G&D:** It seems like MSD is doubling down in some ways on the hedge fund business by actually growing and taking outside capital.

**JP:** I don't know that we're doubling down. We don't think of ourselves as a hedge fund. We think of ourselves as an investment firm. For us, it's not doubling down. We're not guys who run long/short. We don't use any of the Greek alphabet numbers that everyone loves to bandy about. I still can't get anyone really to explain to me what market neutral means; yet, everybody uses it. It's fascinating to me. One of the things I have observed during my investment career that I think is interesting is that the basics of investing do not change only the terminology or lexicon seems to. VAR, sharpe ratio, Market Neutral—whatever that means—tail risk, black swans, Sortino ratio. To me there just seems to be some perverse human characteristic that likes to make easy things difficult.

There are a couple things driving our decision to take outside capital. One was a question of whether we were going to continue to get capital from Michael. It was pretty clear that we had gotten to a stage where that was probably not going to occur anymore. Second, we had a number of people we had worked with on investments and they always asked us if they could invest with us, but we declined because we didn't take outside capital. We started to find that actually started bothering people. I remember we called one person up whom we worked with on two different situations. He said, "You know John, I'd love to work with you guys, but I can never invest with you. Obviously, I can go buy the stock or whatever, but you guys are really on top of it. I'd rather really be able to do that."

We started to realize that our network was inhibited by the fact that we didn't take outside money. The other thing we found is when someone invests money with you, they help you out a lot more. One of the things we did while I was at ESL was to target a strategic group of investors. ESL had a very good group of investors. We're trying to build the same thing at MSD. We want to find people who have got good industry experience and are like minded. We have a lot of ex-CEOs, big families, and a small group of sophisticated institutions that are investors. They have great industry knowledge and expertise. We want to take advantage of that, be able to rely on those partnerships, and create our own ecosystem. Look at what Buffett has done with

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## John Phelan



9th Annual Pershing Square Challenge judges.

Berkshire and his shareholder base.

I don't think a lot of managers engage with their LPs much. It's more "thanks for the money, now let me do my job." We're trying to include them whenever we think they can be helpful. We're trying to build an investment firm which is different than a hedge fund. We will not just take anybody's money. We're long term, fundamental, concentrated guys. If you want to start talking volatility equals risk, sharpe ratios, beta and gamma, the Greek alphabet, we're not a good match for you.

It's funny, Buffett in his 2009 annual report said, "Don't get taken by formulas. Investors should be skeptical of history based models instructed by a nerdy sounding priesthood, using esoteric terms such as beta, gamma, sigma, and the like. These models tend to look impressive. Too often, though, investors forget to examine the assumption behind the symbol. Our advice is to beware of geeks bearing formulas." Same thing applies for investors. We're not formulaic. We're making bets on things that we think are going to happen over time, and I think that's really, really important. When you think about how you create good rates of return and how you are going to make a successful investment, the truth is that it's made by positioning your capital where your view is subsequently adopted and acted upon by others. You need to be in front of them.

**G&D:** Are there funds whose approach to investing

resonates with yours at MSD? What should students be doing to prepare themselves for this competitive environment to create value?

**JP:** I think it all depends on your own DNA. Self-awareness is a really important quality to have, as is humility. If you're someone who is comfortable being in a place

***"When you think about how you create good rates of return and how you are going to make a successful investment, the truth is that it's made by positioning your capital where your view is subsequently adopted and acted upon by others. You need to be in front of them."***

where you may only make a few investments each year and you're not actively trading every day—it's not noisy and you're not whipping stuff around the trading floor—that's a value place. We're a shop like that. Baupost is a shop like that. I also have a ton of respect for AKO in Europe. They are a very good firm and do a very similar thing. They're a little more active but really disciplined, buy and hold type investors.

If you're someone who wants to focus on macro or you want to trade or you want to do long/short, that's a totally different environment. Nothing wrong with it, but you're going to be doing different things and constructing different trades and thinking about your process differently. You've got to decide as a student what you're good at and what you're not good at. I always say to people who come in to see me that you have to realize in our business a really, really good person is wrong 30% of the time. That's a world class investor. Are you comfortable being wrong 30% of the time? By the way, you can't be wrong in a massive way.

I think you have to be someone who thinks in terms of probabilities. Finding the right environment for you is super important. I came from the school of thought where we are all generalists. I think that's a huge advantage. With many hedge funds today, you're slotted into a sector: you're the tech guy, you're the media guy, you're the industrials guy, or you're the chemicals guy, and you're going to learn everything about the companies in that industry. They've all specialized. We still use a generalist model. We need to go figure out what ponds we're going to fish in. I believe that 80% of the game is figuring out what to work on. We've created our firm to be very good at figuring out what to work on.

You can look at the newspaper today, or any day, and find four or five things you might want to look at. Which one you look at and why is really

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important. You're manufacturing ideas. You have a set amount of time each day, week, etc. and the market's going to give you opportunities over certain periods of times. What stocks you follow and why, which ones you keep an eye on and why, which ones you actually buy and why, which ones you pass on and why, that's really important stuff. I think certain people have the mental capacity to be disciplined and do that and not need action. Other people need action. If you need action, that's a different firm.

I also believe that the more businesses you look at and can compare the better investor you will become. This is why we like the generalist versus specialist model. We are confident we can get to 80% - 85% of the knowledge base any specialist has. We can go buy the other 15%. We can go hire a consultant or whatever we need to get up to speed. If we're monitoring the wrong stocks, if we're not identifying the right things to work on, because we have small teams, it's going to be very difficult for us. We force our team to get good at figuring out what to work on and how to spend our time well. That's what our system tries to do. That's one of our views and one of our competitive advantages.

**G&D:** This was great. Thanks again for your time and insights. We really enjoyed it.

**JP:** Thank you, I really enjoyed it and hope you find my comments useful.

***“For a student, the amazing thing today is the number of new companies that are starting up [...] I think that unless you're really passionate about this business, unless this is what you want to do every day, you're better off starting a business today. Find a dislocation and start a business.”***

## Alex Magaro

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Alex Magaro

**behalf of current and former principals of Renaissance Technologies. Prior to joining in 2003, he spent ten years investing in private equity and running a small company. He graduated from Harvard College in 1993. Alex currently lives in San Francisco, CA with his wife and three children.**

**Graham & Doddsville (G&D):** Can you discuss your path to investing?

**Alex Magaro (AM):** I recognized early that I would be a horrible employee for somebody someday, for two reasons. First, I really lacked any political skill to speak of, and second, I never really did well with authority—if I didn't agree with it. Those two things are almost certainly related. Working backwards from that, I started to ask myself, "What can I do to make a living that doesn't rely heavily on political ability?"

I initially concluded that meant pursuing either an academic or an entrepreneurial career. While being an academic probably suited my personality a bit better, once I got to college, I realized that road actually did require a reasonable amount of political ability.

In thinking about the entrepreneurial path I wanted to try to avoid the high death rate of start-ups. If most businesses fail in the first 5 years, then avoid the first 5 years, so it seemed to me the better move was to buy a small business and run it.

During college, I worked for a

small private equity shop that was basically a fundless sponsor—they would find companies and raise money for each deal as they went. I decided to work with them after graduation, but we had an agreement that I could look for companies below a certain size to buy for my own account.

I gave myself two years to find something before going back to graduate school. I went through hundreds of businesses for sale and went down the road with a couple. On one, I pulled the plug because the sellers tried to extract an "n+1" at the last minute. Almost at the end of the two years, I came across a staffing business. In the mid 1990s, staffing had some pretty good tailwinds—and that really surprised me, so I ended up buying it.

***"There's a price that solves almost any quality concern, and I was able to buy the business very cheaply...I bought it for 3x EBITDA."***

**G&D:** What was your investment thesis at the time?

**AM:** In 1995, according to the industry association, staffing was the second fastest-growing industry in the United States, between semiconductors and software. It is a very economically sensitive business, and at that time it was difficult to disaggregate

how much of the growth was cyclical and secular or even if there was a secular trend at all. My hypothesis was that we were seeing the same outsourcing trend that had started to take hold in manufacturing in the 1980s, now moving into service industries. Then, it was just-in-time inventory, now maybe it was just-in-time people.

Companies tended to be staffed for the peaks, and it was clear that if you could make variable some fraction of that lower probability staffing need, this would be a profit improving decision. In addition, companies realized there were potential working capital benefits as they transitioned direct employees to temporary workers whose pay could come with as much as 90-day terms through a staffing company. Over time, more efficiencies became clear—things like workers' comp, unemployment insurance, and non-economic benefits like giving frequent feedback to employees, and so on.

It was basically this opinion that outsourcing would widen that led me to believe that staffing would have pretty decent tailwinds for at least some period of time. Obviously, there's a price that solves almost any quality concern, and I was able to buy the business very cheaply because it was a small company. I bought it for 3x EBITDA, of which one-third was seller financing and another third was in the form of an earn-out. Outside of the negative working capital dynamics on the labor, the mirror image of the benefit the customer got, EBITDA was a

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## Alex Magaro

good approximation of cash flows.

That was really why I bought it. Staffing is not a great business. It's extremely competitive and has very low barriers to entry. In fact, competitors actually used to go through our garbage looking for leads! Yet, I also needed to solve for a business I thought I could run. For example, I thought it would be more difficult to purchase a manufacturing company with a large workforce, because I thought it would be pretty difficult for a 24-year-old without political ability to manage that workforce. With staffing, I was basically dealing with young sales people, so I thought I would have a chance at being able to do that.

We grew the business quickly. The business was generating \$2 million in revenue when I bought it and within 5 years, we were generating \$20 million in revenue.

**G&D:** Why did you eventually sell?

**AM:** I decided to sell it for two reasons. First, we had had a really good run and it seemed to me that we could easily go sideways or even backwards for a long time; and second, I came to the realization that I would probably have to spend decades growing it before we had enough scale to use it as a platform to buy other businesses and I needed to believe that was achievable in order to spend my career at it.

When a business is small, individually, you can add all

kinds of value. You can make a material difference by going on sales calls or personally spotting errors or otherwise improving service. When we were at \$20 million and in multiple locations, it started becoming much more difficult to effect that difference. It becomes an iterative exercise of hiring and training sales people, formalizing and commoditizing an office opening, etc., but maintaining quality is a significant gating factor to maintaining a high growth rate. We picked a lot of low-hanging fruit by virtue of approaching the business in a more professional and financially-oriented way than our competition, but for us to scale to \$200 million, we would have had to compete with vastly better financed and staffed companies.

I went to my partner and said that I thought it was the right time to sell, but her preference was to continue with the business. In the end, the leverage the business was able to take on seemed to me a fair price for my share of the company. Buying the company has worked out really well for her, although it was a tough ten years.

Around that time, a close friend from college, David Zierk, now my partner, invited me to have lunch with him and a friend of his. It was a social occasion, we had a nice lunch, and I never thought anything of it. It turned out that David's friend was the son of Jim Simons' old MIT roommate. Out of the blue about six months later, this fellow I'd had lunch with called me to say that Jim Simons was looking to seed a private equity fund and

that I should try to meet with Jim and Leo, Jim's pick to run the fund, to see about a job.

**G&D:** Was Jim Simons well known by that point?

**AM:** He was well known to me because David had been a trader on Renaissance Technologies' execution desk since 1996. I was very aware of Medallion's performance up to that point.

**G&D:** What was Simons planning with the private equity firm?

**AM:** Jim's hypothesis was that there might be some interesting opportunities following the dotcom meltdown, and he had been trying to recruit his old college friend, Leo Guthart, for years to do something together. Leo had spent the last 35 years running a company whose principal business was alarm monitoring systems and they had just sold it to Honeywell for something like \$2 billion. If I remember right, that business became at least part of the platform for what is now Honeywell's automation business.

I met with Jim and Leo, and the meeting went well (which really surprised me), and I was hired as one of the partners at that firm. I was honest that I didn't have a lot of belief in venture-oriented investing, but I couldn't argue with the fact that median returns in the space over long time periods looked pretty good—even if you considered that it had a high beta versus the market. That said, I pretty quickly concluded that this style of investing wasn't conducive to

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## Alex Magaro

the research-driven approach I was comfortable with and I ended up reverting to more traditional fundamental investing.

During my time at Topspin, I also got to know Jim and his son Nat better. Nat, who had started Meritage in 1997 was looking to take a step back eventually and asked if I would be interested in joining Meritage with a view to co-managing the portfolio with David, who had started working with Nat a couple of years earlier.

**G&D:** What was Meritage at this point?

**AM:** Meritage was a fund of hedge funds. Originally, it was a P&L line item inside Medallion. The basic idea was that as Medallion grew, it started to accumulate some excess capital. Renaissance believed that it could extend the duration on some fraction of this capital and so Nat started to invest it with outside funds. These were uncorrelated strategies and were more profitable than Medallion's internal cash management strategies. It made sense. Meritage was also directly investible for Renaissance employees, and so it was also a way for people to diversify their own capital.

For context, Medallion closed to outside investors in 1993 and started returning capital to outside investors in 2002. My thinking in joining Renaissance was if Medallion continued to perform, not only could it return the outside capital, but you could also arrive at a point where inside investors were also capped and if Meritage could build a good platform in

advance of that, it could be a way for some of those insiders to continue to invest and in something they trusted. Further, because Meritage was essentially captive to Renaissance employees, we wouldn't have the traditional principal/agent problems you find between GPs and LPs. All of this is to say we could have the makings of a minimally-compromised investment platform.

***"I couldn't understand how someone could even come up with an estimate of what a company might print for this quarter's earnings with precision, and, beyond that, how to handicap what 'the market' would think of that."***

However, I didn't think that a pure fund of funds could really be scalable. At that time it really was a strong strategy for that size, but the perverse reality of investing in outside managers is that if you are successful in finding talented managers, you can't increase your position because they close. And given Medallion's performance it seemed possible that we would need scale to be useful. In any case, my feeling was that if we could develop a direct investing strategy maybe that could give us more scale. They didn't

think the idea was wholly crazy and after about a year we started this direct activity.

**G&D:** So the primary selling point was that direct investing solved the scalability constraint?

**AM:** It was that, but it was also that Jim—rationally—prefers liquidity, and if you invest directly, you are vastly more liquid than if you invest in funds. Also, we thought we could be more rigorous on risk control and hedging and the last point was there was a fee arbitrage. Paying 1.5 and 20 is a lot of return to give up. Frankly, we didn't have to generate the same performance on a gross basis to outperform on a net basis. We were able to outperform on a gross basis, so it worked out better than our underwriting case.

**G&D:** How did you settle on a strategy?

**AM:** David and I spend the first year working together re-underwriting the fund of funds portfolio. In addition to the folks in our portfolio, we literally met with hundreds of managers raising capital. My impression was that most of the managers I met were short-term oriented and, in a way, that wasn't natural for me to understand. I couldn't understand how someone could even come up with an estimate of what a company might print for this quarter's earnings with such precision, and, beyond that, how to handicap what "the market" would think of that. It was totally alien to me. What seemed clear, though, was that investors' attention would

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start to trail off after about six months, and beyond a year people really didn't seem to care much at all.

**G&D:** Were there any other takeaways you came away with?

**AM:** The first observation was that if we were going to compete on anything, it was going to be in a fundamental field, and by this I mean deep analytical research. This was also my background. Clearly, we weren't going to compete with someone like a Citadel in multi-strategy or a Medallion in stat arb. We were mortals and we had limited resources. We thought we had an advantage in capital duration going for us and we thought most firms were shorter-term oriented than we were.

Another observation was that if you looked at the embedded incentives many funds had, these actually drove a short-term orientation. The fee structure of 1.5 and 20 is a modest incentive to generate gains sooner. A related nuance was that analysts tended to be paid exclusively out of the incentive fee, which levered this behavior. Third, the contractual terms of the fund (whether we're talking about quarterly liquidity or even more modern gated structures) tend to make the fund favor more front-loaded return streams. Our thinking was that once you layer on an evolutionary time preference for now versus later, there were lots of reasons to believe there could be inefficiency in the medium to long term. As a guiding principle, we wanted our platform and investing philosophy to resist as many of

these cognitive biases as we could.

As an aside, when we were still affiliated with Renaissance, we used to get to attend their monthly colloquia where they would invite an academic to discuss their research. Most of the time, the topics were way over our heads but occasionally they would invite someone whose research a lay person could understand. One researcher presented his research which attempted to determine something like an "internal discount rate" for different animals. An example

***"The final punch line was that in all cases [of the experiment], human or lower animal, the subject's discount rate increased with duration!"***

of an experiment was something like this: you put a rat in a cage and train him that every time he hits button A and then B, he gets food. Then you train him that the longer he waits to press B, the more food he gets. By varying the amount of food payoff per unit of time waited, you can start to get an understanding of the rat's time preference—his "internal discount rate."

I don't recall the details, but the rat's discount rate was something crazy—like in excess of 1,000%. You had to give him so much more food

just to wait a little while. I don't recall the other animals he tried this on, but there were many, and they all exhibited the same kind of behavior. Next, he moved on to humans.

Humans are a little more tricky because they can also reason and if you actually want to understand a time scale that might be interesting, the subject needs to believe you're going to make good on your promise. In any case, he spent a year setting himself up as a reliable counterparty to a group of NYU undergraduates. In this case, the experiments were of this type: You can have \$20 today or some larger amount of money in a month or six months or a year, etc. There were lots of clever twists in his many iterations to ferret out lots of little nuances, but you get the point. The results for his subject group were something like 100% discount rates. I wish I could convey how well he presented the concepts. It was like a Las Vegas magician act. In his final reveal he made the point that the subjects might not necessarily understand finance and time value of money, so he ran the same group of experiments on finance majors from Stern. While the finance majors had lower discount rates, they were still absurdly high. The final punch line—and I still can't believe this—was that in all cases, human or lower animal, the subject's discount rate *increased* with duration! I mean, you could argue that in the human case, the dollars are so small that the actual quantities of dollars matter—why bother with having to remember to track this guy down in a year for \$50

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—maybe that explains why the discount rate is so high. However, the fact that discount rates increased suggested that accepting duration was of increasing discomfort.

If you bring this back to the hedge fund context, the point is that a lot of common incentive schemes and fund structures—whether implicit or explicit—tended to enhance rather than diminish this cognitive bias. As I spent more time trying to understand other elements of standard processes within fundamental funds, it seemed to me that lots of what was common practice seemed to exacerbate this and other biases as well.

For me, the big lesson was, if that's the case, there must be opportunities if you can construct a platform that will allow you to lean against biases in general. For us, the most important bias was definitely focusing on time preference. This was natural for me, because I seem to be wired exactly oppositely on time preference—and unhealthily so. I'm really long-term, and I have to work really hard to bring my time horizon into something that is actually relevant.

