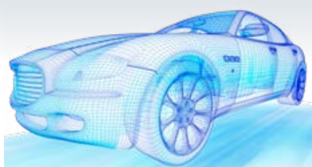
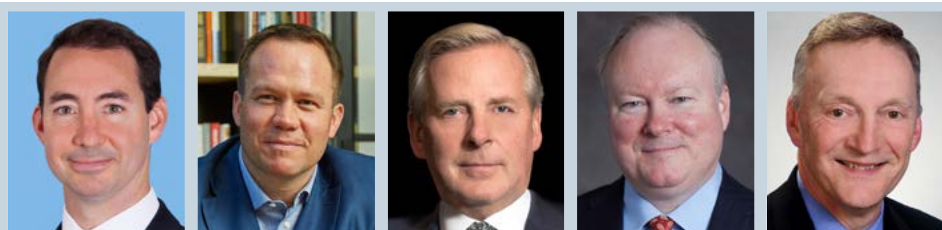
December 31, 2019

Value Investor INSIGHT

The Leading Authority on Value Investing



ON THE ROAD



Ben Preston | Daniel Malan | Alexander Roepers | Win Murray | Bernard Horn

It's been awhile now that valuations in the global automotive sector have seemed from a bygone era. General Motors' stock trades at 5.7x consensus 2020 earnings estimates. Shares of BMW, the class act of the manufacturers, trade at a 7.8x forward P/E. Buying into Canadian parts-supply giant Magna International will set you back a relatively rich 8.2x.

The challenges facing the industry are well known. The global cycle has turned down. Emissions regulations are becoming more onerous. Supply chains are threatened by trade conflicts. And oh, by the way, there are disruptive technologies at hand poised to dismantle the status quo.

This special report calls on five time-tested portfolio managers to offer their takes on whether today's auto-related stocks are attractive bargains, or classic value traps. Hint: These are investors not afraid to make contrarian bets. See page 2

Keeping an Open Mind

Most investors love "compounder" businesses. Not so Kris Medina, who's happy to pursue opportunities "where it's all about buying right and selling right."

INVESTOR INSIGHT

Kristofer Medina
Medina Singh Partners

Investment Focus: Seeks companies for which he believes he has a non-consensus and more accurate view of true earnings power over the next one to two years.

After two years each as an investment banker at JPMorgan and an investment analyst at hedge fund Ivory Capital, Kristofer Medina at the ripe old age of 26 founded Medina Singh Partners in 2010. "I'd been actively investing on my own since I was 16, knew this was what I wanted to do, and thought I had the understanding and ability to do it," he says.

The evidence so far supports that assertion. Medina Singh's long/short fund focused primarily on small caps has since inception at the beginning of 2011 earned a net annualized 13.8%, vs. 10.0% for the Russell 2000 Index. Often targeting less-than-glamorous industrial and basic-materials sectors, he sees mispricing today in such areas as paper products, plumbing equipment, vehicle components and hair salons. See page 14

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Driving Hard Bargains

Experienced auto-sector investors Ben Preston, Daniel Malan, Alexander Roepers, Win Murray and Bernard Horn describe how they're handicapping the numerous challenges and opportunities facing industry competitors and why they believe Toyota, Denso, Dongfeng Motor, Lear Corp. and Inchcape are uniquely well positioned to come out as winners.

INVESTOR INSIGHT

Ben Preston
Orbis Investments

"If and when electric vehicles do become profitable, the Hondas and Toyotas of the world will be fully prepared."

Has the auto sector over time been fertile investing ground for Orbis?

Ben Preston: We are long-term, contrarian fundamental investors. Long-term means we really do focus beyond what's happening in the immediate future. Contrarian means that we tend to find value when most people are looking the other way. And as fundamental investors we're really focused on the true value of the company as opposed to the stock's direction of travel.

We're not always invested in the auto sector, which historically hasn't been a great industry. It's quite fragmented, quite cyclical and doesn't have fantastic levels of growth. Solid players like Toyota [Tokyo: 7203] and Honda [Tokyo: 7267] earn 10% or so returns on equity over history – not terrible, but not fantastic. But as investors trying to compare stock prices at any moment in time to what we think true intrinsic value is, as the prices of many auto-related stocks have come down as much as they have we think the gap between price and value has opened up fairly wide. That has given us an opportunity to buy what we consider to be pretty good value bargains.

What do you consider the key reasons that value gap has opened up?

BP: One is the cycle. A couple years ago we were pretty close to some kind of global peak and now we're off that peak. Sales in China have been declining for 17 months in a row now. Europe has been weak and the U.S. has been sluggish as well. For us as long-term investors it's relatively easy to recognize that cycles come and go. You generally want to invest in the down phase of the cycle, which is what we think we're currently in.

But typically in the past here when share prices have declined in a cyclical downturn you'd see support on the downside from book value. The stocks wouldn't sell off to the full extent that earnings declined because investors could see through the current cycle and that it would reverse in time. Now you're seeing that confidence lost. Honda's stock, for example, has rarely traded below book value, but it's now at close to 0.7x its net asset value. Investors are either thinking the cycle will not recover or that companies like Honda will be overtaken by technological disruption, which is perhaps another way of saying the same thing.

Which brings us, of course, to the technological risks posed by electrification and autonomous driving and the resulting challenges to global industry players having to adapt to a changing landscape and protect themselves from new entrants permanently taking market share.

Let's take those one at a time. Describe how you're processing the advent of more prevalent electric vehicles.

BP: One thing that struck us early on was that electric cars are much simpler to make than a car with an internal combustion engine. Internal-combustion engines have been refined over 100 years and while they've become more efficient they have also become quite mechanically complex. An electric car is essentially a battery that connects to a turbine that connects to the wheels to propel the car. When you consider the remarkable feat of Tesla [TSLA] breaking into the market as a new entrant, perhaps part of the reason it got there was that making the cars wasn't that difficult. James Dyson, whose company has a long history of product innovation, abandoned his electric-vehicle experiment not because electric vehicles were too hard to make but because they were too easy to make and he couldn't see developing a competitive advantage. That's something to bear in mind.

Why have the other big car manufacturers allowed Tesla to lead the charge in getting behind electric cars? The answer is not because the incumbents can't do it, it's because the cars have not to date been profitable to sell – as Tesla has shown. Imagine if the situation in the industry history were inverted and electric vehicles were the standard and then someone came along with an alternative petrol engine promising longer driving ranges, faster and more convenient refills and much cheaper cars. That would likely have been a fantastically successful innovation. So it's not surprising that absent generous government subsidies in many places that real consumer demand from ordinary households for electric cars has been remarkably small.

If and when electric vehicles do become profitable – because the battery costs come sufficiently down, or subsidies encourage it, or the cost of running non-electric cars becomes excessively punitive because of regulatory regimes on emissions – the Hondas and Toyotas of the world will be fully prepared from a manufacturing,

sales and distribution perspective for that. The more we've followed the situation for electric cars, the more we've concluded it won't necessarily be a significant game changer after all.

The hype you see in the stock market is quite different from the reality on the ground. Tesla's market cap is 50% higher than Honda's, but with Honda you're getting more than 6x the revenue and 40 years of history as a profit-making enterprise. With Tesla you've got ten years of data and it's been loss-making in every single one of those ten years. That type of relative valuation makes little sense to us.

Autonomous driving?

BP: Here the more work we do the more it all seems very, very distant. The germ of the idea is that we have too many cars. You've heard the data point, each car is used for only one hour a day, which means it's standing idle for 95% of the time and we should all just share to bring costs down and increase the utilization of what we have.