We set up compensation schemes that attempted to defuse short-term incentives while at the same time pay respect to time preference. We have a concentrated investor base, which introduces other risks. However, they are patient when we struggle, because they also are concentrated in us, have an intimate understanding of what we're

doing, and, importantly, that we are attempting to meet their goals. It also doesn't hurt to have investors who understand risk and volatility better than us.

The basic idea was to build a platform that would be appealing to people who really just wanted to invest and one with as few constraints as possible. Because so many funds were short-term oriented, if you couldn't produce results in a year or so then you had to move on. We tried to be a place that you could successfully invest in a long-term oriented fashion.

**G&D:** At this point, your experience was a few years in private equity, running a small business and manager selection and evaluation. Where did your investment perspective stand at this point? Did you feel you had enough experience?

**AM:** The short answer is no, but I felt confident that if we started small, which let us be really liquid, we weren't going to take a big risk to try. Ultimately, I think outperformance in investing, managing a business, and I'm sure lots of other fields comes down to judgment. I thought we had a good platform and I thought I had better than average judgment. Depending on the day, I still think that.

I always had an interest in investing. I started investing personally in the public markets when I was about 14. In fact, I financed a significant portion of the staffing company purchase from my personal investment portfolio. Also, I thought my experience

in private equity was entirely relevant. Today, private equity is more process-driven. There is more focus on deal flow generation, the auction processes are more competitive, and a lot of a fund's portfolio can end up being determined more by which processes they win than which companies they want to invest in. They are basically participating in private equity beta. That's not a bad thing; the return to that beta has been good, but that's why PE firm returns are always couched in a vintage context and not in an absolute sense. Anyhow, back then and at the small deal sizes we were considering, there were many possible choices to make. Flow wasn't the constraint, the investment choice was.

That was why I thought we had the toolkit to try. Why should public equities be any different than private equity? In both cases we are trying to make predictions about things that are researchable. Of course, there was no guarantee that we'd be good at it. That's another reason why we chose public equity. It's liquid and so if we stunk at it, we could shut it down quickly and easily.

Public equities also solved other problems for us. Because you can easily run a neutral book long/short, the strategy is less cyclical. That is to say, being neutral lets you control for the price level of the market. Other fundamental disciplines like high yield credit, distressed investing, and private equity—which are long dominated—will tend to be only of cyclical interest when they are cheap in an absolute

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sense.

So, we started small. The investing world has evolved, but I think a lot of what was true then is still true. For example, the average holding period in US equities is now just over 4 months. That's actually down from when we started, even though there are definitely more long-term oriented hedge funds in the market today. Obviously, quantitative participation has increased too, and this will tend to reduce holding periods. I still believe that many fundamental funds are shorter-term.

**G&D:** It sounds like you started out with some real structural advantages. How has the firm evolved over time?

**AM:** We haven't changed our investment focus or basic process since the beginning, but we have generalized our initial hypothesis. Originally, we were more focused on this time preference, but now we believe that there are hosts of cognitive biases that can cause mispricings and biases that can distort research itself, so we have gradually tried to integrate those into how we evaluate investments and their valuations.

In terms of performance analysis, from the beginning, we focused on evaluating ourselves in terms of alpha at the position level. We pair every position, long and short, with its beta to an appropriate market index. We think that if you don't understand the alpha that you're generating on a position-by-position basis, it becomes very difficult to assess your performance. By that I mean it becomes very difficult

to disaggregate your returns between stock selection and net position. The goal is really to disaggregate luck from skill, but given our slow moving and concentrated strategy, we still only think that we *probably* have some skill. Track records can tell you something, but you need a really long history of outperformance to have even a moderate belief. They're just noisy.

Another thing that has changed is we try to be more

***"In 2012, we bought our first private company, Columbia Distributing, the fourth largest beer distributor in the US ... It's a very interesting and wide-moated business. I think buying private companies is a key part of our future and a very natural fit for our capital and its intent."***

opportunistic in cyclical asset classes. For example, in 2008-2009, credit was a very obvious asset class to invest in if you weathered the downturn in a reasonable way, and if you didn't have all your investors clamoring for their money back. It was a great opportunity to buy credit and then you could make high

teens returns investing in credits with very low default risk. Further, if they did default, you wouldn't have minded owning the underlying.

In 2012, we bought our first private company, Columbia Distributing, the fourth largest beer distributor in the US. They distribute about 60% of the beer in Oregon and Washington. It's a very interesting and wide-moated business. I think buying private companies is a key part of our future and a very natural fit for our capital and its intent.

Because we don't have a defined fund life, we don't have a selling horizon and because we have a closer relationship with our investors, we have a better idea about how and when they are likely to have capital needs. What falls out of this is—just like when Meritage started—we think we have some fraction of our portfolio that can sensibly be "illiquid."

The experience we have had with Columbia has been great. It's in our nature to give autonomy to competent, passionate people. It's how we treat our analysts, it's how we treat our management teams, and it's how our investors treat us. The team running Columbia is just first rate. Occasionally, we can help around the edges or maybe help lay out a way to think about a problem, but otherwise it's their business to run. We don't meddle. We think they'd agree we're easy to work with and so we think we could be a good haven for a family or entrepreneur-owned business or a management team in search of a capital partner.

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## Alex Magaro

**G&D:** When evaluating Meritage's holdings, it's quite obvious that business quality is very important to you and that's not always the case with investment firms. Can you discuss why you feel business quality is so important?

**AM:** We don't have some novel way of valuing companies. I think most fundamental investors would agree with the view that the value of any company is the present discounted value of the future cash flows—which includes retiring debt. If you've ever played with an Excel spreadsheet, what you probably noticed very quickly, is it's all in the terminal value.

Public markets have generally traded in the mid-teens on a P/E basis over the last 10 years or so, obviously ignoring the recent financial crisis and some modest excursions here and there. The market at the moment is trading about 18x. If you take the inverse of 18, that's a 5.5% earnings yield. On average, free cash flow yields tend to be lower than earnings yields. There are incentives to make accounting earnings look better, businesses often invest more in capex than they expense in depreciation, and companies generally consume working capital—just to name a few. So, maybe the market is at a 4.5% or 5.0% free cash flow yield. We are ignoring leverage in this example, but obviously the average company has leverage—which is to say the unlevered free cash flow yield is probably lower.

What do you have to assume about the long-term growth of the average company in order to be happy with a 4.5% free

cash flow yield? I think you have to be willing to assume that it's going to grow at least a little in perpetuity. If it grows at around 2%, the 4.5% free cash flow yield delivers you an IRR of 6.5%, ignoring leverage and assuming you can exit at the same 4.5% free cash flow

***“The great investments are the companies that are quality but aren't yet obvious, but those are rare. When you find one of those situations, they can be extremely profitable.”***

yield, which maybe isn't a lock.

We think that a company growing in perpetuity is likely to be a company of quality. We think that the whole idea of a market multiple at this kind of level presupposes quality. For example, you would never pay 18x earnings for a company shrinking 1% per year. That would be a 3.5% IRR if you could exit the position at a 4.5% yield. I think a lot of investors are ignoring the terminal value when they pay certain multiples for businesses, because in their relatively shorter time horizon, the terminal value may not be relevant. I think that can be a valid strategy in the short-term, but I'm just not comfortable with it because eventually the correct terminal value may become apparent to other people and then you're

in trouble.

Some investors might think that the stock is in fact public and liquid and that they don't have to stick with the investment, so maybe the terminal value is less important. I disagree because occasionally market events will conspire against you and cause you to “lose time.” Here's an example of what I'm talking about. If you look at 2014 and 2015, we had a lot of central bank activism and there were big FX moves in lots of crosses versus the dollar. An FX devaluation can come through earnings and make it look like it's nothing more than a deceleration of growth. If we assume the valuation doesn't change, although there's a good chance it would contract, the stock will be flat and the growth will again become apparent when the company anniversaries the devaluation. But the point is, if the FX doesn't revert, you end up losing a year of returns in the process. In investing, I find that you very often lose a year, sometimes several. The thing that keeps me up at night is: what if you lose enough years that people start to care about the terminal value? Obviously, nothing is bulletproof forever, but my view is you want to have a very clear opinion about how long that terminal value is secure—but that also doesn't mean you're right about it.

I don't know how you pick a quality company ex ante, but I think that most people know a quality company when they see it and sometimes you have to get under the covers to see that a company really is quality. The great investments are the companies that are quality but

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aren't yet obvious, but those are rare. When you find one of those situations, they can be extremely profitable.

**G&D:** Do you have any examples of companies that didn't appear to be great businesses on the surface but subsequent research showed that they were?

**AM:** In our history, I think the best example is TransDigm, which I'm sure you've seen and have had any number of people discuss. We first purchased the stock in 2007.

I was totally amazed that a company could make returns like this with airlines ultimately determining their economic fate. This was totally shocking to me but only because of my own ignorance. The story is now pretty well-known, but there are enormous regulatory barriers around the manufacture of aerospace parts. However, the revenue cadence of any individual part may not be terribly large or terribly stable. If you were a small company with a small portfolio, you would end up having a really erratic earnings stream. What the CEO, Nick Howley, did was just beautiful. By putting a large number of these different parts together, whose cadences weren't correlated, he ended up with this totally predictable stream. That was like corporate alchemy. Because any individual part is still erratic and there are substantial regulatory hurdles to producing the part, it doesn't pay to compete. The consequence is that TransDigm has real pricing power across its portfolio. We sold our shares some time ago because we thought it was

expensive. I can't remember the valuation that we sold it at, but we held it to a much higher valuation than we would otherwise have imagined we would have, and now I think it is quite expensive, or at least the last time I checked, when you consider they carry 5.5-6x in leverage.

**G&D:** How do you think about leverage in a business?

**AM:** I think ignoring debt is a

***"I think ignoring debt is a little like ignoring terminal value and is another example of a short time preference. It's very easy to ignore debt when the company is doing well ... It doesn't change the fact that you do eventually have to pay this off—you can't refinance forever."***

little like ignoring terminal value and is another example of a short time preference. It's very easy to ignore debt when the company is doing well and the ratio of a company's market cap to its debt is high. It doesn't change the fact that you do eventually have to pay this off—you can't refinance forever. So, in the case of a TransDigm it would take the company about 12 years to pay

off its debt. It's still growing nicely, so if it can keep that up, it might take more like eight years. But the point is that you have you have an eight to 12 year view about some combination of the company's growth prospects and/or the availability and price of credit.

In any case, at this price I think it's hard to underwrite the duration of growth that you would need to have in order to make a good unlevered return. Again, no one may ever care that the company is highly levered. We may miss out, but we can't predict when other people may care about the fact that the company is levered. The events of 2008 were a terrific example of people all of a sudden getting religion on how levered some companies were and the reality that it's senior to you.

I think terminal value and leverage risk explains a lot of the undoing of Valeant's equity. As the market cap shrank, investors increasingly focused on this \$31 billion bolus of debt and rather than thinking about it as a source of future earnings accretion it became a payable with a due date. 5-5.5x EBITDA of debt (especially with a low tax rate) is by no means insurmountable, but if the company has begun to shrink, the equity will have to wait. Obviously, with the company's equity at something like 4x earnings, people are questioning its terminal value.

**G&D:** That brings up maybe an interesting point. Many investors who have studied Buffett and Munger have developed an appreciation for quality which means these companies tend to trade at

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## Alex Magaro

rich valuations. What happens to enable Meritage to buy these quality businesses at valuations that provide attractive go-forward IRRs?

**AM:** The first question is what is an attractive IRR? Most people are familiar with the Mungerism of preferring the lumpy 15% to the steady 12%—I think there are issues with that, by the way. I'd rather 12%'s that are 10-year investments than 15%'s that are 5's. Obviously, even with taxes, if you can string two 5's at 15% together, that's better, but I find that our most limited resource is analytical time. I think ultimately we will generate more return in dollars for our investors this way.

Other than this opinion, by far the most common one is time arbitrage. I would also say that I don't think that the number of great companies in the world that is investible for us is very big. It's probably in the middle hundreds. Over time, as you research more companies, you learn a little bit about how they work. You learn a little bit about their durability. Some stick out to us, and if you just try to stay aware of their valuations, the market will provide you with opportunities from time to time.

We can take Moody's as an example. The volatility of this stock measured over a 50- to 100-day period is about 30%. Just in February, the volatility on a 10-day basis was near 50%. The point is that a high quality company like this has a volatility of about 30%, even if measured over longer term time periods.

What does that mean? That means that, one-sixth of the time, assuming a roughly normal distribution, it will trade more than 30% lower than here, ignoring the drift from its expected return (which maybe is just the market if it's fairly valued or zero which is a common assumption for the short run). My casual observation is, given enough time, it will be 10% or 20% cheaper than fair. You just have to have an opinion at that moment. I think it's much easier to have an opinion about strong companies when they are dislocated than weak ones.

Moody's is trading a little less than 20x 2016E earnings. Earlier this year it was \$83, so 15% cheaper. In February, when there were concerns over debt issuance, you could've bought at 17x earnings or a 5.8% free cash flow yield (in this case free cash flow and earnings are about the same) and the company has de minimis leverage.

The company has pricing power. They would say they raise prices 3%-4% a year. While issuance may be somewhat elevated now, we're pretty confident that over long periods of time issuance will continue to rise on average. In any case, between volume and price it's not heroic to get to 5% revenue growth. The company has about 50% operating margins. If you inflate the cost base at 3%, you get 7% income growth. If the company maintains its very modest leverage and buys stock, the effect to EPS should be a bit better—and could be better still if you believe a

company of this stability could responsibly manage more. I think you can get that for a while, but for sure there will be bumps. If you can sell the stock at a 6% yield—which I don't think is optimistic in the context of today's valuations, you'll end up with about a 13% IRR unhedged and it wouldn't surprise me if you could end up holding the position for 10 or more years.

A big part of when we buy something is that we have an ex ante view about the quality of the business and we can react to a price. Often there's also an accounting component, or there's something that is otherwise obscuring the numbers a little bit for a period of time. Perhaps there's more earnings power available than is currently evident. If you get those things together, then that produces an even better result.

**G&D:** How do you generate potential investment ideas?

**AM:** We don't have any kind of magic screen. In that first year when I met a lot of managers, one of my favorite questions was "how do you generate ideas?" and everyone always wants to provide an answer that demonstrated some kind of systematic capability. I always thought that—unless you're someone like Renaissance—that was unlikely to be what was actually going on.

I think idea generation is very serendipitous. We call it contrived serendipity. We have 14 analysts who are all looking at companies and one company leads to the next, leads to the next, leads to the next, and

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just by covering enough of a relatively small universe, you tend to find opportunities and hopefully add to the universe. We keep trying to come up with ideas to organize it more formally, but I think good analysts enjoy the freedom and the variety. It goes back to believing in backing competence and passion with capital and autonomy.

**G&D:** Could we briefly touch on beer distribution? Given Meritage's prioritization of liquidity, it must be a really exceptional business in order to get you over that liquidity hurdle.

**AM:** Jim has a strong preference for liquidity. I don't feel quite as strongly, but I do have a deep respect for it. I think that ultimately you have liquidity for a reason. I don't think liquidity is an end unto itself and I would argue that you have liquidity in order to take an illiquid position—whether that's funding medical research or buying a private company.

I think the first question is how illiquid is the position really? If you own the whole company you would think it's illiquid. However, if it's very cash generative, which is the case in beer distribution, you get substantial dividends.

I would also ask the question: how long does it take to sell a company? Maybe it takes 12 or 18 months, so the position is not as illiquid as it might seem. Of course, we don't want to sell it and we don't have the need to sell it, and it's very hard to imagine the circumstances that would drive us to sell it, but it is

theoretically not as illiquid as it seems.

The opportunity we saw with beer distribution was the opportunity to buy a company in a very well-protected industry. Beer distribution works like a franchise. You acquire the right to distribute a beer in a particular territory and that right is more or less perpetual. It is similar to buying a Dunkin' Donuts franchise. You have the right to operate your business with exclusive rights in whatever territory you agree on with the franchisor under certain terms.

Essentially, that franchise is a toll road on beer consumption in a given geography for the brands that are in your portfolio. That's a very stable, predictable thing. Another reason that these kinds of assets are particularly attractive to us is a very large fraction of Meritage's capital will ultimately be given away, but probably over a very long time horizon.

We think that being able to generate some of Meritage's income through operating earnings is a good way to defease that rate of giving. If we thought we could do exactly the same thing in public equities, then we would always do that. If you could generate the same return, with exactly the same shape plus have liquidity then clearly that's superior. Actually, in many ways that's Medallion. We felt for Meritage to have that return profile, we needed to own the asset.

**G&D:** Do you have any advice for students interested in entering the investment

management industry?

**AM:** I spend a really large fraction of my time interviewing people. We are always looking for great people. Most of the people we interview are early in their careers, and they have typically spent the previous two to six years in some combination of banking, private equity, and/or business school. We generally focus on hiring folks that haven't been trained by other funds. We think our approach is a little bit different and we are hoping to hire folks before the preceding firm's investment approach is too firmly entrenched in them.

When I first got into investing, the people going into the field were attracted by the work. They just thought it was fun. What has happened in the intervening years is that it's become clear that investing can be a lucrative career and increasingly we are seeing people pursue investing-related careers because it's lucrative and not because the work lights up their brains.

Investing is obviously very competitive and markets are efficient to the first order. I'm convinced we spend really all of our time deep in the land of diminishing marginal returns. I try to tell the folks we interview that we will probably throw out 80-90% of the work they ever do if they work here—because it's true—and how do they feel about that. If they don't really have an interest in investing and don't have a time preference that matches ours, this will defuse their interest. My point really is this: if you don't really enjoy the day to day of investing, it's going to

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wear you out and make you miserable. Even if you're able to retrain yourself to be purely motivated by money, that motivation will in fact wear off and sooner than you think and then you will hate it. You will be vastly happier in a field that naturally lights up your brain.

The second thing I would say is to pursue an investment firm that has a style and culture that matches your own. If you have to work too hard to adapt the way you think to the way the organization thinks, you're unlikely to be successful in any case.

I realize figuring this out isn't easy. But, instead of trying to figure out the firm's culture or style, I'd recommend first trying to figure out your own. Start with something like: what is it you like about investing? Do you like solving puzzles? Do you have more stamina to do research than most people? Do you have a psychotically high level of persistence? Do you perform better in and like a low or high stress environment? What is your natural time preference? Are you comfortable with volatility? Are you relationship-driven? Do you prefer to think about the big picture? Hopefully, thinking about this will offer some clues about your wiring. Once you have a view about that, then you'll know what questions to ask of firms to assess the fit from your perspective.

The point of going on interviews isn't to get the job, it's to figure out which job you want. The point of interviewing people is not to fill an opening, but to find the person that will improve the organization.

**G&D:** Thank you, Alex. That's great advice. Thank you for sharing your thoughts and time with us.

***“[I]f you don’t really enjoy the day to day of investing, it’s going to wear you out and make you miserable. Even if you’re able to retrain yourself to be purely motivated by money, that motivation will in fact wear off and sooner than you think and then you will hate it. You will be vastly happier in a field that naturally lights up your brain.”***

## Adam Wyden

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Adam Wyden '10

**conviction ideas. Mr. Wyden previously worked as a Senior Analyst at SMH Capital, a boutique merchant banking firm where he focused on advisory / principal investing to the lower middle market with sector expertise in technology, media, telecom, business services, consumer products, and industrials. Following SMH Capital, Mr. Wyden was enrolled in Columbia Business School's Accelerated MBA Program. Mr. Wyden holds a B.S. degree in Economics from the University of Pennsylvania's Wharton School and an M.B.A from Columbia University with concentrations in Finance and Accounting.**

**Graham & Doddsville (G&D):** Can you discuss your background with us?

**Adam Wyden (AW):** I come from a long line of entrepreneurs. My grandfather was in the steel business and other family members were in the industrial or manufacturing sectors. From an early age, I was taught that the best path to wealth creation was to find a niche in the market and then exploit it to grow and create value.

My initial introduction to the stock market was through my grandmother, who was an active investor, and still is at 92. She follows a Peter Lynch style philosophy and invests in what she knows and what she understands. My great-uncle was also an active investor. He invested in real estate, made private investments, including

Price Club and others that went public, and made other public investments while sitting on public company boards. My great-uncle was a visionary who had a nose for good deals and was unafraid of reasonable risk when he had conviction. More importantly, he stressed investing in talented people, and this is something that I carefully weigh when making an investment decision.

There were other relatives who gave me stock-holdings as gifts over the years and investing was a frequent topic of conversation at the dinner table. I learned a lot from these conversations and I started actively managing my own personal account in high school and continued to do so throughout college and grad school.

I went to Wharton for undergrad and decided to concentrate in Management. I found the analysis of competitive strategy very interesting. I was interested in why certain companies succeed and why others don't. Why companies get certain margins and why others don't. That was what drove my analysis: what makes a business a good one, why is the business competitive, and why is it going to grow?

I also took several management courses and learned that management was more than just HR. Many investors fail to realize that companies are run by managers and boards with very specific personalities, strengths, weaknesses, and organizational limitations. What motivates people to make certain decisions has

always been of interest to me. I realized that when I make investment decisions I had to carefully factor in human psychology and organizational behavior—motivations, incentives, etc.

In the summer of my junior year, I interned at a large investment firm. The group at the firm I was working in was very focused on understanding consensus earnings estimates, including which companies would likely beat the estimates in the short-term. It wasn't an investing approach that had a long multi-year runway to which I was accustomed. The investment strategy was also very focused on large companies. I remember studying Microsoft and SAP and thinking, "How am I going to get an edge with these companies?"

After this experience, I realized that I was better suited to a longer-term investment approach. A friend introduced me to a merchant bank in New York that invested through some opportunity funds and I joined the firm after graduation. We helped put together several complex deals in companies ranging in enterprise value from \$50 million to \$500 million. I wasn't able to rely on sell-side models. I had to get on the phone with the Controller or CFO and build the model from the ground up. This experience demonstrated to me the value of smaller companies. If a company is doing \$2 million in EBITDA and you can find a way to add an incremental \$3 million in revenue that can drive bottom line results, you generate real operating leverage.

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## Adam Wyden

It was around this time that a co-worker introduced me to the Greenblatt and Buffett material and I just started reading everything I could find on value investing. Contemporaneously, I decided to return to business school at Columbia.

I continued to actively invest in companies in my personal account throughout my time at Columbia and I launched my own fund six months after graduation in early 2011.

**G&D:** Why did you decide to launch a fund so quickly into your career?

**AW:** Initially, it was basically a cost-benefit analysis on a net-worth basis. I had been successful in managing my own account during business school and the opportunity cost of not being able to manage my own “PA” had grown significantly. If I went to a hedge fund, I would not have been able to manage my personal account freely, as most firms implement strict trading policies. I also saw a number of amazing investment opportunities that I wanted to pursue—many of which were smaller cap in nature and too small for big funds to take advantage of. But more importantly, I am an entrepreneur at heart. From selling collectibles on eBay to launching my own car detailing business in high school, I have always wanted to own and operate my own business.

**G&D:** One of the big bets that you mention in a few of your early letters was your investment in IDT. Can you discuss that investment?

**AW:** Yes, and actually there’s a story related to that investment that helps provide context for why I decided to launch my fund. I was, and still am, involved with a program at UPenn called the Jewish Heritage Program that Michael Steinhardt helped found with the Chabad program at Penn. It was through this program that I had an opportunity to meet Michael Steinhardt at his personal zoo in Westchester. This was in the middle of 2010.

**“Many investors fail to realize that companies are run by managers and boards with very specific personalities [...] When I make investment decisions I [...] carefully factor in human psychology and organizational behavior.”**

In between Michael trying to play shidduch—“matchmaker” in Yiddish for all the eligible young adults—I managed to get a side-bar with him on the back of the golf cart he was motoring around in. We had a back and forth going about former employees and different things. At one point, Michael wryly asked, “Well...what do you like Adam?” I said, “I like IDT.” At the time, the market cap was

\$160 million with \$200 million in cash and \$200 million in NOLs. I said, “Michael, I know you invested in IDT’s Genie Oil Shale JV. Why wouldn’t you just buy IDT? With IDT, it’s trading below cash, it’s profitable, and you would still own 100% of Shale.” He looked back at me and said, “Sounds like a good idea.” I’m guessing he made the investment in the shale JV without looking at IDT and was restricted at this point, but I could tell he was very interested. As we were leaving toward the end of the day, I shook his hand and Michael starts singing a song. I can’t remember the exact lyrics, but the chorus went something like, “IDT is the place for me.”

I was almost on the floor howling. You could not invent this experience. In my head, I’m thinking I have roughly 50% of my net worth in this stock that’s already up 4x. I think it can go up another 3x to 5x, and here is Michael Steinhardt singing about it. You couldn’t make this up.

At that point, I just focused on starting a fund. It seemed like some of the best investing guys in the business were seeing what I was seeing. If that’s happening, I started to think, “Maybe I can do this after all?”

The collection of assets beyond the cash and NOLs were interesting. The shale assets were probably worth at least \$200 million—the implied value of the Steinhardt/Rothschild investment in Genie. The patent business assets that I thought had value are now worth several hundred million dollars in a publicly traded company called

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## Adam Wyden

Straight Path (STRP). There was a Video on Demand asset (Fabrix) that ended up being sold for \$100 million, as well as a modestly profitable core business. I ascertained there was potentially \$50 per share in value and the stock was around \$10.

I also spent time with Howard Jonas and felt he was a re-engaged and re-energized executive. He previously sold an entertainment company to John Malone, so I knew he was capable of monetizing assets to legitimate buyers.

In fact, Howard had recently spun off an interesting collection of assets—a brochure/outdoor advertising business and the 4th largest comic book publisher into a separate public company f/k/a CTM Media Holdings. The Company spun off onto the pink sheets and instantaneously traded below cash and was profitable. Howard seized the opportunity and did a tender offer for a sizable portion of the Company. This laser focused capital allocation gave me the confidence that Howard was thinking about the world in the right way and was anxious to create shareholder value.

Seven years later, we are still shareholders in the Company, now re-branded as IDW Media Holdings (OTC:IDWM), and are extremely excited about its long-term prospects. Over the last several years, IDW has managed to grow both lines of its business organically and through acquisition and has created significant value in profits and valuation. In fact, I think the best is yet to come. IDW recently launched an

entertainment division to produce television shows and other mass market media. We think at today's valuation, the market is ascribing zero value to the Company's entertainment division which will have two full series aired in 2016—one of which is starring Elijah Wood and another 11 projects are in various stages of development.

**“Turnarounds can be good investments because many investors don't trust them.”**

I also think that Ted Adams, the founder of IDW and current CEO, is a creative genius that everyone wants to work with.

**G&D:** Didn't you have some doubts in Howard Jonas? He was chairman when IDT had really started to unravel. He had written a book on depression as well, which might give some investors pause?

**AW:** I think that for a long time the IDT business wasn't emotionally rewarding for him and ultimately led to his decision to step away as CEO. It seemed like he had a need to do more. I think Howard felt like he was taking too much from society and not giving enough back. He was also involved in a variety of non-business ventures during this time which were sapping a lot of his time and energy.

But in 2008 and 2009 when Howard realized his business was on the line, he was ultimately determined to save the company and execute a massive turnaround. Howard, his son, and Bill Pereira basically cleaned house and divested a number of the struggling businesses weighing on profitability. They cut \$200 million in fixed costs in total. The Company executed a massive buyback where close to 25% of the shares were retired. Howard also utilized the advice of Morris Smith, a former superstar manager at Fidelity. All of my initial reference checks suggested that Howard was supremely refocused on preserving the business and his legacy.

By the time I invested, you could already see a few decent quarters. But the naysayers persisted, saying the cash on the balance sheet was going to be squandered and today's run-rate profits were ephemeral. I pointed out that a private subsidiary for Howard's shale venture had been established and it would likely be project financed as a JV after it was separated from the holding company. Nobody cared.

You could see the cash. You knew shale would eventually be spun off. There were buybacks underway. The business was producing \$2 per share in FCF on an annualized basis. With the strong personal references on Howard and his motivations, I thought it would be very hard to impair capital permanently with this investment.

**G&D:** Are turnarounds a focus of yours? And what do

## Adam Wyden



Naveen Bhatia, Professor for Applied Security Analysis I & II, introduces the finalists for the 9th Annual Pershing Square Challenge

**you look for when evaluating them?**

**AW:** Turnarounds can be good investments because many investors don't trust them. If you've made the right call that management can be successful, you can often make a lot of money.

IDT was not actually a turnaround. By the time I invested, they had already divested assets and cut costs to the point that it was already generating profits and cash flow. It was a really great opportunity. There will be opportunities like that again, maybe not as good, but you don't need investments that return 15x or 30x. You need 2x, 3x, 5x, etc. You can get that in small cap investments when investors have just gotten blown out and there is forced selling.

**G&D:** Who were some of your major influences in developing your investment philosophy and investment approach?

**AW:** One group of investors I really admire is the group associated with the Bass Brothers in Texas. There is a whole group who are incredibly successful that worked with them: Eddie Lampert, Richard Rainwater, Barry Sternlicht, John Sculley of SPO, David Bonderman, Danny Och, and so on. Richard Rainwater stands out among that crowd.

I think there are a lot of people in the investment world that aren't willing to get their hands dirty. They don't necessarily know how to enact change or talk to people. To

me, what is interesting about Rainwater is that he was able to do all the numbers on the back of the envelope and he had all the technical skills you need, but he understood people and incentives. Sometimes there are bigger elements than the numbers. He was very good at recognizing good and bad people, and that's something I have developed great appreciation for.

Rainwater also understood sizing. Richard took big bets. I take big bets. Understanding that you've got to live with some volatility if you want really great after tax returns was another thing that really resonated with me. I don't care about volatility in my portfolio as much as I care about multiples of deployed capital across a cycle and limited opportunity for permanent capital impairment.

**G&D:** How are you set up from a team perspective?

**AW:** Generally, I do all the stock picking myself, but I rely on interns and consultants if I am working on a special project. My investment strategy, which is to invest in a couple of companies a year, lends itself to doing all the work yourself. When you make those types of bets, you have to be right. You have to be able to know the numbers inside and out. I think my investment strategy is conducive to having one guy. I could see a situation where we grow and have a bigger team, but right now it doesn't seem mission critical. On the business side, running everything is actually pretty straightforward given

developments with the cloud and outsourcing.

**G&D:** Can you discuss your investment process?

**AW:** I do have a lot of filters. I screen for insider buying, spinoffs, IPOs, and any large transactions. But the process is dynamic. I am always looking. Someone might pitch an idea to me, or I might be following an industry and see an interesting new investment from a fund we respect. For example, I saw Arnaud Ajdler take a position in Imvescor Restaurant Group (IRG.TO). That intrigued me. I liked the people involved, I liked the business, and the valuation was quite low. If the right changes were made in the business, it could be an interesting investment on a risk-adjusted basis. I spent time looking at the brands, calling franchisees, evaluating the retail business, and the general strengths and weaknesses of the franchise restaurant business. I did all the channel checks. I spoke to former employees about the franchisees. The underlying theme was that the brands had a lot of value, and with some management changes they could open more stores, increase their packaged foods business, and eventually sell or grow the Company through acquisition.

Today, two and a half years later, we have a new CEO, a better board, and the business is improving dramatically. While we took a lesser role in this "campaign" since Ajdler was in the board room doing the heavy lifting, we are not afraid to roll up our sleeves. In every investment I ultimately make, one of the boxes that

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## Adam Wyden

gets checked off is that if things go differently than expected, can I be the catalyst for change? I have launched a number of public campaigns and feel I have been largely successful effecting change and driving positive outcomes. I also feel that most boards and management—when applicable—find that while sometimes my advice and comments are tough, they ultimately galvanize the right results for the long-term.

The process can really vary though. With a compelling idea, I typically spend at least a month, sometimes much longer, doing exhaustive work. Sometimes we have been following the Company for years. When I see something that looks really obvious and compelling, I drop everything and go to work as quickly as I can. I don't really rely on expert networks or secondary information. I do all of the research and digging myself. It is very hands on—cold calling, in-person meetings, visits to the company, customers, suppliers, etc.

**G&D:** Is your investor base an important part of your investment approach?

**AW:** We have around 65 investors, and almost all of our capital comes from high net-worth individuals. We have a few institutional investors, but the principals of the institutional investors made the money. We have also been fortunate to attract some capital from a number of hedge fund managers, which is equally rewarding.

**G&D:** Can you talk about your approach to capital

raising, especially given the Fund's strong performance?

**AW:** You are right that we have gotten off to a great start. We have compounded at 27% net to investors with our Day I investors tripling their money in five years. We recognize that past performance is no

***“We have compounded at 27% net to investors [...] We recognize that past performance is no guarantee of future performance, so I just put my head down everyday and look for the best ideas I can find wherever in the world they may be.”***

guarantee of future performance, so I just put my head down everyday and look for the best ideas I can find wherever in the world they may be. My passion is really for investing. I am not an asset gatherer at my core. So my general approach has just been to continuing finding high quality ideas and compounding at a high rate, and eventually the dollars will come. We have added limited partners of all types and sizes over the years and I suspect we will continue to do so in the future. Just like our stock selection, we are focusing on quality over quantity.

**G&D:** Fiat (BIT:FCA) and Ferrari (RACE) are two investments that you seem quite passionate about based on the material you shared. It seems a key part of the thesis is incremental margins. Gross margins today are around 50%, but you think incremental gross margins are potentially as high as 75% to 90%. How do you get there?

**AW:** To get to 90%, we have to be looking at a seven-figure car, so that's not necessarily the case with all their units. My research with some very knowledgeable former executives at Ferrari suggests the margins on cars are in excess of 70%. If you get to sell an additional unit from the same facility, you have the opportunity to leverage the fixed costs that are lumped into the COGS line. Some investors miss that, in Italy where they're building these things, there's a variable cost of labor and there's a fixed cost of labor. Then there's depreciation, electricity, production fixed costs, insurance, and everything else that you are leveraging when you go from making 5,000 cars to 10,000 cars in the same facility. Not many manufacturing businesses operate with much spare capacity. When you utilize that capacity, margins look much more interesting.

**G&D:** So the materials just aren't that expensive?

**AW:** The expensive materials largely come from customization, and Ferrari is able to secure a large margin on those. The customer is paying a huge markup for the leather and all the rest. With

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## Adam Wyden

the actual car, you have to remember that the average selling price is nearly 5x an average car. You aren't paying the Ferrari labor force 5x what the GM labor force is being paid. We expect that there is leverage on labor.

I think there has been limited disclosure on this because the options package hasn't been set yet and what incentive do you have to let your customers know they are buying goods at 90% gross margins?

So I think EBIT margins go from the high teens to around 40% and potentially higher over time. The business has gross margins of 50% and you are layering on 75% incremental gross margins. It doesn't take long for the business to have 60% gross margins. I've looked at the gross margins of other luxury goods companies such as Hermes, Richemont, and so on. For a product with the same brand power, I think Ferrari can improve gross margins dramatically, which likely flows down to EBIT. High incremental margins can be really powerful. Look at Mastercard EBIT margins in 2004 and look at them now. I think part of it is that CEO Sergio Marchionne doesn't want to rub it in people's face. I think he wants to keep the bar low so he can keep beating the numbers. There are a definitely a lot of factors at play here.

**G&D:** We have discussed Ferrari, but you are also very excited about Fiat, correct?

**AW:** That's right. With Ferrari, I own options and

outright stock, but I also own Fiat. To me, Fiat is more interesting in many ways. In

***“So I think [Ferrari’s] EBIT margins go from the high teens to around 40% and potentially higher over time. The business has gross margins of 50% and you are layering on 75% incremental gross margins. It doesn’t take long for the business to have 60% gross margins.”***

2018, we think the business could produce \$6 in EPS. If you put an interest expense number that I think is appropriate and you take the Company's guided 2018 EBIT number, I think the \$6 in EPS could actually be conservative. Everyone thinks Sergio's 2018 forecast is too high, but I think it's potentially conservative. So that means we are buying the company at ~1x 2018 earnings.

**G&D:** Are you worried about cyclical in the U.S.?

**AW:** Everyone will tell you that the industry has peaked. There's no doubt the investment is contrarian.

First, SAAR isn't necessarily an apples to apples comparison. Fiat is more global now. They

have localized, low-cost production in South America, which is already in a recession, so this doesn't feel like a peak to me. Some of the growth will come from China which is greenfield expansion. Europe is also coming off a cyclical bottom—growing by the mid-teens in many of their major markets and certainly nowhere near previous peak levels. So, it just seems like there is a lot more going on to the story than whether U.S. SAAR has peaked.

However, turning to U.S. SAAR, even if SAAR goes to 15 million, I think the business can still earn \$3 in EPS. We would still be at ~2x earnings given a potential pullback. Some folks I have talked to claim they can break even at 10 million SAAR because they have improved their cost structure. Also, I think SAAR will stay at these levels or slightly below for an extended period of time, just like housing. I think it was well below a trend and the reversion to trend could take several years. Sergio's plan calls for SAAR at 16 million and SAAR is 18 million, so they are slightly conservative there as well.

I also think that there are interesting dynamics in the overall mix. Fiat has exited the Dodge Dart and Avenger business. They are saying they are not going to compete with Toyota and Honda rental / Uber-style cars geared towards car sharing. They are going to do Jeeps and trucks, which are going to be the last segment affected by autonomous driving and electric vehicles. They are basically turning into a pickup

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## Adam Wyden

truck and SUV business. They also have luxury brands Maserati and Alfa Romeo.