That's a little misleading. I like to joke that I've got a toothbrush that I only use for six minutes a day, but that doesn't necessarily mean I want to share it with everybody. If you think about when everyone wants to use their cars, it's often at the same time of day. There are also plenty of other advantages to having your own car around convenience, practicality and safety. Reducing it all down to these simple catchphrases to us really skews the quality of the debate.

That's not to mention that on the technological side there are also a large number of barriers to overcome before we have safe execution at scale of autonomous driving. Just think about some of the unintended consequences. What if pedestrians, for example, learn very quickly that cars will stop as soon as you step out in front of them, so people just walk out in front of the cars all the time and expect them to stop? That's not just to point out an obvious and worrisome flaw, but in programming a car that can cope with human behavior you have to take into account that the human behavior may very well change because of the programming of the car. There is a very complicated feedback loop in there.

Whether autonomous driving gets there in the long term, who knows, but even if it does it does not necessarily follow that you'll get a big decline in industry sales because everybody wants to share.

ON RIDE SHARING:

I've got a toothbrush I only use for six minutes a day, but that doesn't mean I want to share it with everybody.

It might have a countervailing effect and more miles are driven. Cars wear out faster and replacement cycles get shorter. As time goes on we'll update how we incorporate autonomous driving into our valuation work, but for the time being it's not a material factor.

You mentioned regulatory regimes around emissions. Isn't that also increasing uncertainty around the sector?

BP: One of the things electrification does is give governments and regulators a legitimate pathway for pursuing green agendas that they quite rightly want to pursue. If there wasn't this alternative technology, there's less they could do to really change people's habits. It varies by country and over time, but we generally expect increasingly strict emission-control and fuel-consumption targets. That generally isn't a positive for the industry and gives companies a moving bar to get over. Everyone will have to deal with that and some will do a better job than others.

Your colleague Graeme Forster made the case over the summer [*VII*, June 26, 2019] for two auto-related ideas in very different areas of the market – Honda and China's Autohome [ATHM]. Is your thesis in each case still intact?

BP: The real gem with Honda is that it has 35-40% of the world's motorbike market, where it is the biggest player by a stretch in a more attractive industry sector than cars. The company made more money last year on motorbikes than cars, but the stock at 70% of tangible NAV is priced as if it's just a cyclical car-company basket-case. The shares historically have traded at an average price to book of closer to 1.5x. Given that motorbikes are actually a high-quality business that deserves a pretty decent P/E, the car business here – which is still among the world's best – is even cheaper. We think the value case for Honda is particularly compelling. [Note: Honda's U.S. ADRs, ticker symbol HMC, currently trade at around $28.25.]

Autohome is basically the Google for cars in China. If you're looking to buy a car you can find all manner of research and reviews on its platform as well as information on car specifications and available inventory. The company is the dominant market leader and makes money through advertising from OEMs and by generating leads for dealerships. The shares are under pressure because the new-car market in China has been in recession for a year and a half, but if you consider the current levels of car penetration in China it's not difficult here to see a long-term runway of growth. Also, if you look at how much Autohome charges per lead relative to what manufacturers and dealerships make per lead, we believe over time it can extract considerably more value through higher pricing. We don't believe either of those things is accurately reflected in the current share price [of around $81].

Flesh out in a bit more detail your investment case for Toyota.

BP: We generally believe that companies that are ahead of the game in achieving those emissions targets we discussed are in a much better position than those who aren't. That's a key reason we've gone with Toyota, which has a significant lead when it comes to hybrids, combining the technology of an electric car with the technology of a petrol one.

One of the key constraints in the rollout of electric cars is obviously the battery. It's heavy. It's expensive. There isn't close to enough lithium currently being produced to outfit 100 million new cars every year around the world with lithium batteries. So imagine you have a big lump of lithium that would allow on the one hand one all-electric car to run emission free, or on the other hand would allow 50 hybrid cars with far smaller and less-expensive batteries to run short trips around town emission free but would also be capable of taking longer trips. In the first case you reduce emissions by something like 2% – one car is all electric and the other 49 use petrol – while in the second case you reduce emissions by closer to 50%. All 50 cars are running emission free roughly half the time.

The point is that hybrids are an excellent way to get emissions down without forcing consumers into the highest-cost option, and we believe the technology plays a significant role in the industry's evolution. In our view Toyota's leadership in commercializing that technology provides it with a fairly significant advantage.

More broadly, the company is one of the biggest scale players – #2 in global market share behind Volkswagen – with a full product line not only in hybrids, but in big SUVs, minivans, small runaround cars, cars that run all petrol, all electric, or all hydrogen. Whatever the regulatory regime or consumer tastes, it can provide what suits the market at price points that work for it and for the consumer. It doesn't have to play games like selling more of certain types of cars in certain markets to get credits needed to offset emissions standards somewhere else.

A couple other things I would mention: Even in a weak market, both Toyota and Honda have been taking market share and growing nicely in China. Toyota also has one of the best balance sheets in the industry, which positions it to continue to make the investments necessary to compete. If you separate out the company's finance business – where the debt is more or less matched by the receivables on loans and leases – the industrial business has quite a lot of net cash.

How inexpensive do you consider the stock at today's price in its local market of just over ¥7,700?

BP: In most industries, a company with the characteristics I've described with respect to market leadership, technology prowess and financial strength would at the moment command a pretty sizable valuation multiple. But on next year's estimated earnings Toyota's stock is priced at a 9.6x P/E, vs. around 16x for the FTSE All-World Index. So you can ask, is Toyota an above- or below-average company? Maybe an historic average ROE of 9.6% isn't overly special, but it's not bad, and given the company's market and technology leadership you could argue the shares should trade at least near the average company's valuation.

While the future is never quite like the past, we believe how Toyota's stock has been priced on its fundamentals in the past is at least a fair guide for how it should be valued going forward. The stock price to tangible net asset value is currently only 1.1x, versus an historic average of 1.5x. We think the short-term upside may be

INVESTMENT SNAPSHOT

Toyota Motor
(Tokyo: 7203)

Business: Global automobile manufacturer selling a wide range of models under the Toyota, Lexus, Daihatsu and Hino brands; unit sales of 10.6 million in its latest fiscal year.

Share Information
(@12/30/19, Exchange Rate: $1 = ¥108.65):

Price	**¥7,714**
52-Week Range	¥6,161 – ¥7,949
Dividend Yield	2.6%
Market Cap	¥21.88 trillion

Financials (TTM):

Revenue	¥30.84 trillion
Operating Profit Margin	8.5%
Net Profit Margin	6.2%

Valuation Metrics
(@12/30/19):

	7203	S&P 500
P/E (TTM)	11.6	25.5
Forward P/E (Est.)	9.6	19.8

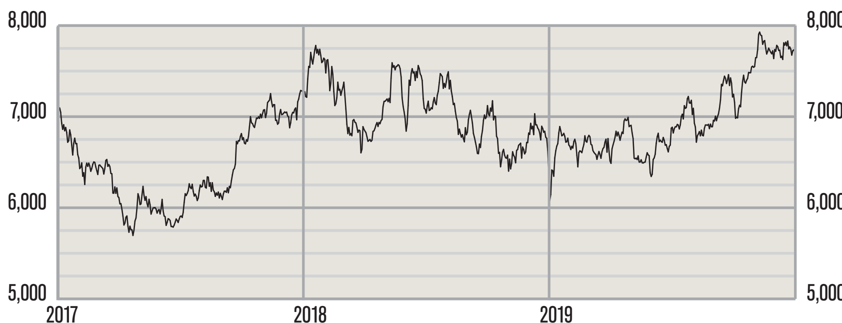
Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Sumitomo Mitsui Trust	2.7%
Vanguard Group	2.1%
Nomura Asset Mgmt	1.9%
BlackRock	1.1%
Norges Bank Inv Mgmt	1.1%

Short Interest (as of 12/15/19):

Shares Short/Float	n/a

TOYOTA PRICE HISTORY



THE BOTTOM LINE

In most industries a company with the market leadership, technology prowess and financial strength of Toyota would command a "sizable valuation multiple," says Ben Preston, not the 1.1x tangible net assets at which its stock trades. At its historic average NAV multiple the stock would trade 35% higher, he says, on a book value growing 8% annually.