Within the group, there is a parts business called Magneti Marelli. It's a pretty decent business selling aftermarket parts. It does €6.5 billion in revenue and operates at a 5% to 6% margin. We think they should be able to operate at a 10% margin over time. At a 10% margin on €6.5 billion of revenue that's roughly €650 million of EBIT and at a 10x multiple would be worth €4 to €5 a share, or \$4.50 to \$5.50. For reference, Fiat only trades for \$8 today! Needless to say, we think Sergio still has levers to pull if investor indifference/intransigence persist.

To me, Sergio is a genius. Many investors do not understand Sergio Marchionne. They didn't like his presentation, "Confession of a Capital Junkie." Everyone loves Uber and Tesla and companies with really high valuations. If SAAR avoids declining all the way back to 10 million, I think they still make good earnings.

Even if earnings come in at \$1 per share instead of \$6 in an extreme pullback in auto sales, it would still be trading around 6x trough earnings. Again, the risk/reward seems asymmetric.

**G&D:** Are you worried about losing Sergio to retirement?

**AW:** He has said that he plans to retire at the end of 2018. I think he'll continue to be the executive chairman of Ferrari and remain on the board of Fiat. I also think there are a couple of guys at Fiat that could run the company. The CFO Richard Palmer and Mike

Manley/Reid Bigland who run FCA U.S. could definitely manage the whole company.

**G&D:** There are a few auto analysts who are quite skeptical on Fiat, aren't there?

**AW:** There have been. But some of the skeptics have been short since 2006, and some of the more prominent bears are actually retiring. It's a hard space to invest. Another consideration is you have Sergio and John Elkann saying a merger with GM would unlock \$10 billion in synergies. Put a 10x EBIT multiple on those synergies alone and you have \$100 billion in value creation across the two companies. If Fiat gets half, you have synergies worth around \$30 per share on an \$8 stock! The math works at synergy splits well below 50% as well.

We've seen other parts of the supply chain consolidate, and it seems like the only reason the top part of the chain hasn't consolidated is ego. You know what my grandfather used to say? "Never let your ego get in the way of your gold." I'm of the belief that at some point the gold is going to trump ego.

We are also optimistic that Fiat will soon be able to return capital. They are at the tail end of an investment cycle. They have invested to grow units from 4 million to 7 million. They have net debt today that we think will shift to a net cash position by 2018.

**G&D:** Do you think about the threat from autonomous driving at all?

**AW:** I do. First, I think this scenario is many years down

the road. Second, I think tech players will not want to replicate the manufacturing capacity of the incumbents. It requires so much capital. So the incumbents likely have some role, even in this new industry structure. Third, the average vehicle in the U.S. is 11 years old. In order for full autonomy to work, the autonomous units will need to be able to interact with non-autonomous cars. I don't see an easy way for that to happen. I think hybridization happens before autonomous vehicles.

I also recognize that Fiat is very different from our past successes. With IDT, no one knew about it. With Fiat, everyone has an opinion. A ton of institutional investors don't want to be contrarian. They side with Uber and Tesla and fast growing companies that feel like they are well positioned for the future. Anything with negative stigma attached is hard to invest in. I think we've done a pretty good job trying to understand the competitive landscape, the different macro-scenarios, and our corresponding downside protection.

**G&D:** We imagine consolidation would be great for competitive dynamics. Munger has pointed out recently that the car industry is the most competitive he has ever seen it.

**AW:** I agree. I think it's getting better, and consolidation will happen eventually. But at the end of the day, we just think there are too many ways to win. Fiat has the parts business, solid brands with Alfa Romeo, Maserati, Jeep, and Ram. They have cash building as a result of

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## Adam Wyden

EBITDA growth and the end of an investment cycle, upside to a consolidation scenario, and a really low valuation of 1x 2018 earnings. We haven't generated great performance on it yet, but we are optimistic.

I recognize it may take a while for people to care, but every single data point that I have seen supports my longer-term thesis. Sergio took his 2018 plan up in January, a plan that was released in May 2014 that no one thought he could hit!

It is our belief that whether it's Sergio Marchionne or Howard Jonas, the best course of action when one bumps into genius is to "hold on tight."

**G&D:** Thanks so much for your time Adam.

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## Marc Cohodes

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**Marc Cohodes**

### Graham & Doddsville

**(G&D):** Can you tell us about your background? We saw that you entered the hedge fund industry in 1984. How did that happen?

**Marc Cohodes (MC):** I was working for Northern Trust in 1984. I was only 24 years old at the time and the youngest person the bank had hired into the investment department. I was actually very bullish at the time. I was able to buy Coca-Cola at a 7% yield, bought into Walt Disney after they had been greenmailed by Irwin Jacobs, and saw a few other interesting opportunities. I think due to my age and my bullish stance, my colleagues at the bank really hassled me for being too bullish and claimed I had my fiduciary hat screwed on wrong. I was being hassled and held down by a bank culture, and I didn't like it, so I was looking to move on.

A mutual friend introduced me to David Rocker in 1984. Rocker Partners was just starting then and had around \$20 million in AUM. At that time, there weren't really large hedge funds that had billions in AUM or even a billion. It was a different time. It was pre-internet, pre-message boards pre-Twitter, pre-social media. There was no Reg FD. You could do real, hardcore, pick-up-the-phone research and figure it out. It was a very fun, energetic, enlightening time.

The fund's performance was very good for a long period of time. It slowly grew through compounding. In the early stages, we weren't necessarily bullish or bearish. There were pockets in the market where we found some great longs. Canandaigua Wine now (STZ)

comes to mind. We owned 13% of the company when it had a \$60 million market cap. Needless to say after making 8X our money on it we sold a bit too soon. The Sands brothers have done a heckuva job there and their dad would be very proud of his boys. I guess it wasn't until we first started dropping bombs on Saddam in 1991 that I got incrementally more bearish on the world. While I was decent at finding longs, I haven't been overly enthused in names on the long side in quite some time. I've seen a lot of things, but I've been very skeptical of what has been going on for the last 10 to 15 years.

**G&D:** It sounds like you have spent almost all your time shorting for quite a while?

**MC:** Exactly. The way my mind is currently structured, I see very few opportunities as longs and I see a whole heck of

**“Getting burned by Data Access opened my mind to the fact that a lot of these companies and management teams are just completely and utterly full of crap.”**

a lot of stuff as shorts. I think while some are drawn to activism, buybacks, and financial engineering, I see most of that as completely negative. I view crappy

businesses borrowing money to buy back stock because activists say you should do so as a very poor use of funds. Time that should be spent on improving the business is spent on financial engineering, which is a joke.

**G&D:** Do you think people are born with this orientation towards the short side? Are some investors quite critical and skeptical by nature? Or does it develop over time as you get burned by management teams lying to you?

**MC:** I think it's sort of all of the above. I think you are born with a short selling gene, or a “genetic defect,” as I like to say. You see the world differently. You tend to see things through a different prism. You tend to smell bullshit better than most, or you can realize someone is telling a provable lie. It's interesting, as I am probably one of the most optimistic people you'll ever find even though people claim all short sellers are pessimistic and evil and want to see the world blow up. If people took the time to understand the message instead of shooting the messenger, the world would be a much better place.

When I was a younger guy, I invested a lot of my money at the time in something called Data Access Systems. It was a computer leasing company that turned out to be a total fraud. It was a valuable lesson in my life. The investment taught me that management doesn't tell the truth. I realized that in order to be serious in this business, you need to raise your research skills to a high

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## Marc Cohodes

enough level to assess management teams and whether your investment mosaic is accurate.

Getting burned by Data Access opened my mind to the fact that a lot of these companies and management teams are just completely and utterly full of crap. Although I lost my ass and I lost money for my friends, which deeply affected me, it paved the way to what I ended up doing. You need to learn from your failures and mistakes and I have had many.

**G&D:** Can you discuss some of the changes you made to your investment process as a result?

**MC:** It taught me the importance of rooting through filings and developing an in-depth understanding of the financials. I'm not an accountant, but I do understand accounting. I understand when financials make no sense. In my mind, if things cannot be explained simply, that is a signal that you should start to dig because things in general shouldn't be convoluted or complex. When someone explains a business or an investment thesis to me, and it can't be explained to a 10th grader in a paragraph or less, that's a bad sign. It was a combination of looking at the numbers harder as well as making sure to verify what some of these management teams say. It's much easier now with the internet to figure out what's what.

Another change was improving on-the-ground research. It's very easy to call customers, call former employees, mark boxes, and things like that.

People like to talk and people also like to help. It's really a function of being more on the ground, keeping your eyes open, asking questions, being direct, understanding the numbers, why the numbers are moving, how they're moving. I always ask myself "does this make sense?"

***"When I'm looking for shorts, I look for career failures. I'm looking for people who always mess up. If you mess up once, you tend to mess up again, and again, and again."***

I think something that helped me in the past, and continues to help me, is checking people's track records and seeing how they've performed. I always like to say, "I bet the jockey and not the horse." When I'm looking for shorts, I look for career failures. I'm looking for people who always mess up. If you mess up once, you tend to mess up again, and again, and again. I tend to call it the "Family Tree." Some companies brag about our CEO being Ex-IBM. Years ago that was a plus, in this period...not so much.

Many of my shorts over the years have been management teams that are repeat offenders. Some of these guys, no matter where they go, hype whatever the current product, idea, concept or whatever

flavor of the day people want to hear. Investors get excited about the "current," but never realize what complete business failures the guys actually are. It happened with the guys at NovaStar, Media Vision, Lernout & Hauspie, to name a few.

If you're interested in shorting stocks, it's very labor intensive. You probably have to do 6x the work that the longs do. You have to have the courage and faith in your work. I used to say, 96% of the time, you go home feeling and thinking like you're an idiot, and you get paid 4% of the time. So when you have a good day, you have a great day. But your bad days are numerous. It takes a certain mind and mindset to be able to deal with that. Most people just can't. People have a great tolerance for losing money on longs, but they have very little tolerance or temperament on losing and getting squeezed in shorts.

**G&D:** Can you discuss what you are up to these days? Are you focused on managing your personal capital? We know you are still a highly active short seller from your Twitter feed.

**MC:** The only money I manage is my son's and mine. I'm completely out of the hedge fund business, and I thank Goldman Sachs for that, which is a different story for a different day. Good, bad or indifferent, this stuff is in your blood; I just can't get out of it. Names and games just jump out at me, and given the remarkable rally and re-leveraging of the system that we've seen since 2009, I think the opportunities on the short side in the past 12 months

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## Marc Cohodes

have been outstanding. Twitter is a great forum to go “fishing” with an idea or a thought and where it’s ok to speak out. Many people have come forward with research on concepts I have discussed that have truly moved the needle. I am a big supporter of the “free flow of information” and view it as vital in the marketplace. Silencing critics and attacking “skeptics” is always a Hot Button with me and something that turns me on. I used to be on the Yahoo message boards back in the day and posted under my own name. You talk about the Wild West! You never know what you may pick up out there, so keeping an open mind while listening and reading is important to my process.

I spend my days researching, analyzing, and trying to figure out stuff. I also take care of my son, do some farming, and travel. I enjoy spending time with my wife who brings great happiness to me. I lead a very interesting, enjoyable, wonderful existence. I enjoy investing as a purist, rather than running a fund. I don’t have to answer to clients or manage people. Running a fund is a very ball-and-chain exercise. The people who run funds earn what they earn, and deserve what they earn, because there’s a lot of pressure in the hedge fund business. Short-biased investing in the hedge fund business ages you in dog years and I was at it for 25 years, so I guess by those standards I am quite old. There’s a lot of wear and tear, and you can never really get away from it even on vacation. I enjoy my investment existence as it currently stands where I just pick and choose

my spots and only answer to myself.

I’m not afraid of anyone. I’m not afraid of clowns who run companies. Since I don’t run a fund, and I’m a civilian, I’m a free speaker, and I speak without malice. I can back up what I say. I think there are important opinions and thoughts out there. With something like Twitter, albeit kind of new, you find some really smart people, and I’ve met some interesting folks who have very fascinating viewpoints. They do some very hard and good research. Whether it’s people like yourselves, who are in college or grad school, or folks working at funds, or wanting to work at funds, there’s a real grassroots underground of people working their way up and thinking critically, and I view that as something very good for the markets, and very good for the system.

***“I think it’s a high crime to rip off hard-working people. I despise that kind of behavior, and I do look for it. I do sniff it out.”***

**G&D:** Can you discuss your idea generation process? It seems like most of the hedge fund industry generally thinks it’s pretty challenging to find

**compelling shorts. How are you able to do it so consistently in a variety of different environments?**

**MC:** That’s an excellent question, and I have talked to some pals about it. Maybe I like short selling because it’s not just blindly plugging numbers into an Excel model. There’s always management that are encouraging investors or the sell-side to plug in numbers, and I’m more likely to say, “This doesn’t make any sense.” You always need to “leapfrog” the estimates both up and down and work hard to try to understand how the business works.

Something that just makes me smile and laugh is thinking back to shorting this company called Old Country Buffet. It was run by a guy named Roe Hatlen. This was a business that prior to being public was bankrupt twice. There’s a reason for that, and it’s because it’s a crap business. A buffet format attracts two kinds of people. You have the people who come in and try to eat you out of house and home and you also have the people who stay there for three and a half hours. Either way, it’s a flawed concept because those types of people are going to try to get a bargain. You can’t charge enough, you have food cost issues, and you can’t really grow the business. When you put leverage on something like that, you just go broke.

When the company needed to raise money to grow, certain restaurant analysts would say this is great, they can grow from 10 states to 50 states, etc. But when you actually think about it, this is not the

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## Marc Cohodes

kind of business you want to be in. Sometimes there's just a lack of critical thought on these situations. Although the numbers may look compelling in the short term, this is a business that fails and it fails for a reason.

I think it's the lack of thought by current market participants, perhaps due to impatience and the pressure to perform. There are some investors who say, "Although the comps were bad, they got better in the second half of the quarter and we are optimistic about the trends." That doesn't mean crap to me unless a "fix" was made, and in Buffet's case it never happened. You can't let short term nonsense jerk you out of a long term trade that should probably work. I think under the current hedge fund structure, people aren't patient enough to see through so-called failures. You have to see it through, or why put in the effort and energy to begin with? You need to have the courage to ride your thought through.

**G&D:** *It sounds like there can be cases in which there is a vast divergence between expectations when one investor is plugging numbers in on a spreadsheet while another is thinking about the business and the underlying reality of the economics.*

**MC:** I think right now there is a huge lack of critical thought. More people need to ask "Does this make sense? How does this make sense? What really is the end game here?"

I don't know if you have looked at Outerwall (OUTR), but activists got involved and

encouraged the company to buy back stock at ridiculously high prices. No one stopped to think that this move does nothing to help their business. It's just leveraging up to help hedge funds out when it's a really bad use of their money and it could cripple the company.

Now the stock is down and the hedge funds and activists who championed the idea are nowhere to be found. The critical question was, are people going to be renting

***"Any company with a management team that focuses on, mentions, is bothered by, or attempts to squeeze short sellers, is almost definitely a short."***

DVDs from a red kiosk or not? It may be a dying business, so it doesn't make any sense for the company to lever up to buy back stock at a very high price. That is probably the dumbest thing they could have ever done. It just shows that management had no ability to engage in forward thinking in running their business. They just kowtowed to a bunch of hedge funds looking for short-term performance in a dead end stock.

**G&D:** *It also seems like you are very attracted to situations in which the consumer is being taken advantage of in some*

*way. Is that a theme that you have relied on over time?*

**MC:** You're right. I think it's a high crime to rip off hard-working people. I despise that kind of behavior, and I do look for it. I do sniff it out. I really, really, have it out for subprime. I've been involved in shorting subprime auto, subprime housing, subprime education, subprime consumer lending, and subprime vacation timeshares.

Analysts plug numbers into a model and say "God, this is a great business. Look how much money you're making." Well, you're making money ripping off financially unsophisticated people which, to me, is awful.

I had some hedge fund guy call me about World Acceptance. He was telling me what a great business it is. I said, "If you think they're in a great business, I'm not your call. It's an awful business, run by awful people who rip off financially unsophisticated folks."

It turns out many of these are terrible businesses. You wouldn't pay much of a multiple to sell drugs on the corner. You have great margins and make all sorts of money until you are arrested or shot. It's just not for me. You have a number of people focused on the great ROE or ROI, but I think it's a crap business over the long-term because the company can be regulated out of business and the management team is simply in it to enrich themselves while not caring what happens to its customers or the effect it has on society.

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## Marc Cohodes

**G&D:** It's interesting that many people typically refer to short sellers as short term in nature. The edge you have referred to a few times is taking the other side of longs who are overly focused on the short term returns of the business.

**MC:** I'm not a short term guy. I've never viewed myself as a trader or market timer. I have to rely on the business getting in serious trouble, getting impaired, filing for bankruptcy, or fundamentally changing. The ballgame is nine innings and I have to have a vision. I have to think it through. I have to research it. I have to do things like that because I have every factor known to man working against me including the upward bias of the market. I also have to be comfortable being in the minority.

**G&D:** What was your insight on Nu Skin Enterprises (NUS) that allowed you to have such an improved view relative to all the bulls?

**MC:** I have no thought or position on Herbalife, but multi-level marketing (MLM) businesses are very dangerous structures. It's a model where, when things are good, they get better, and when things get bad, they get worse. There's nothing in between. In MLM land, you are either going forward rapidly or you're going backwards.

The thing that caught my eye on Nu Skin was that they have a complete joker, buffoon, and clown running it. A guy named Truman Hunt. He got on a conference call and said, "I don't know why in the world anyone would short our stock.

We have a great company here and I work hard every day to frustrate and make the short's life miserable." I saved the transcript and printed it. I post it on Twitter every now and then. I said to myself "I need to get to know that Rat Bastard. He sounds like a guy for me."

Any company with a management team that focuses on, mentions, is bothered by, or attempts to squeeze short sellers, is almost definitely a short. As a CEO, you shouldn't worry about the shorts. You

***"I prefer situations in which I can have five shooters on the target rather than one."***

should just run your damn business. Run it hard, do the best you can. At the end of the day the numbers will prove out, good or bad. He got my attention when he started pounding his chest and baiting the folks who were short his stock.

As I'm following the company, they announce a huge amount of Chinese business out of nowhere and the stock goes crazy. I thought, "Hmm, this is interesting." I didn't get involved until the stock broke when they got busted by the Chinese and had to settle an investigation. The company claimed it was not a big deal. But I looked at the MLM structure with its reliance on China, and I said numbers here are just way, way too high. They had used all sorts of

chicanery to recruit and now that the recruiting mechanisms were gone, there wasn't a chance in hell they could make their numbers. At the time, the estimates were \$8-\$9 dollars, but the actual EPS has come in around \$4.

For me, it was purely a bet against the geometric progression that the bulls were counting on. Management was hyping an MLM structure selling garbage products into China where there was no real demand. When an MLM goes bad, recruiting goes bad, incentives go bad, the money trail goes bad and people stop working for Nu Skin and go work for Amway, Herbalife, or whomever.

Nu Skin could go out of business tomorrow and no one would miss them. Analysts were recommending the stock using estimates and theories that were completely and utterly out to lunch. If your producers aren't making money, they'll move on to the next thing. The bottom line with Nu Skin is there's just nothing there. With Nu Skin, you're selling face creams to Chinese people who have very little money for food, let alone this garbage. It's been really good, and I still think it has a way to go, and I think management is clearly full of crap. So, until proven otherwise, there's no reason for Nu Skin to even exist.

**G&D:** MLMs seem to lend themselves to the on the ground research you spoke about. Were you able to conduct any investigative research to give you an edge?

## Marc Cohodes

**MC:** John Hempton had some excellent research out there on empty factories in China that I thought was needle moving. I think, at the time, the stock was in the mid-to-high forties, and it backed up my thesis that a lot of their claims were just lies.

You can also look on Google Earth at where the company claims their facilities are. One was 60 miles south of Siberia. You think to yourself, man, that's kind of a funny place for a plant. Who knows if it even exists?

The evidence forced me to bring an even more skeptical viewpoint to the company. I think it's a little bit of everything with Nu Skin. It's balance sheet, management, structure, where they do their business, their rhetoric, the quality of dopes who follow and recommend the stock. In particular, Tim Ramey who is one of the three worst analysts I've ever come across in my life. For him to be touting Nu Skin was another tell.

**G&D:** Do you have any thoughts on Tesla given how popular that has been within the short selling community over the past few years?

**MC:** I have no position in Tesla. I've never had a position in Tesla. I mean the fundamentals are the fundamentals in terms of their losses and things like that. I find Elon Musk to be a polarizing figure, both long and short. I think Elon should be a little more thick-skinned with the critics and focus more on his business. Investors should be entitled to say whatever they want about the company. That said, in some ways I

admire Elon Musk. He is a chippy guy who doesn't take shit and in many ways that's ok. He needs to execute, though, and people seem to love his cars, but the stock and the cars are not for me.

I can't really add value to the debate on that company. I generally try to avoid positions in biotech or high tech situations. It can be unanalyzable in certain ways. It becomes very hard to prove or disprove in the short term. I prefer situations in which I can have five shooters on the target rather than one. For example, with Canadian housing, I think I can win on a bubble, on fraud, on lack of reserves, on the macroeconomics, on money laundering. There's a zillion ways I can win.

**G&D:** Speaking of Canadian housing, that is clearly a passion of yours. Do you mind discussing your views?

**MC:** Canadian real estate is really something. Canadian real estate, ex-Toronto and Vancouver, is not doing well at

***"I like to short complete pieces of garbage with fraudulent management and horrifically bad balance sheets."***

all, but Vancouver, which is very hard to play publicly, is the money laundering mecca of North America. Toronto real estate is also really something.

I'm short Toronto/Canadian/Alberta real estate through being short Home Capital Group (HCG). Last July, they copped and admitted to \$2 billion of mortgage fraud, which was brought to their attention by a whistleblower. The company has no controls. It has no systems. They take zero reserves. They missed origination numbers for the last six quarters with all sorts of excuses. I think it's an incredible short because if the market were to cool, they would have a big problem. Management lies at every turn and their financials misrepresent their business. The turnover at their "risk" department is of interest to me as well.

When you take no reserves in Canadian subprime mortgages, you can run any drawdown assumption you want and the company will not have a business. It will be gone. I think it's a question of when, not if. So, I happen to love HCG as a short.

**G&D:** What do you think is the misperception here? Are people fooled by a low price-to-book valuation?

**MC:** Well, I think their book is overstated and unstable and with that being said it trades at 1.8x book here with Wells Fargo at 1.4x and Bank of America at 0.9x. The company is sitting on \$50-80 million in losses of short-term investments they've made that they won't run through the P&L because they don't want to take the hit. Also, when you don't take reserves your book is overstated. I don't think their loans are good, so I don't believe their book at all.

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## Marc Cohodes

Their book value is around \$1.6 billion. They have \$25 billion of loans, and I don't think they are good loans. They have about \$800 million in loans in Alberta unsecured subprime housing which I think is an issue. They have \$1.5 billion in fraudulently underwritten mortgages and they won't quantify the potential losses. They're hitting the last quarter with 13 bps in provisions. In the US, when things went bad in subprime, provisions went to 12%-17%. The consumer in Canada is leveraged far beyond where the US consumer was in 2007. Canadians take out home equity lines of credit, second mortgages, and private mortgages, so the slightest tip in the price of housing, especially in Toronto, is going to completely and utterly put this thing into the soup. Shadow banking in Canada will one day unglue the country but regulatory capture and money laundering seems to be saving them for now.

Everyone thinks they can time it. Everyone thinks they know exactly when it's going to happen. No one is that smart. When things happen, they happen at lightning speed, without warning or notice and it tends to be wicked. So HCG is the pure play in subprime lending in Canada, generally Ontario. There's no real pure play in Vancouver to my knowledge.

**G&D:** With the fraudulent mortgages, are there any contingent liabilities associated with those? Can they be put back to the company?

**MC:** By the time the market turns, there will be no

company to put the mortgages back to. It is one of the great setups I have seen over the last 15 years. HCG's CEO, Gerry Soloway, is an absolute coward. In one of his previous roles 25 years ago, Soloway shorted his own company's stock into a Dutch tender and he covered by issuing himself warrants. He was slapped by the OSC and has recently announced he is retiring. I say he is a coward because in past conference calls he made every excuse as to why he was missing numbers and it turned out to be mortgage origination fraud. This kind of stuff would not play to U.S. investors but different places have different rules.

***"You have to have a lot confidence in yourself. You have to believe that you're right and everyone's wrong. You have to be able to deal with adversity and have a clear mind."***

I don't care about the analysts who plot their numbers and claim it's cheap. The stock is going to go to a very, very low number one day and I am patient. If HCG wants to buy back stock and try to squeeze shorts, that's fine with me. I will wait them out. The second that credit spins in Canada, everybody is going to get shut off. It's akin to serving a guy 23 drinks at a bar. I'm asking "Isn't

the guy drunk?" "Hell yeah. He was drunk on 15, but now we're 23." "What are you waiting for? Why do you keep serving him?" "Well, you could have told me that at 13 drinks. I keep serving him because he keeps paying." Eventually it changes and that's what I am waiting for.

**G&D:** Are there other companies that you think have overextended themselves in lending operations? You were recently mentioned in a Bloomberg article about Signet Jewelers (NYSE: SIG).

**MC:** Well I think SIG is a great short because I'm not a fan of roll-ups in general, and I'm definitely not a fan of roll-ups in retailing. Except for auto parts companies, they tend to fail in retail. I think SIG is a cross between Conn's, which is a subprime lender for home appliances, and Jos. A. Bank and Men's Wearhouse. I believe Signet makes 60-65% of their money from lending and their extended warranty program. Why you need an extended warranty on jewelry is beyond me. That's the dumbest thing I've ever seen. Oh, it includes "free ring sizing." Come on now. I was born at night, but not last night.

It's a hedge fund hotel name. You have an activist or wannabe activist involved in the thing. It's covered by retail analysts who do not understand the weird accounting associated with subprime lending. Analysts think they are recommending a retailer. You actually have a retail rollup with low quality brands. I actually don't view it as jewelry retailer; I view it as

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a retailer of trinkets that uses subprime finance techniques to make their sales. So their business model is not that of a traditional retailer. I view that as a very bad mix. Everyone on Wall Street who loves the stock misses that there are CFPB issues with the company as well.

I think there's a huge misperception of exactly what this thing is. Specialty retailers trade at much higher multiples compared to a subprime lenders with jewelry or trinkets as collateral. In jewelry, Tiffany and Blue Nile are struggling, but Kay, Jared, and Zales are somehow succeeding? I think that's due to their financing arm and aggressive extension of credit. I think there are some big time risks with the company and they seem to be very concerned about the skeptics and again are using money to buy back their overpriced stock...good luck to them.

**G&D:** *There's that famous Keynes saying about the market staying irrational longer than you stay solvent. From a process standpoint, what do you do to ensure you don't face really large, painful mark to market losses before you are able to see your thesis come to fruition?*

**MC:** I have been carried out many times. I know few professionals who haven't. It's difficult to have hard and fast rules. When you short stocks, you get involved on a carnival ride that's called 'anything goes,' which includes buy-ins, manipulations, fake tenders, and all sorts of shenanigans which can cause stocks to gyrate in a crazy fashion.

Before I short anything, I have a few protections. First, I always assume the short can double on me. I size the position accordingly. Second, I guard against "thesis creep." If the thesis changes, you better get the hell out. If you don't, you'll clearly get buried. As long as your thesis is pretty good and your analysis is right, you can hang in there. Third, I never, ever, ever get involved in what I would call open-ended situations. I've never been short a drug company that can theoretically solve a big problem. I have avoided pie-in-the-sky names. To use an analogy, I'm not interested in climbing into a tree and wrestling the jaguar out of the tree. I'm interested in someone shooting the jaguar out of the tree, and then I will go cut the thing apart once it hits the ground. Instead of open-ended situations, I like to short complete pieces of garbage with fraudulent management and horrifically bad balance sheets. I look for change, I look for "if this goes away tomorrow will anyone miss them"? What do they do well?

In terms of timing, I think if I've watched these companies long enough that I can get close on timing it properly, but if I do it's generally lucky. I normally lose first then hopefully win. I do look for breaks in the fundamentals first before I dive in. When the market begins to care is anyone's guess.

I'm not particularly worried about mark to market losses. I do this personally, not for a fund. I think one of the problems with investing now is people have to be tracked week to week and month to

month. This forces you to cut losses fast which again I am not a trader and don't mind being down for a while if I think I can make 50-90%.

**G&D:** *It seems like quite the challenge to balance conviction with flexibility. How do you achieve that balance?*

**MC:** I think that's hitting the nail on the head. You have to have a tremendous amount of confidence in your research. You have to have a lot confidence in yourself. You have to believe that you're right and everyone's wrong. You have to be able to deal with adversity and have a clear mind.

I am lucky to have a wonderful son, who happens to be disabled. I have watched him grow up and face adversity on a day-to-day basis and he never complains, and tackles things head on. He inspires me to no end and whenever I think I have things tough, I always think of him. Seriously, it's probably the greatest thing that has ever happened to me. Some would view it as a hardship, I do not and it gives me great strength.

There's been situations when I had to have conviction that strategic buyers were wrong, like when Intel & Microsoft took a stake in Lernout & Hauspie. When bulls said "Do you know more than Intel on Lernout & Hauspie?" I said, "I don't know more than them, but I know that Lernout's a fraud, and Intel doesn't know the first thing about financial frauds." That's the attitude you need to have, because otherwise, you will just get carried out to the sea, and

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that's a really bad feeling. The Lernout experience taught me a lot but we went from being buried alive to making it out which was a miracle in itself. The pressure to cave was enormous but thank God it went bust.

That's why I always say, "Don't try this at home." You have to be genetically flawed to even want to try to do this. It's very, very difficult. Short selling serves a great function in the marketplace in terms of free flow of ideas, and the people who do it should be respected instead of trashed, threatened, beaten up, manipulated against, and run-in, not to mention sued, or investigated. I have been all of those. It's not fun, but you have to have skin as thick as an armadillo and be able to look at them and spit.

It's not for everybody. It's a dying art, as evidenced by only three or four short-dedicated funds still active in the market. It's like mining with a pick and shovel, instead of a bulldozer. It's not an easy thing to do.

**G&D:** You mentioned that management teams attacking short sellers is a strong signal to you. Do you rely on any other signals? Too much of a focus on capital return to shareholders seems like it might be one for you?

**MC:** I'm very against buybacks. I think buybacks should only be used as a last resort. There are very few examples of buybacks having actually worked over the past 18 months. Over the last year, so many pieces of garbage that I've been short have announced or completed buybacks. Nu Skin was buying back stock at 2x the current

level. World Acceptance's average cost is probably \$80 versus the current price of ~\$38. HCG has just finished a Dutch Tender. Every one of these hucksters who've done buybacks have seen these things blow up in their faces. The activists force management teams into doing something dumb with their money so the activist can sell, but then the rest of the shareholders in the company are left holding a company loaded up with debt.

A lot of these energy companies were initiating huge buybacks and look where it got them. I think companies should borrow money to expand their businesses, to hire people, to grow organically, not to engage in buybacks or roll up acquisitions. When your business is not doing well from a fundamental perspective, the last thing you're supposed to do is buy back stock. Financial engineering is a byproduct of low rates. Bad outfits need to and should fail. Cheap money lets these guys manipulate numbers and earnings for much longer than need be and this is why the economy is in "muddle."

**G&D:** Have there been situations that you sourced through ill-advised buybacks or rollup acquisitions? Anything like Valeant (VRX) or in healthcare more broadly?

**MC:** Well, I'm not an authority on Valeant. There are people I respect who are long this thing. That said, the guys I know who are short this are lethal. The smartest pharma guy I've ever come across is Mike Krensavage. He's smarter than heck. He thinks this thing

is a zero. I wouldn't bet against Krensavage. We worked on AAll Pharma together when he was on the sell side and it went Bankrupt. VRX has a good chance of going in that direction as well.

I have been involved in what I call the "Poor Man's Valeant" and that is Concordia Healthcare. They are more levered than VRX and their strategy is being run by ex-Biovail guys who to me are in way over their heads. They have overpaid for acquisitions and have recently missed numbers. I don't think their assets are worth the debt by a long shot and they seem more than lost. They are concerned about the shorts and have lost focus in running their overleveraged business. Their conference call transcripts given their leverage levels are worth a listen.

**G&D:** Are there any other shorts you'd like to discuss?

**MC:** I'm very intrigued with Tempur Sealy (NYSE: TPX) as a short. I haven't talked publicly about it yet. I've been short this thing 5 or 6 times in my life, and it's been good to me. When they first went public I noticed the top two guys in management wore wigs. I am 10/10 in shorting guys who wear wigs. It's another indicator of mine. I don't know what it is with guys who wear wigs but they make great shorts.

At the end of the day, they sell foam mattresses. TPX is a commodity business. They sell foam and now everyone can sell foam. You can buy foam in a box. You can buy foam at Costco. You can buy it

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everywhere. There's nothing magic about what they do. The bed industry grows about 1%-3% a year. The share has been taken and I think the road for them ahead is rocky.

TPX is a sales-driven model. In a sales driven model, when you miss on revenue, you tend to miss for 3, 4, 5 consecutive quarters. When they beat, the opposite happens. This past quarter was the first quarter of misses. The stock is down, but it could get more than cut in half from here. The company is highly leveraged and activists are involved. They threw in a new board and a CEO who is a former rental car guy. I have no respect for players who encourage the company to take on more leverage to buy back their worthless stock. That's what the company has been doing. If they want to buy the stock here, great, I'm selling it to them. I like TPX as a short.

I also like two bust Canadian online gambling roll-ups. Intertain (IT) and Amaya (AYA) are both worthy here. They are both over-levered and run by "shady characters." The CEO of AYA is on "leave" for an insider trading investigation. After buying the world, Intertain now wants to sell itself. I think digging into the capital structure of both of these outfits will be rewarding. These two remind me of children who take out a puzzle, spread it all over the room and after 20 minutes say I am done. The house is a mess and no one wants to clean it up. Canada seems to love rollups. When they go bad, they can go really bad. I like these two as shorts. Time will tell.

**G&D:** Given your activity on Twitter, we'd love to know who some of your favorite folks on FinTwit are. Who are some of the folks you benefit the most from following and who is underrated?

**MC:** In general, I find a lot of these guys on Twitter to be very, very sharp. I think @donutshorts would be my first choice. He is outstanding. That guy is dogged. He knows what he's doing. He's smarter than heck. He's experienced. When I grow up I want to be as smart as him.

***"It's important in this business to do it your own way. Be yourself. Have an identity. Have a plan and be you. Win, lose, or draw, do it on your own terms."***

I'll give you some of my favorites in no particular order. @AZ\_Value, @Whipsawcap, @KennethCosco, @Nevadaturkey, @Tysoncapllc had this BOFI dead to rights. @RetardedBearcap is really good. I've known @SpartucusZoro forever. There's one guy who will probably write a book or a movie on Canadian housing and that's @SCooper. There's @CarringtonLedge, @HardcoreValue, @AC\_ECO. It goes without

saying that @Mega\_Man\_2 is very good.

It's good for people to lurk and monitor what these people say and how they think. It can serve as a starting point before you do your own work.

**G&D:** Would you like to close with some words of advice for students, especially aspiring short sellers?

**MC:** One important thing to understand is that there are many easier ways to make a living than shorting stocks. If you want to make a lot of money on Wall Street, shorting stocks is not what you want to do. I short stocks because I really enjoy it. You have to love the work and the challenge. At the end of the day, I feel good cracking the code and getting to the bottom of these scams. If you don't have a passion for it, you will get worn out and you shouldn't do it. If you follow what you are passionate about in your investment career, money and success should and will follow.

Lastly, it's important in this business to do it your own way. Be yourself. Have an identity. Have a plan and be you. Win, lose, or draw, do it on your own terms. For better or worse, there is only one David Einhorn, Mike Krensave, Jeff Ubben, Warren Buffett, Jim Chanos, Roland Keiper, Stan Druckenmiller. Be your own person because otherwise it just all gets diluted and you can't beat the market or do exceptional things over time. You're just an imitator and there's too much group think.

## Marc Cohodes

If you want to get in this business, you can understand how these people have gotten there, but you need to develop your own style, your own abilities, your own way of doing things, and make sure no matter what you do, you do it on your own terms. Don't do it someone else's way. That's a true problem. Don't just watch the talking heads on CNBC – and just blindly follow what the talking heads say. Kevin O'Leary as an “expert and market commentator” tells you how “infomercial” the markets have become. It's not that simple or easy. Think for yourself is always a great place to start. Just think it through, do it yourself, and do it your way. Long or short.

**G&D:** That's wonderful advice Marc. Thanks for your time. What's the best way for people to find you and follow your investment related thinking?

**MC:** You can find me on Twitter, @AlderLaneEggs.

**Thais Fernandes '16**

Thais is a second-year MBA student and a member of Value Investing Program at Columbia Business School. During the summer, Thais worked for First Manhattan, a long-only equity fund. Prior to Columbia, she was a partner at Brasil Capital, a long bias hedge fund.

**Melody Li '17**

Melody is a first-year MBA student at Columbia Business School. Prior to CBS, she worked in sell-side equity research including Oppenheimer & Co. and Brean Capital and real estate private equity at ACE Capital in New York.

**Joanna Vu '17**

Joanna is a first-year MBA student at Columbia business school. Before CBS, she worked at Colony American Homes and Colony American Finance, portfolio companies of Colony Capital. She is currently an intern at Litespeed Partners, an event driven hedge fund.