Sources: Company reports, other publicly available information

limited by where we are in the industry cycle, but eventually just closing that gap to average would provide a fair amount of upside. On top of that, tangible book value has grown over the years – and we believe can continue to grow – at an 8% or so annual rate.

INVESTOR INSIGHT

Daniel Malan, Mikael Liefferink
Perspective Investment Management

"Parts suppliers should offer more diversity, stronger balance sheets, better operating efficiencies and higher economic returns."

You over the past year took a deep research dive on the global auto industry. What prompted that?

Daniel Malan: We generally seek out businesses that meet our four core investment criteria: understandability, trustworthy owners and leaders, robustness and cheapness. It's a sequential process. If we can't understand the industry or company, we don't do any further work. If we don't trust the people who own and run the show, we don't do any further work. If it doesn't have a super strong balance sheet, we stop. Only then do we get to valuation. We respectfully disagree with the notion that there's a price for everything – there's a large part of the investment universe we won't touch at any price.

Against a backdrop of an expensive market environment, there have been very few industries and geographies that appear to offer the potential of robustness – by which we mean the ability to weather difficult times and provide sustainable, solid returns – at attractive prices. One of the more interesting ones to examine was the auto industry.

Mikael Liefferink: When we think about understandability, this considers not only how a company makes money but also why its stock might be cheap at a point in time. In the auto industry there have been several potential reasons, including dwindling new-vehicle sales growth, trade wars, major economic uncertainty in some key geographies and emissions legislation becoming increasingly punitive. Headline-grabbing governance issues at Volkswagen and Nissan haven't helped either. At the same time, investors have been spooked by disruptive technologies such as electrification, autonomous driving and mobility as a service (MaaS). All of this has created considerable uncertainty and has obscured short-term earnings visibility, which the market detests.

We built our research plan around understanding the legitimacy of the feared disruptions and then determining how each of the industry participants were positioned in anticipation. That involved building peer sets for both original-equipment manufacturers and auto-parts suppliers to evaluate the robustness of the companies on an absolute and relative basis and to identify those that were best-in-class. We tried to understand through all means possible the impacts of disruptive technologies on the industry and on individual companies, which included diagramming from the ground up the components of a vehicle with an internal-combustion engine versus one powered by an electric battery [*see diagram on p.6*].

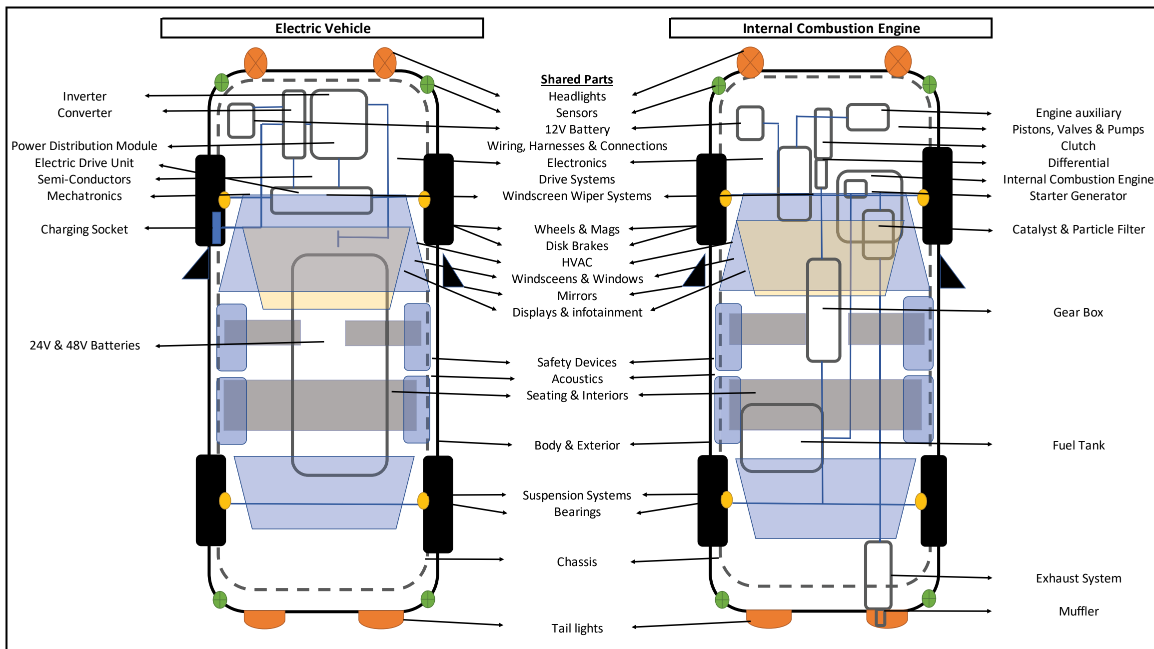
Some of our important conclusions: We expect internal-combustion engines, predominantly in hybrid form, to still be used in 80% of new vehicles even 20 years from now. Given the relative sizes of the global used- and new-car markets, aftermarket parts and supplies will take much longer to be disrupted by new trends. Auto-parts companies are increasingly trusted by OEMs to manufacture more of the vehicle, and the deepening of the cooperative alliances between OEMs and suppliers has resulted in fewer parts suppliers with the proven quality, know-how and responsiveness to deliver on a global scale. In addition, legislation, investment and customer demand differ from one geography to the next, which affects the rates of new-technology adoption.

All things considered, we believe the market has been overly punitive toward manufacturers of internal-combustion engines and parts and that auto-parts suppliers appear the better investment relative to OEMs. The stock valuations in each subsector are similarly attractive, but we believe the parts suppliers should offer more diversity, stronger balance sheets, better operating efficiencies and higher economic returns over time.

Describe why the three suppliers that have made it into your portfolio – South Africa's Metair [Johannesburg: MTA], Canada's Magna International [MTA] and Japan's Denso [Tokyo: 6902] – did so.

DM: The short answer is that these were the companies that in combination met all of our criteria with respect to end-customer exposure, end-product exposure, geographic diversification and product-obsolescence risk. They all have a proven history of being focused on research and development and have already invested in and commercialized important new technology ahead of the curve. Each individually also met our core investment criteria of understandability, trustworthy owners and leaders, robustness and cheap stocks. We're essentially thinking of these three investments as one idea in the portfolio that provides us with highly liquid, diversified access to the best businesses in the world in this industry.

ML: Metair is focused on South Africa, the Middle East and Europe and divides its product mix into two verticals, energy and auto parts. The energy vertical, which accounts for about 60% of revenues, provides smaller-scale batteries that we believe should remain relevant in hybrid as well as fully-electric vehicles. Magna International is more of a North American and European business – just over 50% of



As part of their assessment of investment opportunities in the global auto sector, Mikael Liefferink and Daniel Malan of Perspective Investment Management prepared this schematic comparing the individual components of a vehicle powered by an internal combustion engine with one powered by an electric battery.

sales are in North America, with 40% or so in Europe – and has a wide range of products for things like the chassis, seating, lighting and heating of the vehicle that should overlap nicely in both ICE and EV environments.