## Alimentation Couche-Tard (TSE: ATD.B) - Long 9th Annual Pershing Square Challenge—First Place

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### Investment Thesis Summary

- High-quality business misunderstood by the market: Convenience store segment generates stable/high FCF while fuel margin isn't correlated with oil price
- Best positioned player to consolidate a highly fragmented market
- Management has a proven track record of making accretive acquisitions with integration expertise and we expect them to continue to do so

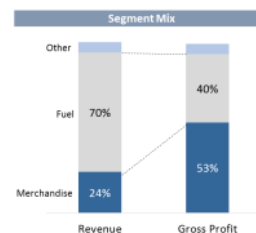
### Investment Recommendation

We recommend a long on Alimentation Couche-Tard with a target price of CAD83/USD65, which represents a potential 44% upside. ATD is a great opportunity to buy a high quality, recession resistant business that is thinly covered, flies under the radar and lead by true value investors.

Ticker	ATD.B
Price (CAD / USD)	57.97 / 45.21
Shares Outstanding (M)	569.2
Market Cap (\$M)	25,736
Net Debt	1,777
Enterprise Value (\$M)	27,513
ROE 5Y Avg	21.4%
ROIC 5Y Avg	12.8%
ROCE 5Y Avg	17.7%
Dividend Yield	0.47%

### Company Overview

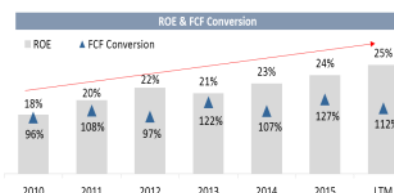
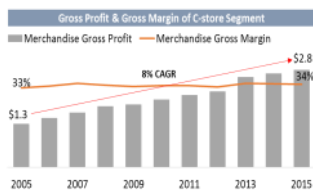
ATD is a Canadian company that grew up internationally in the US & Europe to become the world's largest c-store and gas station operator. Over 10,000 stores generate revenue from transportation fuel and convenience stores, which grow organically year after year. ATD operates under brands Circle K in US (No.2), Couche-Tard in Canada (No.1) and Statoil in Scandinavian Europe (No.1).



### Investment Thesis

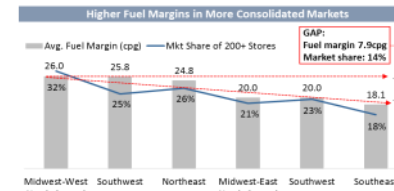
#### A. Resilient retail cash cow

- **The convenience store ("c-store") business is misunderstood by the market.** C-store is gaining market share from other retail formats driven by the **increasing consumer preference of convenience**, especially for the millennial generation. At ATD, **C-store contributes to >50% gross profit and has very stable gross margin (~34%) over years.** C-store revenues experienced **positive SSS growth (3%/1% in '08/'09) during the recession**, evidence of the business' resiliency. C-store segment's resiliency and stability contribute to a consistent **>100% FCF conversion and >20% ROE.**



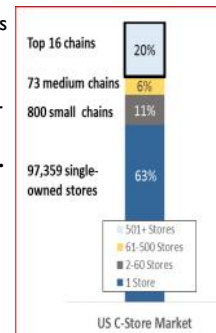
#### • Fear of fuel margin decline is unwarranted.

Bears argue that fuel margin will get squeezed as oil price recovers, however, our analysis shows that fuel margin is **not correlated with oil price** but rather **driven by fundamental and bottom-up factors** such as **operation profitably at the store level and local competition**. Our variant view on fuel margin is: fuel margin **will stabilize at 18.5cpg** (cents per gallon) near-to-mid term and **will trend upward** driven by pricing control shifts from big oil to operators like ATD, more sophisticated pricing strategies, rising operating costs, and industry consolidation.



#### B. Best positioned to consolidate

- The US c-store / gas station industry is **extremely fragmented** with over 60% of stores owned by moms and pops
- **Only four players are capable to consolidate the US industry:** 1) 7-Eleven, a complicated holding that doesn't exactly love the gas station business; 2) Marathon Petroleum (Speedway) and 3) ETP/Sunoco - two integrated downstream oil companies going through operational issues right now. **ATD is the only well-positioned consolidator.**
- **The c-store consolidation story looks a lot like that of the drugstores in the 90's**, when chains started dominating over the mom and pops. ATD currently has a similar market-share as CVS in 1995 (3.5% vs. 4.2%). Since then, CVS compounded at a 18% CAGR and reached 20% market-share today. Drugstores and c-stores bear similarities in the sense that scale is crucial for success for such a low margin business, we see no reason why ATD cannot follow in CVS's footsteps.

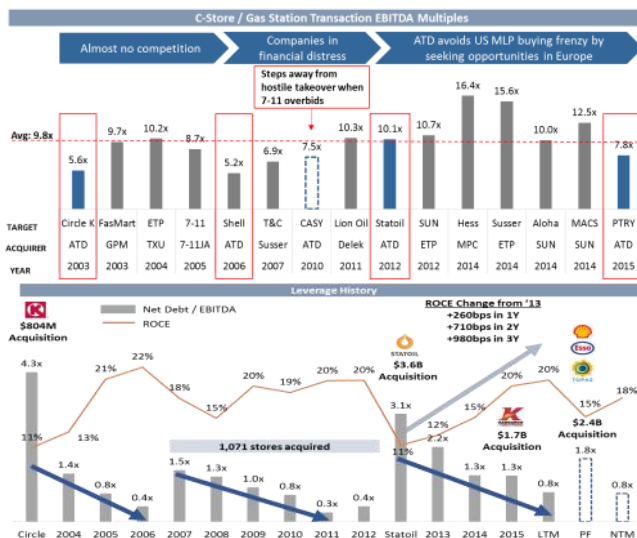


## Alimentation Couche-Tard (TSE: ATD.B) - Long (Continued from previous page)

- **Scale is also hard to replicate** as it takes a lot of time and effort to build a substantial size. ATD took 15 years in the US with several small, medium and large acquisitions to reach 3.5% market share.
- Additionally, by entering **Europe in 2012 with the acquisition of Statoil**, **ATD built a new and very exciting platform** in an opportunistic time when Big Oil is exiting the retail side of the business due to the oil crisis. As a matter of fact, ATD recently announced two acquisitions – one in Ireland and one in Denmark.

### C. Best-in-class management with integration expertise

- In 1980, Alain Bouchard purchased one convenience store in Canada. Today the company owns over 10,000 stores globally. Alain has a **lot of skin in the game** as most of his \$3 billion net worth is invested in the company. As a matter of fact, all 4 co-founders own 20% of ATD's stock
- A top ten shareholder told us that they only get to speak to IR twice a year. A current shareholder has been trying to meet Alain for years, with no luck—this indicates that management is **more focused on the operational aspect of the business than wall street**
- **Decentralized business model empowers business units of 600 stores to react to local challenges immediately.** The VP of acquisitions told us that he is able to buy single stores in a pre-defined box without management approval, thus cutting down on the slow bureaucracy that oftentimes plague large organizations
- **Management consistently acquires at below industry multiples.** ATD buys when others aren't buying and are disciplined enough to walk away when the price is not right. For example, in 2012 during the US MLP buying frenzy, ATD found opportunities elsewhere, in Europe
- **Management is disciplined with debt but not debt adverse.** History shows that ATD is not afraid to lever up for a transformative acquisition but quickly pays down the debt to be ready for the next deal
- Management has an **in-house M&A team** to reduce financial advisor fees



### Why Now

1. **ATD will beat estimates**—Three deals of \$2.5Bn in last 6 months are not included in consensus estimates
2. **Over-levered US MLPs must sell assets to pay down debt**—Catalyst for accretive acquisitions in sought after markets
3. **Low oil prices forcing European oil companies to sell non-core assets**—Another catalyst for accretive acquisitions

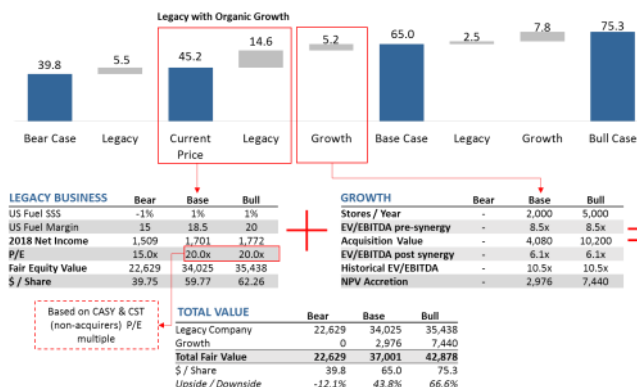
### Risks

1. **US fuel margin will deteriorate as oil price recovers**—Fuel margin is not correlated with oil prices and will stabilize near-to-mid term and trend upwards
2. **Acquisitions to support growth is unsustainable**—ATD can grow organically and does not have to acquire to grow. Given the fragmentation of market, we see a long runway for ATD to further consolidate and management has proven track record of making accretive acquisitions
3. **Competition from big box retailers intensifies / price war**—Big box retailers failed in gaining market share in the pharmacy business, expect a similar story in gasoline
4. **Succession of leadership**—Alain Bouchard is still more active in acquisitions than ever after stepping down as CEO. He personally mentored CEO Hannasch
5. **Growing electric cars will hurt traffic to gas stations**—If the most optimistic forecast is correct and half of the cars sold in the US is electric by 2025, the number of non-electric cars will be ~260mm by then (still a higher number than the current ~250mm that exists in the US)
6. **UBER taking some customers away**—what matters for gas stations are the miles driven, which doesn't change because of UBER. The average "UBER driver" – male, middle-age, low income that can't afford to lose time - is exactly the main consumer target for convenience stores

### Valuation & Scenario Analysis

We value ATD using sum-of-the-parts.

1. The legacy part of the business provides stable and consistent free cash flows. Factoring in the 3 announced acquisitions (Esso, Topaz, Dansk Shell), dropping fuel margin to 18.5cpg, and assuming 1% fuel volume organic growth, produces a 33% upside for the Legacy business.
2. Adding on the acquisitions part of the business (\$4bn acquisitions in 2 years) gets us to our price target of CAD83/USD65 (44% upside).





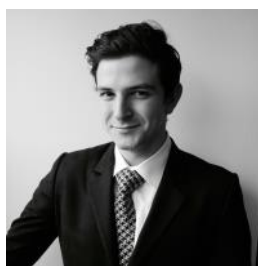
### Chris Andreola '16

Chris is a second-year MBA student at Columbia Business School. Prior to CBS, Chris spent four years working at Syncarpha Capital. He graduated from Lehigh University with degrees in Finance and Mechanical Engineering.



### Brandon Cohen '16

Brandon is a second-year MBA 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 in St. Louis *summa cum laude* with degrees in finance, economics, and accounting.



### Daniel Rudyak '17

Daniel is a first-year MBA *Feldberg Fellow* at Columbia Business School. Prior to CBS, Daniel worked on the buy-side at Guggenheim Partners and on the M&A team at Houlihan Lokey. He graduated from USC *cum laude* with a degree in finance.

## Charles Schwab (NYSE: SCHW) — Long 9th Annual Pershing Square Challenge—Second Place

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### Recommendation

Schwab is a secular grower with a wide moat, which has allowed it to earn a ~20% return on equity, on average, for more than 25 years. Since its IPO in 1987 the stock has compounded at ~18%/year. From 2008 to 2015, its earning assets (float) grew from \$44 billion to \$172 billion, and its total client assets grew from \$1.1 trillion to \$2.5 trillion. However, operating income has only risen by ~12%. As a result, SCHW's return on equity in 2015 was 42% below its long run average. This is because SCHW is very sensitive to changes in the Fed Funds rate as it invests client cash in 2yr duration, liquid securities. It also charges money market management fees, which it has had to waive in order to give clients a positive yield. These waivers reduced earnings by 36 cents/share (fully taxed) in 2015. As a result, a **100 basis point increase in the Fed Funds rate would more than double SCHW's earnings.**

However, at **21x forward earnings**, it trades at a ~20% discount to its **25 year average** (excluding 1998-2001, when it averaged 58x earnings). This is also the low end of the pre-crisis (2004-2007) forward P/E range of 21-25x.

The street is too short-term focused, providing the opportunity to buy a great franchise at a very reasonable price. Our base case analysis results in a 20.4% IRR over a 5 year hold period and assumes that interest rates only rise by 100Bps over 5 years.

### Business Description

Schwab makes money by 1) investing client cash (float) in loans and securities, 2) fee-sharing with mutual funds offered on its platform, 3) charging money market management fees, and 4) collecting trading commissions.

### Investment Thesis

#### 1) High Quality Business

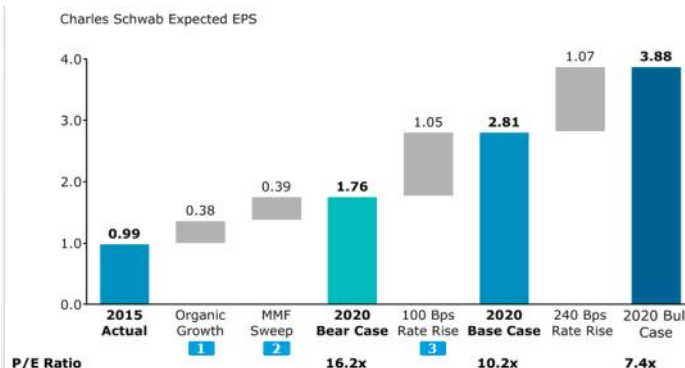
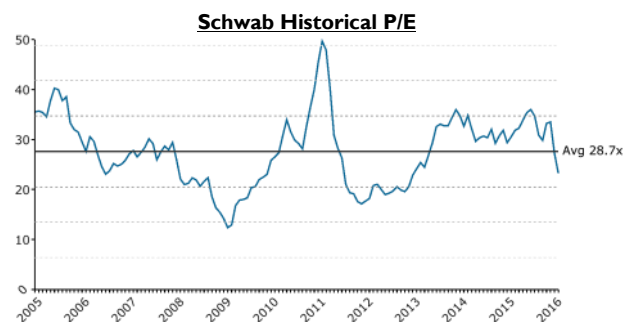
SCHW holds \$2.5 trillion in client assets, > 4x more than TD Ameritrade and >8x that of Etrade. As a result, it is able to spread the fixed costs of marketing, technology, branches, and call centers over a larger base of assets. Due to its scale advantage, SCHW can charge less per account than it costs TD Ameritrade and Etrade to maintain each account, while still managing to achieve 36% operating margins. This allows it to provide better services at lower prices, which creates a virtuous & sustainable cycle. SCHW is able to collect more assets, increasing its cost advantage, allowing it to provide even better services over time.

SCHW's cost of deposits are substantially lower than banking peers, including Wells Fargo, because its customers view brokerage cash as convenience cash. If they haven't simply forgotten about the cash build from dividends, interest payments, sold securities or matured securities, they want the cash available for the next time they decide to make an investment decision so aren't worried about transferring it out to make a few extra basis points. Currently, SCHW's cost of funds is 8 basis points.

As a result of its competitive advantages, SCHW has grown client assets from market share gains alone by ~7%/year for the last 15 years. Growth from market share gains was even higher in the earlier years, and has been positive every year. Since 1993, it has grown its share of investable wealth in the US from 2.5% to 7.5%. In addition, its existing assets tend to grow by ~60% of the total return of the S&P 500.

We believe over the long-term SCHW can grow client assets by a minimum of 7%/year (3% from market share gains

Key Financials & Ratios		Other Metrics	
Market Cap / Price	37.0B / \$27.99	P/B	3.2x
ROCE TTM	11.4%	10yr Avg P/B	4.1x
Avg ROCE (1992-2015)	19.7%	NIM	1.6%
Forward P/E	22.6x	Cost of Funds	0.08%
10yr Avg. Forward	22.1x	Debt/Equity	7.7%
Pre-Crisis Forward P/E Range	21-25x	Div. Yield	.84%

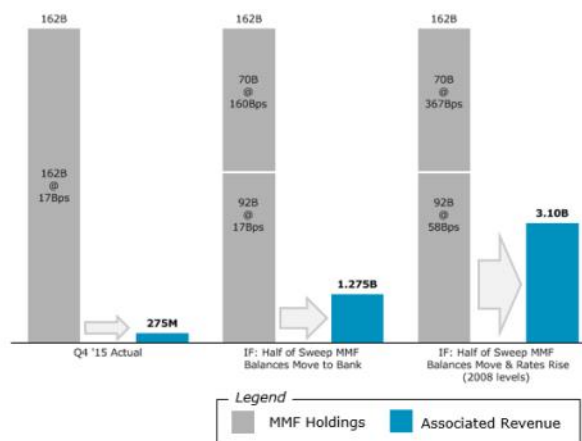


## Charles Schwab (SCHW) — Long (Continued from previous page)

and 4% from organic growth of existing client assets) and through operating leverage (expenses grew at a 2% CAGR over the last decade) can **grow earnings by 10%+ annually, holding rates constant.**

### 2) Money Market Sweep Opportunity

Since the financial crisis, ~\$70 billion in yield insensitive cash has built up in Schwab money market funds, where Schwab earns 17bps on cash. If that cash were instead on the bank balance sheet, Schwab would earn its 160bps spread. However, in order to move the cash to the balance sheet, Schwab must build \$5 billion in equity on its balance sheet to maintain its targeted 7% leverage ratio. Schwab plans to retain future earnings to build that equity capital. We expect this will take less than five years. That alone will grow EPS by 48 cents/share. The ROIC on this balance sheet investment will be ~13%, with no risk. However, if interest rates rise, that ROIC will increase substantially as the 160bps bank spread could trend closer to the 2008 level of 367bps.



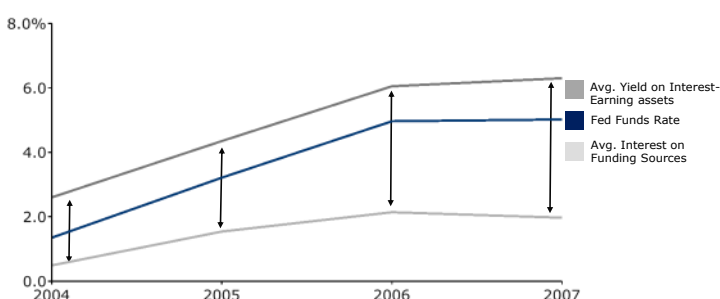
### 3) Free Option on Rate Rise

In the last period of rate rises from 2004 to 2008, the Fed Funds rate rose from 1.4% to 5.0% and Schwab's NIM rose from 2.1% to 4.3%. Based on end of year 2015 client cash balances, Schwab would be trading at 8x TTM earnings today if interest rates were at 2008 levels. Zero interest rate policy is responsible for Schwab's currently depressed ROE, which is 42% below its 23 year average.