Go into more detail on Denso, whose largest customer as well as shareholder is Toyota Motor.

DM: Denso is the second-largest global auto-parts manufacturer, after Germany's Bosch, supplying new parts to original-equipment manufacturers and replacement parts to the aftermarket. It has grown up with Toyota, which still owns about one-third of its stock, but has a broad product mix across air-conditioning systems, engine-control systems for ICE and hybrid vehicles, electronic systems and sensors. Toyota remains the largest single customer, accounting for roughly 50% of annual sales, and Denso's main markets are in Japan and the rest of Asia, which make up 65% of total revenues.

Like many Japanese companies it generally outspends its competitors in terms of innovation, typically putting 10% of annual sales back into R&D. We love companies like this who are willing to sacrifice short-term benefit for long-term robustness – provided that spending eventually ends up benefitting the long-run business economics. When that's a habit, it also allows an additional element of flexibility in a declining business cycle – they can cut costs for a time without harming the business long term.

ML: Building on the case for robustness, Denso historically has been able to generate strong free cash flows even in severe economic downturns. Cash-flow conversion remains very high. The balance sheet is rock solid, with net cash and plenty of flexibility if the company needed to step up borrowing, which it hasn't needed to do. Finally, like a lot of Japanese companies, Denso owns various assets – like parts businesses for industrial and agricultural equipment – that it could easily sell if it had to.

We assume you think Toyota is a trustworthy control owner.

DM: We do. Not only has it invested in its own business to position itself well both geographically and in terms of product mix – which obviously benefits Denso – but it also has acted responsibly in its governance. We pay careful attention to the behavior of control owners toward minority shareholders at various points in the cycle, particularly any attempts to dilute our position at extreme market-cycle lows or highs. Toyota has had several opportunities to try that over the years and it hasn't done it. This is not a guarantee that it will never happen, but at least we have evidence to support this aspect of our thesis.

The shares at just under ¥5,000 trade at 30% below their highs of two years ago. What upside do you see from here?

ML: The story would be similar for other metrics as well, but if you look at the company's history going back to 1980, the evidence suggests that the best time to buy the stock is when the ratio of enterprise value to sales falls below the long-term median of 0.9x, and the best time to

INVESTMENT SNAPSHOT

Denso
(Tokyo: 6902)

Business: Manufacturer of automotive components used in powertrain, thermal, safety, electronics and informational systems; Toyota is both its largest customer and shareholder.

Share Information
(@12/30/19, Exchange Rate: $1 = ¥108.65):

Price	**¥4,966**
52-Week Range	¥4,081 – ¥5,225
Dividend Yield	2.8%
Market Cap	¥3.85 trillion

Financials (TTM):

Revenue	¥5.36 trillion
Operating Profit Margin	5.7%
Net Profit Margin	4.6%

Valuation Metrics
(@12/30/19):

	6902	S&P 500
P/E (TTM)	15.8	25.5
Forward P/E (Est.)	14.5	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Nomura Asset Mgmt	2.8%
Vanguard Group	1.6%
Daiwa Asset Mgmt	1.3%
Nikko Asset Mgmt	1.3%
Norges Bank Inv Mgmt	1.2%

Short Interest (as of 12/15/19):

Shares Short/Float	n/a

THE BOTTOM LINE
The company's R&D emphasis and close ties to Toyota position it well to ride out cycles and thrive as vehicle technology evolves, says Mikael Liefferink. Assuming revenue growth and margins in line with history, if the shares return to the high end of their past valuation range he'd expect to earn an annual 15-16% five-year return from today's price.

Sources: Company reports, other publicly available information

sell – which has happened five times over the past 40 years – is when EV/Sales approaches or exceeds 1.2x. The ratio at today's price is just over 0.7x, which is one standard differentiation cheaper than the median over time.

In our base-case model we assume annual revenue growth of 5%, in line with long-term medians and the experience over the last five years, and that operating margins return to the long-term average of about 8%. If the EV/Sales multiple gets to even 0.8x, with those assumptions we'd have a roughly 8% annual return in Japanese yen on the stock over the next five years, including dividends. Holding all else the same, if in the optimistic case the valuation got back to 1.2x EV/Sales, our five-year annual return would be 15-16%.

DM: We always look if possible at 40 years or more of market history when we evaluate a stock, and in this case we believe this is hard and stable valuation data that is relevant to the company's current situation.

I can share with you that for pretty much any asset in the world – stocks, orange juice, pigskins, gold, silver – over any 21-year period you generally find three fantastic buying opportunities and three fantastic selling opportunities. It's almost a biblical thing, with the lean years followed by the fat years. To me that dovetails with the logic of it around business cycles and around market cycles, where companies, industries and indeed many things in life seem to go serially out of fashion and then serially back into fashion.

We spend a lot of our time looking for big dislocations where the entry point into the proverbial seven-year cycle is significantly attractive. We think the auto sector – specifically the auto suppliers – is giving us that kind of opportunity today.

INVESTOR INSIGHT

Alexander Roepers
Atlantic Investment Management

"Powertrain electrification and autonomous driving are dominating the narrative today, almost to a nauseating degree."

As someone who has been investing in auto and auto-parts companies for decades, how would you characterize the investor sentiment around them today?

Alexander Roepers: These companies have been integral elements of our investment universe, which focuses on industrials with $1 to $20 billion in market cap. We look at the sector globally and have tracked almost every company in it for 30 years. We attend many of the important auto shows and are in regular touch with key industry participants up and down the value chain.

Powertrain electrification and autonomous driving are dominating the narrative today, almost to a nauseating degree.

I say that because so many of the related tangible impacts are quite far in the future and the talking points can be superficial. I remember hearing a speech by the head of the U.S. National Transportation Safety Board to an industry audience in which he pointed out that for 50 years we've had automatic-pilot technology on large ships and airplanes, but still no one today would get into either one without qualified people in the cockpit or on the bridge. And, with both airplanes and ships there is more time to respond than in a car. That's not to say autonomous driving won't develop, but it is highly unlikely to happen at the pace many people think and if it does it will be mostly in controlled environments.

People are throwing out the baby with the bathwater when it comes to these narratives. An obvious example is how the traditional car companies are trading versus Tesla [TSLA], the clear leader in the electrification trend, but one that still has to prove that it can be sustainably profitable. We were at the auto show in Frankfurt this past September and everything was about electrification. Electric cars were literally hanging from the ceiling. At the show, Tesla's cars were absent, but its head of investor relations gave quite an impressive presentation, describing how the traditional car makers remained far behind and that its market share continued to rise. Recently Tesla announced that it will be opening a big factory near Berlin, right in the backyard of all these German carmakers. They are masters at messaging and their stock's valuation proves they're successful at it.

I'm not here to trash Tesla – we actually came out of that presentation impressed, prompting us to cover our short – but we don't believe the capability gap it currently enjoys in electric cars is permanent given the massive spending by the traditional carmakers to catch up. As the capability gap closes over time so will the gap in respective valuations.

Some of what's impacting auto-related stocks are good old-fashioned cyclical concerns. How are you processing those?

Kristian Gevert: We've now had four quarters in Europe and China where volumes have declined fairly dramatically. Unit sales in China are down about 10% in 2019 after strong growth through much of the decade, due primarily to a cooling economy, tighter credit and the tariff and trade situation. Europe is down 5-6% amid continued pressure from more stringent emissions regulations; car companies will have to slash their fleet's carbon-dioxide emissions next year to avoid paying substantial fines.

ON TESLA:

I'm not here to trash Tesla, but we don't believe the capability gap it now enjoys in electric cars is permanent.

We're not calling the bottom of the cycle, but we do consider the global market to be stabilizing at a lower level, with potential upside from China. Many auto suppliers, particularly in Europe, had to hit the brakes pretty hard and pulled production levels down significantly. That should at least result in improved profitability next year as companies had time to adjust. In any event, at today's valuations we don't have to be optimistic about the cycle in 2020 to see value in auto-related stocks.

Give an example of an auto supplier you're bullish on today, Germany's Continental AG [Frankfurt: CON].

KG: Continental has been working through issues related to the market weakness in China, where it had invested heavily in growth initiatives, and related to difficulties in Europe, where its restructuring efforts have been painfully slow. One part of our thesis is that corrective actions taken are just now starting to show through.

We also like that the company has a stable, cash-generative business selling tires – accounting for some 60% of operating profit – that if anything could be positively impacted by the advent of electric cars, which are heavier and need more-expensive tires. On the auto-parts side, Continental has an attractive product portfolio that will soon be powertrain agnostic, in high-value-add areas such as infotainment, electrification and advanced driver-assistance systems. The company recently announced that it plans to spin off its powertrain business, Vitesco Technologies, next year. We think that the separation will better highlight the value of the remaining businesses.

AR: This is a stock that less than two years ago traded at €240 per share. We're in around €120 and it now trades at around €115. With even a slightly improved cycle, the earnings should increase significantly. When the powertrain business spins off, we expect a positive re-rating of the company. That combination should result in a much higher stock price than where we are today.

Is your interest in Chinese car manufacturer Dongfeng Motor [Hong Kong: 0489] as much a bet on the market as it is the specific company?

Allan Chang: The current automotive cycle in China is clearly not good – in the modern era there have never been two years in a row of negative growth in new-car sales in China before 2018 and 2019 – however we remain positive on the Chinese car market long term. The population is roughly 4x that of the U.S., but annual new-car sales are running at only around 20 million, versus the current 17-18 million in the U.S. From a market-penetration standpoint, there's a lot of runway for growth.

Dongfeng is one of the key state-owned enterprises in the auto sector in China. It sells its own branded vehicles, but the significant majority of its profits are generated through 50/50 joint ventures with – in decreasing order of importance – Nissan Motor, Honda Motor and Peugeot. The company is also a key player in the com-

mercial-vehicle sector, where it sells heavy-duty trucks under its own brands and has roughly 10% market share. That's about the same share it has with all its venture partners in the Chinese passenger-vehicle market.

Even though the industry is down in China, the Japanese JVs have been doing well and are taking market share in the downturn. Japanese management in general had the foresight to primarily put local managers in charge of the businesses and as a result their JVs have been successful in tailoring their product offerings to the Chinese market. We expect that to continue to be a positive for Dongfeng going forward.

Is Dongfeng well positioned for the increasing penetration of electric vehicles in the Chinese market?

AC: Just a few weeks ago the government clarified its electric-vehicle penetration goals for 2025, setting targets for roughly seven million EVs sold by then, versus around one million today. Local Chinese brands thus far have been the biggest players in EVs, and Dongfeng is right there, but as the market opens up its Japanese JVs – which also have good technology – should benefit also from the increased EV sales. We wouldn't necessarily say the company is better positioned on this front than others, but it certainly shouldn't be at a disadvantage either.

Some Chinese restrictions on foreign ownership in this industry have been lessened and BMW, as a first example, is taking full management control of its subsidiary. Is something like that a risk for Dongfeng?

AC: The Nissan and Honda JV agreements currently in place run for another 20 years or so. These JVs are so well run and generate so much cash that we don't believe it would make sense to interfere with the current structure. We think all relevant parties here agree. If anything, we'd argue that Dongfeng should try to increase its stake in the JVs so that it could consolidate the results on its own financials. That would better highlight value and would likely lead to a significant re-rating of the stock. Again, for the foreseeable future, we're not expecting any changes.

Now at HK$7.35, how are you valuing the shares?

AC: There's a lot of value here. The current market cap in U.S. dollars is around $8.5 billion. The stake the company took in Peugeot when it was in dire straits in 2014 – and which Dongfeng recently agreed to sell down to no more than 5% of the company as part of Peugeot's agreement to merge with Fiat Chrysler – is now worth about $2.7 billion. There's also net cash on the industrial company's balance sheet, not including the finance subsidiary, of close to $2 billion. After netting those two items out, we're buying the operating business today at a 2x P/E, which doesn't even take into consideration the net cash the Honda and Nissan JVs have on their own balance sheets, which is substantial.

We think the company can generate around HK$2 in earnings per share next year. Assuming a P/E of 7x, which is within the historical range, the shares could reach HK$14 in the next 12 to 18 months.

INVESTMENT SNAPSHOT

Dongfeng Motor
(Hong Kong: 0489)

Business: Partly state-owned Chinese manufacturer of commercial vehicles, automobiles and automotive parts; joint venture partners include Honda, Nissan, Renault and Peugeot.

Share Information
(@12/30/19, Exchange Rate: $1 = HK$7.79):

Price	**HK$7.37**
52-Week Range	HK$5.87 – HK$8.80
Dividend Yield	5.3%
Market Cap	HK$63.50 billion

Financials (FY2018):

Revenue	HK$104.54 billion
Operating Profit Margins	(-0.9%)
Net Profit Margin	13.8%

Valuation Metrics
(@12/30/19):

	0489	S&P 500
P/E (TTM)	4.3	25.5
Forward P/E (Est.)	4.4	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Westwood Global Inv	8.1%
Fidelity Mgmt & Research	7.5%
Invesco Asset Mgmt	6.6%
Edinburgh Partners	5.4%
Eastspring Inv	5.0%

Short Interest (as of 12/15/19):

Shares Short/Float	n/a

DONGFENG PRICE HISTORY

THE BOTTOM LINE

After accounting for the company's stake in Peugeot and the net cash on its balance sheet, Allan Chang says the company's operating business – anchored by joint ventures in China with Honda and Nissan – is currently valued at only 2x earnings. At a more reasonable 7x his overall-company 2020 EPS estimate, the shares would trade at HK$14.

Sources: Company reports, other publicly available information

If you take into consideration the Peugeot stake and the net cash, the stock could trade well above that.

The biggest risk?

AC: The shares are already trading near a ten-year low and have shown strong technical and fundamental support in the HK$6-7 per share range. To go much below that we would probably need a worse-than-expected turn in the trade war and a stronger hit to the Chinese domestic economy. That scenario wouldn't be impossible, but we think the probability of it occurring is low.

INVESTOR INSIGHT

Bernard Horn
Polaris Capital

"Auto-related companies have shown up on our screens often as having cash-flow streams that appear undervalued."

You've described in the past [*VII*, May 31, 2015] how you filter your global database to identify potential ideas for further research. Have auto-related stocks been on your radar screen?

Bernard Horn: Just to summarize briefly our process, we determine for each company in our database a trailing level of maintenance cash flow. That's operating cash flow adjusted for the maintenance capital spending we believe is necessary to keep that operating cash flow constant in real terms. We then filter out companies based on things like balance-sheet leverage and when cash flow as a percentage of sales or per fully diluted share is declining over time. After the filters are run, the database ranks the remaining companies – usually 2,000 or so out of 40,000 at the start – based on the maintenance cash flow yield on the current market value. If that yield is greater than 9%, which is the long-term real return on global equities plus the 2% excess return we hope to earn, that's a candidate for further work.