### 4) Free Option on Advice Growth

Only \$193 billion of SCHW \$1,359 billion in retail client assets are advised by a SCHW advisor. Advised assets have been growing by 15%/year over the last five years as SCHW is making a large push into this area. Each additional \$100 billion in advised assets generates \$460 million in revenue (46bps fee for advice, on average). That translates to ~22 cents/share in EPS.

Selected interest rates (US, 2004 - 2007)

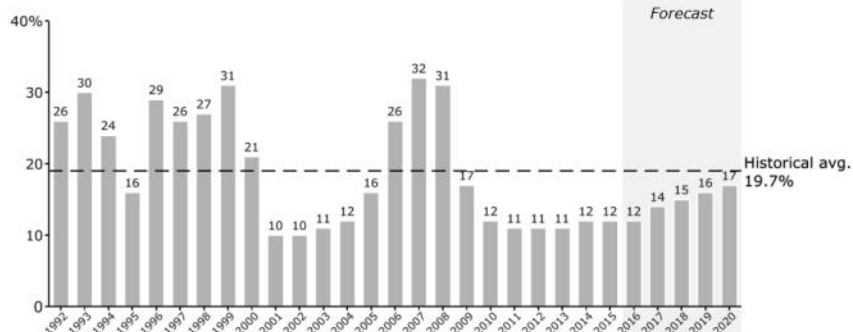


### Valuation

In the long run, we believe SCHW can grow by ~10%/year organically. It pays out about 1% annually in dividends based on today's purchase price. Therefore, We think the total return an investor can expect, giving absolutely no value to the money market investment opportunity, the option on rate rises, and the option on advice growth, is ~11%/year.

If over the next five years, SCHW grows by 10% organically, reinvests all earnings into the business for the money market sweep opportunity, and we get a 100bps increase in the Fed Funds rate (which is roughly the bond market consensus), we think SCHW will earn ~\$2.80/share. At 20x earnings (discount to past trading range), the stock would be worth \$56/share. This would result in a 16% CAGR. We think that is highly attractive given the low risk nature of the investment and conservative assumptions used.

SCHW Return on Equity (1992 - 2020F)



### Key Risks

	Risks	Mitigants
Negative Risks	Will customers take cash out of their brokerage accounts?	Savers will always need brokerage accounts, and given Schwab's scale advantage, if Schwab can't earn a reasonable ROE for an extended period of time, nobody else in the industry can, so pricing in other areas will need to evolve to maintain a viable business model.
Cyber Security	What if Schwab's customers financial data is compromised?	This risk is pertinent for any financial institution. But Schwab's scale allows it to spend more than competitors to defend against this risk.
New Entrants	What if competition / new technology enters the market?	Schwab's scale has given it an edge in adjusting to new technologies, e.g. E*trade was 18 months earlier to online trading, but Schwab just copied them and continued to dominate. Schwab was also
New Regulations	What if new regulations reduce Schwab's ROE?	Schwab is the most conservative bank in the industry and as a result, we expect regulators will treat it accordingly. It is still only 1/10th the size of Wells Fargo, so does not pose the same risks to the financial system. To the extent our forecasts are correct and it grows the balance sheet significantly, minor tweaks to the business model will be a nice problem to have.



Jordan Barron '17

Jordan is a first-year MBA student at Columbia Business School. Prior to CBS, Jordan worked as an Engagement Manager at L.E.K. Consulting, a global management consulting firm. This summer he will be interning at AUA Private Equity in New York.



Nielsen Fields '17

Nielsen is a first-year MBA student at Columbia Business School. Prior to CBS, Nielsen was a Co-Portfolio Manager and Senior Analyst at Summit Global Management, a long biased hedge fund. This summer he will be interning at Headlands Capital in San Francisco.



Noah Scherz '17

Noah Scherz is a first-year MBA student at Columbia Business School. Prior to CBS, Noah worked as an Associate at American Securities, as New York based private equity firm. This summer he will be interning at Surveyor Capital in New York.

## Advance Auto Parts (NYSE: AAP) - Long 9th Annual Pershing Square Challenge Finalist

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### Recommendation

We recommend a long on Advance Auto Parts (AAP) with a price target of \$280, offering 75%+ upside from today's price of \$161 with desirable upside/downside dynamics (3.8x). We believe EPS can double to ~\$16 over the next four to five years via multiple operational improvements; at 18x forward EPS – which contemplates zero multiple expansion – AAP is worth \$280 in 2019.

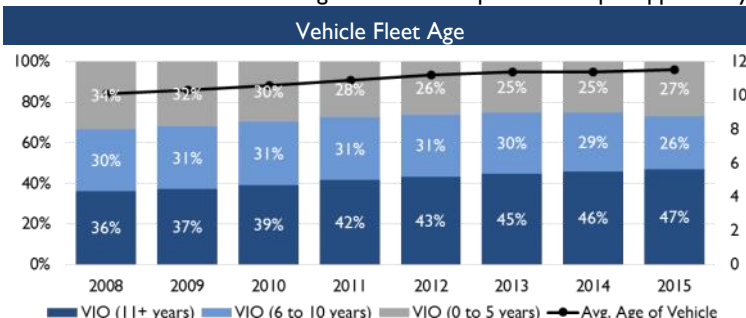
### Business Description

Advance Auto Parts is an aftermarket auto parts retailer serving the do-it-yourself ("DIY") and do-it-for-me ("DIFM") market across a nationwide network of ~5,200 stores. The company operates under four banners, Advances Auto Parts, Auto Part International, Carquest, and Worldpac, the latter two being acquired in the Company's 2014 acquisition of General Parts International. Over the past several years Advance has underperformed relative to peers on multiple operational fronts for no structural reason. Activist investor Starboard is now catalyzing change and has brought in a new CEO with requisite experience to fully utilize the company's existing asset base to unlock significant value.

### Investment Thesis

#### 1) Strong Industry Tailwinds in a Highly Fragmented Market

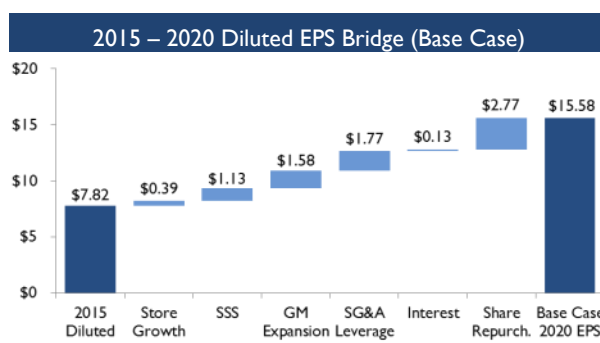
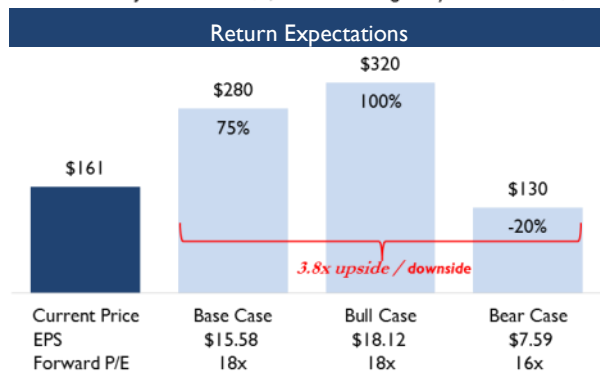
Advance operates in an industry driven by strong secular tailwinds as the company benefits from growth in miles driven and longer lasting cars (i.e., favorable vehicle age fleet dynamics). The top three players in the space currently have a ~33% share of the DIY market and ~12% of the DIFM market and the fragmented landscape offers ample opportunity to consolidate competitors.



advance has seen market share loss on existing assets, lower margins, higher working capital needs and lower organic new store growth resulting in lower overall and incremental ROIC's and thus a lower market multiple. We attribute this underperformance to a lack of execution on one key front, distribution capability. By improving its supply chain proficiency progress in part availability, same store sales growth, margin, and working capital efficiency should follow.

**i) Distribution Capability:** In both the DIY and DIFM sales channels, the first question a customer asks is "do you have the part" and specific to the DIFM market "can you have it to me within 30 minutes". If you are

Trading Statistics			
Share Price	\$161.19	52 Week High	\$201.24
Dil. Shares O/S	73.9	52 Week Low	\$131.59
<b>Market Cap</b>	<b>\$11,915</b>	Dividend Yield	0.15%
Plus: Debt	\$1,232	Shares Short	4.1
Less: Cash	(91)	Short Interest	5.5%
<b>Enterprise Value</b>	<b>\$13,057</b>	Days to Cover	6.0
Memo: Lease Adj. Net Debt	\$4,360.94	Avg Daily Value	\$110



#### 2) Operational Improvement Opportunities are Levers for Value Creation

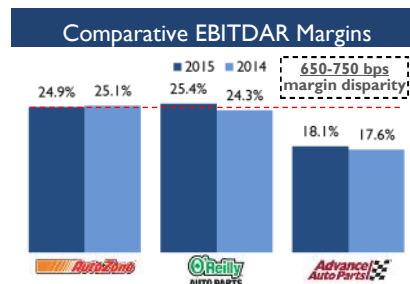
Despite favorable industry dynamics, Advance has underperformed relative to competitors O'Reilly (ORLY) and AutoZone (AZO) in total shareholder return over the past 10 years to the tune of 350% and 400% respectively. During this time, Adv-

## Advance Auto Parts (AAP) - Long (Continued from previous page)

Advance you want to be that customers “first call” and get that part out to the customer as soon as possible. We believe O'Reilly is the leader in part availability due to nearly 100% of its stores receiving daily deliveries from its DC's and HUB's. The GPI acquisition increased the number of Advance DC's from 12 to 50 and will enable the company overtime to achieve daily delivery similar to O'Reilly.

**ii) Same Store Sale Growth & Margin Improvement:** The market has grown consistently between 2% and 5%; however Advance has seen lower comparable, and recently negative, same store sales growth due to missed sales opportunities from a lack of part availability. Operating leverage on negative sales has been a margin headwind. By improving its distribution capability and thus part availability, Advance would begin to capture the natural low to mid-single digit growth of the industry resulting in \$2 of incremental EPS by 2020 at today's margins.

However we believe Advance has substantial room for improvement on today's margins. Advance's EBITDAR margins fall between 6.5% to 7.5% below its competitors for no long term structural reason. The DIFM mix relative to O'Reilly – which has significant DIFM exposure – is minimal while independently owned stores account for ~250bps of the margin differential. Advance will let these independently owned stores roll off over time. A 6% EBITDAR margin improvement would add more than \$6 of incremental EPS by 2020.



**iii) Working Capital Efficiency:** Our final point on operational execution relates to working capital. Over the past 15 years, the large competitors have financed an increasing portion of their inventory through vendor financing. As the GPI acquisition is digested, leverage decreases, and same store sales increase, Advance should be able to drive AP-to-inventory higher and pull out roughly a \$1b in cash while reinvesting organically in new stores. Importantly, with 100%+ AP-to-inventory, AutoZone and O'Reilly are effectively paid for growth, and improving working capital efficiency dramatically improves incremental ROIC.

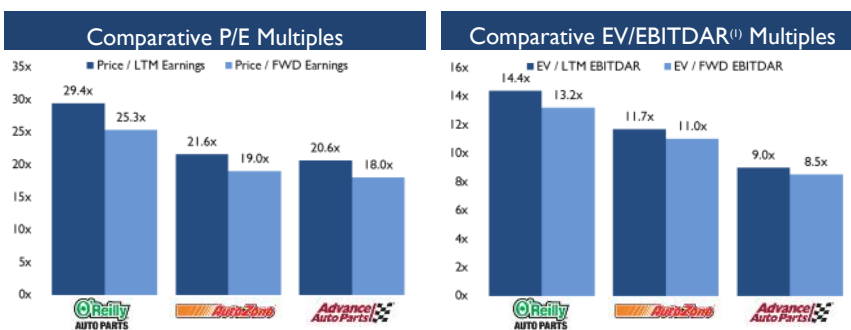
We believe the new CEO, Tom Greco – known as an “operators operator”, supported by an upgraded board with supply chain and change management experience give Advance the highest probability of closing the operational gap to peers. Several conversations with PepsiCo board members confirmed that Greco is a strong operator, has experience running one of the most difficult supply chains in the world, and comes from an organization with a history of placing successful leaders throughout the retail industry.

### 3) Improving Unit Economics Can Supercharge Growth

At current working capital levels, we estimate that the 5-year unlevered IRR for new units falls in the mid-single digits. However, if the company can achieve O'Reilly-like levels of inventory financing, these returns jump to the 30%-40% range. This dynamic can set off a chain of value creation whereby new units become more attractive, the company accelerates its store growth, the earnings growth-rate accelerates, and the multiple rerates higher.

### 4) Great Business Selling at a Fair Price

Since its recent selloff, the company trades at a steep discount to peers on both a P/E & EV/EBITDAR basis. We believe a multiple rerating is possible and can contribute to additional upside. However, more importantly, we believe that the current discount represents a meaningful margin of safety for investors entering at the current price level.



<sup>(1)</sup>Based on adjusted net debt, calculated based on 6.0x LTM operating rent expense

### Valuation

Based on multiple valuation methodologies and scenario analyses, we believe that Advance remains undervalued and offers an attractive risk / reward: In our base-case scenario, we believe that the company offers **~75% upside through 2019**, equating to 16% IRR over 3.5 years. The resilient business model supports limited downside risk in our bear case, leading to a **3.8x upside / downside ratio**. Importantly, significant possible upside from a multiple re-rating is not contemplated in our valuation analysis. Further, the opportunity appears attractive given the multiple levers for value creation and the clear catalyst for change in the newly appointed CEO.

### Key Risks

**Risk of e-tailing:** Customers continue to prefer picking up in-store where they can interact with knowledgeable salespeople, even when they order online; hurdles are higher in the DIFM where retailers deliver to commercial customers up to three times per day - this is exceedingly difficult to replicate without a broad / distributed retail footprint (even for Amazon).

**Choice of CEO:** The chief concern is that Tom is not an “auto parts guy”, however Pepsi Alums have been successful throughout the retail industry and former colleagues confirm Tom is a talented, blue collar operator which is exactly what Advanced Auto Parts needs.



### McCoy Jen, CFA '17

McCoy is a first-year MBA student at Columbia Business School. Prior to CBS, McCoy worked at UBS, Brean Murray and Fidelity. He holds a BS in Finance and International Business from NYU's Stern School of Business.



### Austin Kim '16

Austin is a second-year MBA student at Columbia Business School enrolled in the Value Investing Program. Prior to CBS, Austin worked at Citigroup and during this past summer, he interned at Invesco. He holds a BS from UC Berkeley's Haas School of Business.



### Audun Nordtveit '17

Audun is a first-year MBA student at Columbia Business School. Prior to CBS, Audun worked at Norges Bank Investment Management. He holds an MS in Industrial Engineering and Technology Management from the Norwegian University of Science and

## Alcoa Inc. (NYSE: AA) - Long 9th Annual Pershing Square Challenge Finalist

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### Executive Summary

- 1) Robust margin improvement potential (the largest business line in the value-added segment, Arconic, has a 10% EBITDA margin lag relative to PCP, which features a similar product catalogue)
- 2) Misunderstanding of quality nature of Alcoa's core businesses
- 3) Aluminum market may remain oversupplied, but alumina should be supportive (China will likely replace its high cost smelters, but China does not possess domestic bauxite supplies)
- 4) Security is currently significantly mispriced (Alcoa is spinning off Arconic in 2H16 and has not yet filed its Form 10) and one can purchase the upstream business for free at current valuation

### Key Statistics

Capitalization		Key Metrics	
Current Share Price	\$ 10.01	Short Interest	11.69%
Shares Outstanding (in mm)	1,314	52 Week Low / High	6.14 - 14.29
Market Cap (in \$ mm)	\$ 13,150		
Less: Cash	1,919	Consensus FY16 EPS	\$ 0.32
Plus: Preferred Shares	58	FY16 Forward P/E	30.8x
Plus: Minority Interest	3,047	Consensus FY16 EBITDA	\$ 2,568
Plus: Pension	2,500	FY16 Forward EV / EBITDA	10.0x
Plus: Debt	9,103		
Enterprise Value (\$ mm)	\$ 25,939	Base Case Target Price	\$ 15.91
		IRR (2018)	18.7%

### Financial Summary

Base Case Revenues	2014	2015	2016	2017	2018
Value-add	13,589	13,462	14,243	15,083	15,787
Upstream	10,309	9,046	5,857	5,726	5,820
Other	8	26	-	-	-
Total	23,906	22,534	20,100	20,809	21,607
YOY Growth	3.8%	-5.7%	-10.8%	3.5%	3.8%
Consensus YOY Growth	3.8%	-5.7%	-6.9%	5.2%	4.9%
Base Case EBITDA Margins	2014	2015	2016	2017	2018
Value-add	14.0%	14.8%	16.1%	17.5%	18.3%
Upstream	21.6%	21.6%	17.1%	22.6%	23.1%
Other	-	-	-	-	-
Total	14.9%	14.4%	13.8%	16.2%	16.9%
Consensus Margins	14.9%	14.4%	12.3%	13.9%	14.8%

### Investment Recommendation

We recommend a long position on Alcoa with a 2018 price target of \$16, representing 60% of upside to current valuation and a 19% IRR. Alcoa's share price reached a peak of \$17.60 in November 2014 but recent financial underperformance driven by the decline in aluminum and alumina pricing has led to investor flight despite a compelling split of the company in 2H16. On one side, a new standalone value-added company (Arconic) can leverage recent acquisitions and improve margins, while the upstream segment will be a pure play aluminum/alumina company investors get for free.

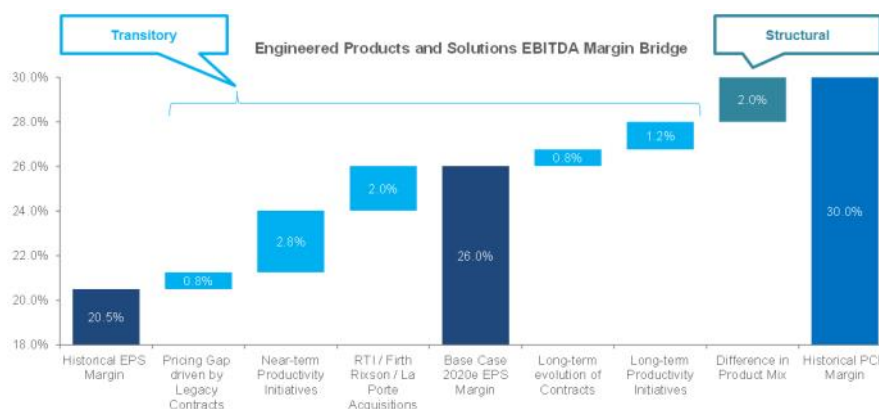
### Company / Situation Overview

Alcoa is an integrated upstream and downstream aluminum company. Its upstream business consists of bauxite mining, alumina refining and aluminum smelting. The bauxite and alumina business is structured in a 60% owned JV called AWAC, where the remaining 40% is publicly traded as Alumina Ltd. on the Australian stock exchange. The upstream segment accounted for about 50% of EBITDA in 2015, but the trend is curtailment of capacity and low capex into this capital intensive part of the business. The value added business (Arconic) produces rolled products, aluminum components for the road transport industry, and higher-end engineered products, mainly to the aerospace sector. The value-added business has been invested heavily into over the past two years, and is the new driver of growth for Alcoa.