Auto-related companies have been showing up on our screens often as having cash-flow streams that appear undervalued. It's an area we've spent a good amount of time on.

Auto suppliers appear to have particularly caught your attention. Explain why and describe a few that have made it into the portfolio.

BH: Even with all the technological change going on in the industry, we generally believe that demand for driving isn't going to decrease, and that producing parts for the 90 to 100 million new cars built every year and for the even bigger aftermarket provides a solid backdrop for well-positioned suppliers. That's even more true today now that the supply industry in many cases has consolidated to the point where these are better businesses with improved pricing power.

For Hyundai Mobis [Seoul: 012330], we like that it is a primary supplier to large shareowners Hyundai Motor and Kia Motors, which have been steadily gaining global market share as a result of producing higher-quality cars, moving upmarket and expanding geographically. The company's relationships with Hyundai and Kia are also structured in a way that gives Hyundai Mobis more of the responsibility – and margin – for aftermarket sales. That's rather unique and a positive for the business model.

An example of a more broad-based supplier we own would be Magna International [MGA]. It has an extensive product lineup, a diverse customer base and a strong geographic footprint. We believe they've developed their product mix in a way that those lines benefitting from electrification will continue to compensate for any lines that might be hurt, and we see their move to assemble entire cars in some cases for companies like BMW as an interesting developing business. There is sometimes drama around the founding family that still owns a significant stake in the company, but for the most part we think it's very well managed and that management is focused on maximizing free cash flow for shareholders.

We also have a stake in Michelin [Paris: ML], which as a premium supplier of tires is actually primed to be a beneficiary of the move to electric vehicles. Electric cars are heavier, put more torque on tires and require more premium features around things like sensing and noise reduction. That should mean more value-added pricing as well as shorter replacement cycles. Higher-end players like Michelin, Bridgestone [Tokyo: 5108] and Pirelli [Milan: PIRC] are likely to incrementally capitalize on that changing environment relative to the more commodity suppliers in the market.

You also own U.K.-based Inchcape [London: INCH], which operates in a rather unique place in the industry. Describe why you're high on its prospects.

BH: This is an interesting niche player, which basically helps original-equipment car manufacturers enter markets that are too small or difficult for the OEM to want to go it alone. The manufacturers build the cars but Inchcape handles everything from product planning, to distribution, to marketing and sales in order to bring the cars successfully to market. The company has seven core OEM partners – Toyota/Lexus, Jaguar Land Rover, Suzuki, Mercedes-Benz, Volkswagen, BMW and Subaru – and currently operates in 31 markets. It has represented Toyota, for example, for over 45 years in the U.K., Hong Kong and Singapore. As another example, one recent big success has been bringing Subaru into Australia.

In many ways this is a bet on the growth potential in developing markets. The geographic footprint is already broad and well diversified and management con-

tinues to push the company deeper into faster-growing areas. With such diverse partners, it has a wide range of products to offer, and the more fully it establishes itself in individual markets the more operating leverage it has and the more effective a partner it can be.

The company's stock can be somewhat volatile when there's bad news in individual countries, but that becomes less of an issue as they continue to diversify their revenue streams. And while cycles go up and down we think the long-term story of more cars being sold in developing markets will remain intact.

How often do partners pull business back in house?

BH: That is a risk but it hardly ever happens. The individual markets generally don't get big enough to warrant that, and the breadth of what Inchcape handles makes it less likely for an OEM to want to take all aspects of that on. This is not just a manufacturers-rep type of relationship where the OEMs are responsible for most things other than sales.

At a recent price of around £7.10, how cheap do you consider the shares?

BH: The company currently generates annual maintenance free cash flow as we define it of around £275 million. That results in a free-cash-flow yield of close to 10% on today's market cap.

In our model we assume conservative real revenue growth of only about 1% per year over the next five years. We expect some very modest margin improvement driven by higher growth in Asia and emerging markets and the divestment of some low-margin retail operations. With those what we think are conservative assumptions, we estimate from the current stock price that we can earn north of a 10% real return on the stock. While that's high for today's market, a number of auto-related stocks are trading in that range. What stands out for us here is the growth potential – which we're not fully building in – as the company deepens its relationships and broadens its geographic footprint.

INVESTMENT SNAPSHOT

Inchcape
(London: INCH)

Business: Distribution, marketing and sale of passenger vehicles in secondary global markets through partnerships with a variety of original-equipment auto manufacturers.

Share Information
(@12/30/19, Exchange Rate: $1 = £0.76):

Price	**£7.07**
52-Week Range	£5.36 – £7.20
Dividend Yield	3.7%
Market Cap	£2.82 billion

Financials (TTM):

Revenue	£9.39 billion
Operating Profit Margin	3.9%
Net Profit Margin	0.6%

Valuation Metrics
(@12/30/19):

	INCH	S&P 500
P/E (TTM)	54.8	25.5
Forward P/E (Est.)	13.3	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Standard Life Inv	6.4%
M&G Inv Mgmt	4.5%
Vanguard Group	3.4%
Norges Bank Inv Mgmt	3.2%
Polaris Capital Mgmt	3.0%

Short Interest (as of 12/15/19):

Shares Short/Float	n/a

INCH PRICE HISTORY

THE BOTTOM LINE

The company's niche in partnering with car manufacturers to enter new geographic markets makes it a "bet on the growth potential in developing countries," says Bernard Horn. Even with only 1% real annual revenue growth and "modest" margin improvement over the next five years, he believes he can earn a 10%-plus real annual return on the stock.

Sources: Company reports, other publicly available information

INVESTOR INSIGHT

Win Murray
Harris Associates

"If I were to generalize, today's technological innovations aren't dramatically impacting our valuation estimates."

Harris Associates is no stranger to investing in out-of-favor cyclicals, which one could argue is a somewhat out-of-favor investing style at the moment. Why do you think might be?

Win Murray: I'm not going out on a limb to say that many "active" investors have short time horizons. Their clients often don't give them permission to hold stocks

based on a five- to seven-year outlook if there's a risk they might be wrong for the first half of that. To avoid getting fired, managers care more about news flow than what a business might be worth to a strategic or financial buyer or based on conservative estimates of future cash flows.

The news flow around the auto sector isn't great at the moment. Unit sales have been weak globally, particularly in China and Europe. There's concern about tariffs. There's concern about emissions regulation. There's concern about the longevity of the U.S. economic expansion. There's concern about the U.S. election. That's not to say these types of things won't impact cash flows, but if you look out three to five years as we do, in many cases they just wash out. But stocks can decline as if those cash flows are permanently impaired, which is what we believe is happening in many cases in the auto sector today.

Complicating things further is the legitimate issue of how technological innovation could impact the demand for products sold by existing industry players up and down the value chain. This we're very interested in, but if I were to generalize, those innovations aren't dramatically impacting our valuation estimates. Autonomous driving in some areas like long-haul trucking may have a more material impact on valuation, but given the time frames over which we think this rolls out we generally don't consider it a big factor. Maybe if we were doing a discounted-cash-flow analysis we'd take it into consideration in thinking about the terminal value 10 to 15 years out.

Electric vehicles are certainly more of a near-term issue, but even there, if you consider the length of time it will take to convert the current fleet from internal-combustion engines to electric – given the low penetration of electric in new-vehicle sales and given the remaining life of the existing fleet – it's not something that dramatically impacts our value estimates.

Even if it isn't having a big impact on your valuations, we assume your views on how technology is evolving plays a big role in where you're placing your bets.

WM: Of course. A good example of that is that we believe there will be a long period of transition to battery electric vehicles that relies on more affordable hybrid solutions. So while the market is down on a supplier like BorgWarner [BWA] because of its exposure to the internal-combustion engine, we actually believe its expertise in efficient powertrain and clutching technologies makes it well positioned to capitalize on the transition to hybrid vehicles.

The company typically outgrows the auto market by 400 to 500 basis points per year as stricter global emission standards increase adoption of its products that make engines and drivetrains more efficient. As it has further transitioned its product mix, 70% of the current backlog through 2021 is for components on hybrid electric vehicles. Despite what we consider to be durable growth prospects and strong returns on capital, the stock [at around $43.50] trades at only 11x this year's expected earnings. If we're right that earnings in a couple of years approach $5 per share and that the quality of the business warrants at least a 15x P/E, we'll see quite a bit of upside from here.

ON TRANSITION:

There will be a long period of transition to electric vehicles that relies on more affordable hybrid solutions.

Are you generally finding opportunity more in auto suppliers than OEMs?

WM: We own both – there is a price for everything – but we generally think suppliers are better businesses than OEMs. Suppliers in many cases were even more aggressive than the car manufacturers coming out of the financial crisis in restructuring their balance sheets and reducing onerous pension and labor obligations. They have also consolidated quite a bit, to the point where in most segments of the market there are only two or three players with the global scale necessary to supply the big OEMs. That's not to say there isn't plenty of competition, but that consolidation has made it a better business.

We don't believe the market recognizes that. Industrial companies exposed to the same economic cycles still trade at material valuation premiums to auto suppliers. That in our view reflects more the historical belief that auto supply is a terrible business than is warranted today.

Describe the investment thesis for Lear [LEA], one of your largest auto-supplier holdings.

WM: Lear's primary franchise is in seating, where it earns roughly 70% of its operating income and is one of only three truly global manufacturers, along with Magna International and Adient [ADNT]. The company has been taking share in seating – it now has 23% of the market, up from 18% in 2012 – and it's a higher-return business than it appears at first blush. They often manufacture the seats at partner OEM facilities and literally have to hold finished-goods inventory less than 30 minutes as the seats come up through the factory floor and get installed into the cars. So while seating operating margins are currently around 8%, the returns on capital are well into the teens and the business is very cash generative. The company has produced enough cash to fund all its business investment, make acquisitions, and retire nearly 50% of its outstanding shares since 2011.

How exposed is the seating business to technology disruption?

WM: It's actually one of the areas with incremental opportunity to grow content per vehicle as a result of electrification and autonomous driving. For example, in a car powered by an internal-combustion engine, if you want heat you just open the vent between the engine and the cabin and heat naturally comes in. Electric vehicle engines don't create heat in the same way,

so carmakers are going to need to find ways to heat (and cool) the cabin more efficiently in order to save battery life. It's likely that will involve more seat-specific climate control, to avoid having to heat or cool the entire cabin in the traditional way. That has the potential to considerably increase the content per vehicle for seating manufacturers.

If you think about autonomous or shared driving, you can imagine vehicle seat configurations that are much different than those that exist today. Fleet operators may see seating as a competitive, premium differentiator. Seats could be required to move in different and more complicated ways. You may even see some safety features like airbags built into seats rather than the frames of vehicles to accommodate new seating layouts. All this could provide another big content opportunity for seating manufacturers.

We don't think any of this is going to happen soon, but the point is that the risk is arguably low that technological change is going to make current seating manufacturers obsolete or disintermediate them in a substantial way. That means they may not deserve the low valuations and high discount rates the market seems to be assigning to them due to fears about technological disruption.

Is there anything of note going on in the rest of Lear's business, primarily in what it calls E-Systems?

WM: This business sells things like wire harnesses, terminals, connectors and power distribution boxes used to manage cars' electrical systems. It's a more capital-intensive business, but the company has grown it nicely over time, particularly in building out capacity in China. But margins in this business have been cut in half over the last couple of years, from 14% to 7%, largely due to the cyclical downturn in China and the loss of Ford as a large customer there. We generally think this is an attractive business long term and that margins will normalize at something materially higher than the current level.

What upside do you see in the shares from today's price of around $138?

WM: We're estimating 5% annual top-line growth over the next couple of years as the company continues to gain market share and as contract wins make their way more fully into the financials. If we assume seating margins stay around 8%, E-Systems' margins get back to the 10-11% level and that share repurchases continue, we think earnings by 2021 can be $19 to $20 per share. We also believe this is a far better business than is currently recognized and that the appropriate P/E multiple for Lear is closer to 15x. If we're right on earnings and on the multiple that would result in a $300 stock.

Balance sheets have blown up on auto suppliers in the past. Do you consider that at all a concern here?

WM: The company as of the end of 2019 will have about $1 billion in net debt, against what we consider depressed 2019 operating earnings that will still be more than $1 billion. In keeping with the improved quality of the business, the debt is quite manageable. VII

INVESTMENT SNAPSHOT

Lear Corp.
(NYSE: LEA)

Business: Manufacturer of automotive seating, electrical and electronic systems, serving all major global automakers and with content in more than 400 vehicle nameplates.

Share Information (@12/30/19):

Price	**138.11**
52-Week Range	105.10 – 160.00
Dividend Yield	2.2%
Market Cap	$8.35 billion

Financials (TTM):

Revenue	$19.94 billion
Operating Profit Margin	7.4%
Net Profit Margin	4.2%

Valuation Metrics
(@12/30/19):

	LEA	S&P 500
P/E (TTM)	10.1	25.5
Forward P/E (Est.)	9.1	19.8

Largest Institutional Owners
(@6/30/19 or latest filing):

Company	% Owned
Vanguard Group	9.6%
Norges Bank Inv Mgmt	8.8%
Pzena Inv Mgmt	6.9%
Harris Assoc	6.6%
Massachusetts Fin Serv	5.0%

Short Interest (as of 12/15/19):

Shares Short/Float	1.3%

LEA PRICE HISTORY

THE BOTTOM LINE

The company's product mix positions it well to prosper as vehicle technology evolves, says Win Murray. Assuming continued market-share gains in seating and improved profitability in its electrical-systems unit, he estimates 2021 earnings at $19-20 per share. At the 15x multiple he would then consider appropriate, the stock would trade near $300.

Sources: Company reports, other publicly available information

Investor Insight: Kristofer Medina

Kristofer Medina of Medina Singh Partners explains the rationale behind his less-than-glamorous opportunity set, why high-quality businesses are not at all a priority for him, why today's investing environment is yielding plenty of good ideas, and what he thinks the market is getting wrong about Regis Corp., Stoneridge, Clearwater Paper and Uponor Oyj.

For a young up-and-coming hedge-fund manager your investment approach is pretty no-frills. Describe generally where and how you look for opportunity.

Kristofer Medina: We invest primarily in industrials and basic materials, with some exposure to energy and consumer-focused companies. We stick to those areas primarily because I find them interesting when most people don't. That's also where my experience has been, allowing us to develop what I'd like to believe is valuable intellectual property.

We target market caps of $3 billion and below and industries and companies where important things are changing. We don't screen, but we do track companies within our circle of competence whose stock prices or consensus earnings estimates move significantly up or down. We're also looking out for any number of fundamental changes. Maybe there's deal activity. Maybe there's a new management or a new strategic direction. Maybe the capital structure or the financial reporting is changing. The uncertainty around those types of things can result in mispricing, especially when sell-side coverage is scant, inexperienced, or both.