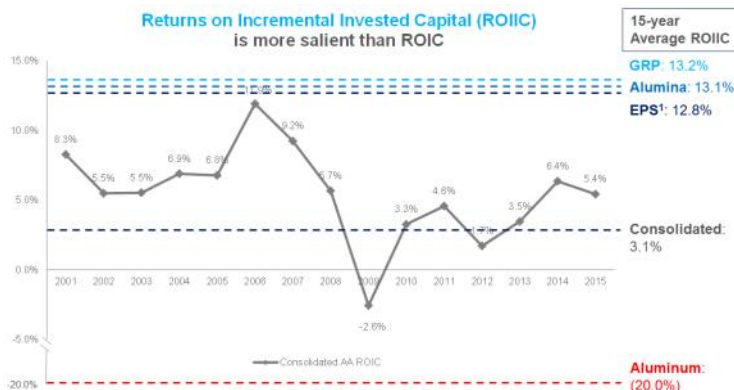
Alcoa is spinning off Arconic in the second half of this year (the company is aiming to begin trading as two entities in 2H16) and has not yet filed its Form 10, which will provide pro forma financial information for the separate business entities (AA is aiming to file the Form 10 in 1H16). The lack of visibility into segregated financial information and the difficulty of ascertaining even the most basic of financial metrics, namely ROIC, due to the opaque nature of consolidated financials are the sources of our contrarian view.

### Investment Thesis

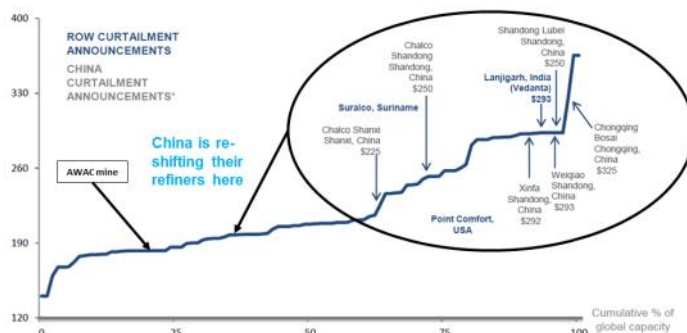
1) **Arconic's robust margin expansion opportunity:** The Engineered Products & Solutions (EPS) division within Arconic has significant margin expansion potential with EBITDA margins running at 10% lower than those generated by PCP. We believe that a substantial portion of this gap is transitory and can be closed over time.



Our team completed numerous conversations with the top institutional shareholders of Alcoa and it was immediately evident that the average investor oftentimes quotes AA's lackluster consolidated ROIC as a proxy of the supposed "low quality" nature of the business. We believe that this is greatly unfounded and primarily driven by the value-destructive nature of the aluminum business. In fact, the core franchises of Alcoa are quality business generating returns in the low to mid teens. For Alcoa, Returns on Incremental Invested Capital are more salient than ROIC (given that there is no split of debt and book equity by business unit in AA's consolidated financials; this is the primary driver behind why top shareholders and the company themselves have not been able to articulate an ROIC figure on a business unit level) and upon completing an analysis of the trailing 15 years, you can clearly see in the exhibit to the right that the core franchises of Alcoa, EPS, GRP and Alumina generate robust ROICs in the low to mid teens, while Aluminum has generated substantially lower returns of ~20%.



Global alumina cash curve by refiner



- **Sum of the Parts Valuation:** we believe Arconic's intrinsic value is ~\$14. We value the upstream business at \$2.1, which is ~\$0.30 higher than AWAC's publicly traded price. As a sanity check, we note that we have only ascribed \$.30 to the aluminum business, which is easily exceeded by the replacement cost of its assets (replacement value is pertinent due to the fact that in our analysis, we have determined that the aluminum business has not been able to generate returns on capital above its cost of capital)
- **Base Case Returns:** relative to current pricing of \$10.01, our target price of \$15.91 represents ~60% upside and ~19% IRR (2018).
- **Upside / Downside Ratio:** our Upside Case yields a price target of ~\$24 (+140%) and our Downside Case yields a price target of ~\$7 (-31%), which implies a favorable Upside / Downside Ratio of 4.5x.

### Potential sell-off of Upstream Co post spin-off for uneconom- ic reasons

- Security is mispriced today due to lack of segregated financial information for the Upstream Co & Arconic (Form 10 will not be filed for another few months)
- Post spin-off, we believe that the market will better appreciate the value of Arconic and have greater visibility into the underlying value of Upstream Co

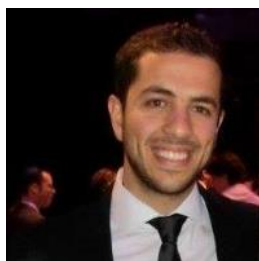
**Sum of the Parts Alcoa valuation**

Component	Value (\$B)
Alcoa AWAC value	\$1.9
Alcoa Primary metals	\$0.3
Alcoa upstream - base case	\$2.1
Arconic - w/o margin expansion	\$8.2
Arconic - margin expansion	\$5.5
<b>Alcoa</b>	<b>\$15.9</b>

Valuation Arconic	2018e	Berkshire Multiple	Public Comps Multiple	Base case Multiple	Per share
EBITDA	\$ 2,501	13.0x	9.5x	9.5x	\$ 12.78
EBIT	\$ 1,848	15.0x	14.5x	13.5x	\$ 13.68
NPV					\$ 13.77

Valuation Alcoa Upstream	2018e	Public Comps Multiple	Base case Multiple	Per share
EBITDA	\$ 1,161	8.0x	7.5x	\$ 2.25
EBIT	\$ 506	15.5x	15.5x	\$ 1.59
NPV				\$ 2.14

Consolidated	2018e	Multiple	Per share
EBITDA	\$ 3,662	8.9x	\$ 15.02
EBIT	\$ 2,354	14.6x	\$ 15.27
NPV		6x	\$ 15.91

**Simon Bennaim '17**

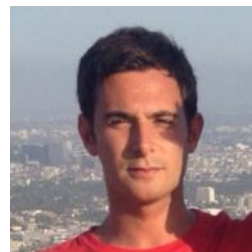
Simon is a first-year MBA student at Columbia Business School. Prior to CBS, Justin worked as an Investment Specialist at J.P. Morgan. This summer, he will be interning at XL Catlin.

**Deepak Prasad '17**

Deepak is a first-year MBA student at Columbia Business School. Prior to CBS, Deepak spent six years across venture capital, M&A, and IT consulting.

**Nick Turchetta '17**

Nick is a first-year MBA student at Columbia Business School. Prior to CBS, Nick worked at Fidelity Investments in global asset allocation. This summer, he will be interning at American Century Investments.

**Adam Walder '17**

Adam is a first-year MBA student at Columbia Business School. Prior to CBS, Adam worked in the private equity division at Allianz Capital Partners. This summer, he will be interning at Stelliam Investment Management.

## Alliance Data Systems (NYSE: ADS) - Long 9th Annual Pershing Square Challenge Finalist

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### Recommendation

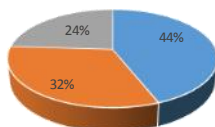
ADS is a BUY with a target price of \$370 per share (~73% upside) assuming a P/FCF exit multiple of 15x. A reasonable bear case yields 25% downside rendering an upside-to-downside skew of 3:1.

### Business Description

Alliance Data ("ADS" or "the Company") is the leading integrated provider of private label card services and marketing and loyalty solutions. Originally a card services business, ADS has been transformed to a unique platform that seeks to enhance end customer loyalty through a synergistic combination of three services-based businesses: private label credit cards ("Card Services"), marketing and data analytics ("Epsilon"), and loyalty solutions ("LoyaltyOne"), to a variety of a corporate customers.

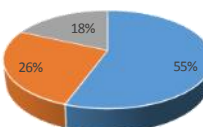
Having compounded revenue and earnings at a ~20% CAGR since 2007, ADS now generates more than \$7 billion of revenue and \$1.4 billion of pro forma 2016E EBIT. Its integrated network includes approximately 18,000 employees globally serving over 1,500 companies consisting primarily of large consumer-based businesses.

Revenue Contribution



■ Card Services ■ Epsilon ■ LoyaltyOne

EBITDA Contribution



■ Card Services ■ Epsilon ■ LoyaltyOne

### Investment Thesis

**1) ADS has a sustainable competitive advantage via its fully integrated platform that should afford continued market share gains as customers seek end-to-end marketing solutions.** Each of ADS' segments are strong on a standalone basis and have grown in excess of industry as each is highly differentiated. Card Services offers private label credit card programs to smaller customers, primarily specialty retailers, with smaller receivables portfolios (average of \$100mm). These retailers tend to lack in-house marketing teams and so, benefit from ADS' data analytics and marketing capabilities. ADS' cards are often the third or fourth credit card in a consumer's wallet and as such, the consumer tends to maintain balances. As such, ADS generates very healthy fees and net interest margins on its receivables portfolios, as manifest by its industry-leading return on assets (6.5% three-year average) and operating margins (36% three-year average). Second, Epsilon is the only end-to-end marketing and loyalty solution provider in the market. Epsilon has capabilities in all major segments including email marketing, customer loyalty, marketing database, customer engagement and agency services. Epsilon has competition in each area but its one-stop solution resonates with companies' chief marketing officers seeking one provider for all marketing and loyalty needs. Finally, LoyaltyOne, which operates Canada's leading coalition loyalty program, has dominant positioning in Canada with 70% household penetration and has fast-growing nascent operations in other markets such as Latin America.

That said, the real platform value is ADS' ability to leverage transactional data to curate credit card programs and marketing platforms. Theoretically, every Epsilon client can be a Card Services client and having a customer embedded in both platforms creates a high level of stickiness. Currently there is 15% customer overlap between the two businesses but this figure should be able to appreciate meaningfully over time. Recent customer wins speak to the strength of ADS' comprehensive model. For example, ADS won the contract to provide card services for Wayfair, an e-commerce retailer, Toyota, an international auto manufacturer. Both clients were existing Epsilon customers and chose ADS' Card Services given their satisfaction with ADS' marketing efforts. E-commerce and auto are verticals to which ADS is underpenetrated. ADS should continue to attack a larger addressable market by virtue of its strengthened integrated platform.

**2) Secular trends are moving towards private label credit cards from general purpose cards; the Company should disproportionately benefit from these tailwinds given its data-driven marketing solutions.** ADS' separate businesses have secular tailwinds that should drive top-line organic growth of over 10% over the next five years. Customers are very focused on the shift from traditional marketing to data-driven targeted programs which are delivered by Card Services and Epsilon. SKU-level data allows tailored advertising and promotions, which has yielded private label growth of 3x that of general purpose cards (e.g. 3% same-store sales at a retailer would translate to roughly 9% growth in private label card transactions). ADS is also picking up share gains as they are able to take on 12-15 new clients per year representing an additional 10% organic growth. In the marketing segment, digital advertising is growing at a mid-teens CAGR and over

In millions except share price data

Trading Statistics	
Share Price 4/15/16	\$214.77
Diluted Shares Outstanding	62.3
Market Cap	\$13,380
Excluding non-recourse Debt	
plus: operating debt outstanding (qtr end)	\$ 5,063
less: excess cash	1,687
Operating Enterprise Value	\$16,756

Summary Valuation	2016 E	2017 E
Operating EV/EBIT	11.9 x	9.4 x
P/E	19.9 x	15.0 x
P/FCF	13.8 x	10.8 x

Trading Statistics	
52-Week Range	\$176.63 - \$312.00
Dividend Yield	0%
Average Daily Volume (3 month)	157mm
Short interest as % of float	3.6%

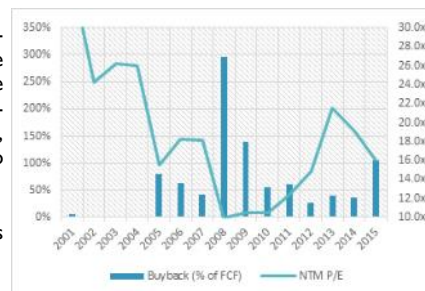
## Alliance Data Systems (ADS) - Long (Continued from previous page)

time, digital spend should eclipse traditional spend. ADS has added capabilities, largely through acquisition, to be well-positioned in digital.

**3) Management should continue to create value through savvy capital allocation.** The management team at ADS is led by Ed Heffernan, a best-in-class CEO with an outstanding track record. Since Heffernan's arrival at ADS in 1998, he has transformed the company from a singularly focused private label card services company to a full-service marketing solutions provider through several strategic acquisitions. Under his leadership, ADS ranks in the top 1% of S&P 500 companies in terms of shareholder returns, compounding at a rate of 21% p.a. since its IPO in 2001.

Heffernan has an incredible track record of accretive capital allocation, particularly during the last recession. During the depths of the crisis, Heffernan instituted a massive repurchase program to take advantage of trough valuations and repurchased ~30% of the Company's shares (see accompanying chart). These shares have compounded at an average of 22% p.a., creating tremendous shareholder value. Notably, Heffernan views the current environment as the most favorable since 2009 for repurchases and accordingly, has instituted a \$1.0 billion buyback for 2016. With Heffernan at the helm, management should continue to create value through clever return of capital, including share repurchases and acquisitions.

To drive continued growth, management is focused on aggressive, but profitable growth. Heffernan is specifically targeting 8-10% top-line organic growth per year and 10% free cash flow growth per year.



**4) The business model is defensible to withstand another recessionary environment. The current valuation already implies a bleak macroeconomic outlook.** ADS has recently sold off to a 2.5 year low driven primarily by concerns related to its credit card receivables portfolio and is now trading at trough multiples such as 12.7x forward P/E, which is in line with credit card peers (despite ADS' higher profitability) and well below multiples that its marketing services peers (e.g. Interpublic, Experian) enjoy. To this end, as ADS is composed of three businesses, the investor community tends to have issues appropriately valuing the Company; ADS occasionally trades at a premium like a marketing or fin-tech company and otherwise, at a discount like a credit-bearing institution. Currently, ADS has been given a valuation similar to that of a credit card peer and so, is not being given sufficient credit for its marketing and loyalty businesses.

However, ADS' diversified business model provides downside protection. While Card Services is a pro-cyclical business closely tied to macro data around consumer spending, Epsilon and LoyaltyOne are generally non-cyclical and tend to grow during downturns as they offer fairly cheap alternatives to customers seeking low marketing spend. With respect to ADS' receivables portfolio, we stress-tested the Company's balance sheet using charge-off levels generated during the financial crisis, and concluded that the Company should be quite profitable even assuming elevated charge-offs. In fact, a 50 bps increase in net charge-offs decreases cash EPS by ~10%. Further, ADS maintains a fortress balance sheet, is conservatively levered and generates significant free cash flow. As such, there is a real margin of safety at the current share price.

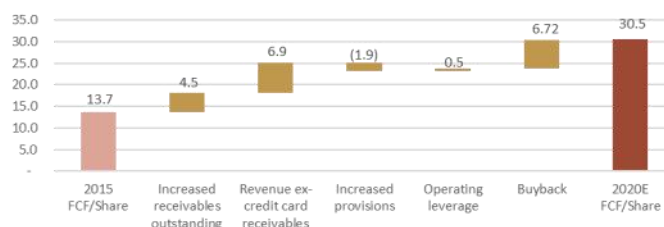
### Valuation

Our \$370 target price is based on a DCF using an exit multiple of 15x P/FCF (five-year historical average) and a discount rate of 10%.

Our projections assume sales growth of 12% CAGR through 2020 reflecting continued strong organic growth in Card Services, Epsilon and LoyaltyOne and incremental cross-selling revenue capture. In Card Services, provisions are based on expected charge-offs of 5.5%, which should closely reflect normalized levels. There should be margin improvement at Epsilon via more favorable product mix, as its higher-margin digital agency business contributes a greater proportion of EBITDA. Finally, in line with management's historical actions and guidance, the Company buys back \$1.0 billion of common stock per year.

Our bear case valuation employs an exit multiple of 10.5x P/FCF and a discount rate of 10%. Sales growth broadly decelerates to 8% CAGR through 2020 attributable to increased competition. Provisions then correspond to expected charge-offs peaking at 9.3% as they did during the crisis. In this scenario, ADS' pro forma share price is \$158, which implies ~25% downside.

Financials	2013	2014	2015	2016 E	2017 E	2018 E	2019 E	2020 E	CAGR
Revenue	4,319,063	5,302,940	6,439,746	7,529,514	8,245,511	9,268,459	10,227,918	11,300,902	12%
Revenue y/y change	18.6%	22.8%	21.4%	16.9%	9.5%	12.4%	10.4%	10.5%	
EBIT	1,098,912	1,098,467	1,261,860	1,407,802	1,790,560	2,244,391	2,664,261	3,295,890	21%
EBIT margin	25.4%	20.7%	19.6%	18.7%	21.7%	24.2%	26.0%	29.2%	
Net Income	496,170	506,293	596,541	672,267	891,153	1,136,126	1,359,691	1,716,745	
Net Income margin	11.5%	9.5%	9.3%	8.9%	10.8%	12.3%	13.3%	15.2%	
FCF per share	\$5.98	\$10.73	\$13.73	\$15.56	\$19.89	\$24.58	\$26.22	\$30.48	17%



### Key risk to thesis and mitigants

(-) A macro-driven decline in consumer spending could yield elevated losses in the private label portfolio. Further, the securitization market could then be difficult to access. **Mitigant:** Having stress-tested ADS' receivables using recessionary charge-offs, the Company maintained significant profitability. We expect that a 1% decrease in consumer spending would have a 2% effect on ADS' revenue. Also, generally consumer balance sheets and spending patterns are healthy and show little signs of deterioration. ADS was also able to access the capital markets during the crisis; 67%+ of its receivables funding are long-term. ADS has diversified its funding sources to be less reliant on ABS by using certificates of deposit.

(-) "Plastic cutting" in the U.S. could pose as a secular headwind in the card business. **Mitigant:** One-third of Card Services' sales do not employ a physical credit card; 40% of credit sales are currently conducted online. ADS' private label cards are compatible with applications such as ApplePay.

## Get Involved:

To hire a Columbia MBA for an internship or full-time position, contact the Heilbrunn Center at (212) 854-1933 or [valueinvesting@gsb.columbia.edu](mailto:valueinvesting@gsb.columbia.edu).

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### **Graham & Doddsville Editors 2015-2016**



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