What we do is all fundamentally oriented. The first part of our process is fairly standard, focused on building out a financial model, doing preliminary valuation work to understand potential intrinsic value, and then tearing through the SEC filings. In those we put particular emphasis on the accounting, to understand the business and the numbers. Next comes the detective work, which is more manually intensive and not always very glamorous. We're looking for useful primary information from various sources, including conversations with competitors, customers and suppliers, reading through third-party or government data, or attending industry conferences or online webinars.

The goal is to build intellectual property on a name that can give us an edge. For an investment to make sense we need to believe we have a superior, more accurate view of a company's true earnings power that is materially different than the market consensus.

ON KEEPING AN OPEN MIND:

We've invested in more than 500 names since inception and have gone long and short the same name 90 times.

In looking at your holdings, business quality in a classic sense wouldn't appear to be of paramount importance.

KM: It really isn't. Given the opportunity set we've defined, we're often not looking at the highest-quality businesses with great competitive moats. That sets up fine for us as a long/short manager where we try to come at everything with a completely open and dispassionate mind. Because our process is focused on coming up with a more accurate estimate of earnings versus market consensus, above or below, we're making it more about buying right and selling right than being champions of businesses and counting on the long-term compounders everyone wants to invest in these days.

We've invested in more than 500 names since inception and have gone long and short the same name 90 times. We're making a disciplined evaluation of the earnings outlook, which for the companies in our investment universe can be volatile for any number of macro, cyclical, commodity-related or company-specific reasons. When you have a lot of volatility in these factors that drive a company's earnings, that's going to make for a more ripe environment for the consensus numbers to be inaccurate. That creates opportunities for us on the long and short sides of the portfolio.

Sticking to the long side of your portfolio for now, describe some fairly recent positions added and why they attracted your attention.

KM: One representative example would be Insteel Industries [IIIN], which manufactures the steel-welded wire reinforcement used in concrete construction projects. The company missed earnings badly in the first part of this year, partly due to tariffs but even more so because bad weather last year negatively impacted construction activity in the U.S., particularly in Texas. Forward earnings estimates got whacked – there are only two sell-side analysts – and the stock fell from a high above $40 in the summer of 2018 to below $20 nine months later.

This is a business we know well and there is regular and solid current data available on obviously the weather, but also things like non-residential construction activity and the pricing of welded rod. That gives us an informed sense of where the business is going that may not get incorporated into the share price when the current sentiment is bad and most investors are sitting it out until "the fundamentals begin to turn the corner."

There's certainly risk in these cases that we're sitting on dead money in the near term, but those risks are mitigated by the low valuation and low expectations already built into the stock price. In this case we believe the shares have close to 50% upside if, as we expect, 2020 earnings come in much higher than consensus, with free optionality if tariff news goes the right way or we see any big infrastructure

spending bills passed. [Note: Insteel shares recently closed at $21.60.]

Mueller Industries [MLI] has been in the portfolio a bit longer, but it's a good example of the emphasis we put on going through the accounting detail in order to hopefully gain some insight others might be missing. The company manufactures plumbing and refrigeration components for construction and industrial customers and while it's been public since 1991, it isn't well followed by the Street. Management also doesn't put much emphasis on investor relations – they don't do earnings calls and don't provide any of the non-GAAP adjusted earnings figures most companies do.

When we first got interested in Mueller in early 2018 its GAAP earnings were declining but we didn't think those earnings were representative of the company's true earnings power and its ability to generate cash flow. Without earnings adjustments spoon-fed from management, the market seemed to be pricing in a number of negative – but we thought temporary – hits from things like inventory markdowns after a fire in a brass-rod mill, cost overruns and delays in a plant modernization effort, and volatile copper prices that tied up free cash flow in working capital. We estimated the annual earnings power of the firm to be $115 million and growing rather than the $86 million and falling reported in 2017. The market putting a compressed multiple on what we thought were temporarily depressed earnings gave us the opportunity to invest.

The stock has remained pretty volatile, but we continue to believe the business is underestimated and actively size our position around the degree of misanalysis we see in near-term consensus forecasts. We originally bought in when the shares were in the mid-$20s and if we're right that this year's consensus earnings estimates prove to be too low, we think the stock can revalue to north of $40. [Note: Mueller shares recently traded at $32.]

Describe why you actively short and the types of things you look for in attractive short candidates.

KM: The first reason we do it is because we think we can make money at it, creating a separate profit center while reducing the overall risk of the portfolio. If you look at where we invest, it's in smaller-cap companies in not super attractive industries and with not always the best management. Just as expectations can be beaten down too low, they're just as likely to run up too high and we try to take advantage on the short side of the resulting mispricing. We think shorting is very natural for our opportunity set.

ON SHORTING:

I don't care about business quality on longs, but we only short unattractive businesses in unattractive industries.

The other main reason we short is it helps us on the long side. We typically own between 15 and 25 longs and the portfolio's gross exposure has historically been about 120%, 80% long and 40% short. We can be a little more aggressive and concentrated on the long side if we have an active short book – we believe that adds significant value over time.

Our shorts typically meet three primary criteria. While I said we don't care much about business quality on the long side, we only want to short unattractive businesses in unattractive industries, which lessens the risk something runs away from you. Almost all of our short ideas also have some kind of accounting element to them. Today that most likely stems from all the non-GAAP addbacks companies are throwing out there that can boost numbers in some cases to what we consider bogus levels. We're looking closely at change reports and things like adjustments in accounting treatment, accrual rates and reserve levels. The third characteristic of our shorts – which is mostly true on the long side as well – is that they all should have at least one clear catalyst, such as an expected earnings miss, a guidance reduction, a material credit amendment or a dividend cut.

We tend to have a shorter time horizon with our shorts and the position sizes are typically smaller, from 1% to maybe 2.5%. We will also use stop losses pretty actively on the short side. It's not absolutely mechanical, but if a short name goes against us by more than 20%, I would say the vast majority of the time it comes out of the portfolio. If a stock you're expecting to disappoint in the next few quarters goes up 20-30% in the interim, even if you're eventually right, there's a good chance you're going to lose money on the position anyway. Our use of stop losses has helped us quite a bit. We can always re-short something again if the situation warrants.

Explain why you have a negative prospective outlook on Regis Corp. [NYSE: RGS].

KM: The company owns and franchises hair salons under such brand names as Supercuts, SmartStyle, Regis and MasterCuts. At last count there are roughly 3,700 company-owned salons and 4,400 franchised locations, almost all in the United States.

We first started looking at this nearly two years ago because there were activist investors involved and a lot was going on as new management was brought in to implement a turnaround. As is always the case we tried to have an open mind, thinking the potential was there that the stock was mispriced, but not knowing if that would make it a long or a short.

The background here is that customer visits to Regis salons are quite dependent on physical retail traffic, which makes the majority of locations concentrated in and near malls vulnerable as mall traffic has secularly declined. On the back of consistently declining operating performance, the company's stock fell from a peak price just over $45 in 2004 to less than $10 in May of 2017. That's about the time Hugh Sawyer took over as CEO and started implementing a reasonable plan to reduce company-owned stores, shift risk to franchisees and reduce overall corporate

overhead. The market has been reasonably impressed and the shares now trade at around $18.

While moving to a more asset-light business model is a tried-and-true strategy for companies like this, the problem here is that the franchise-level economics aren't good. According to franchise disclosure documents, the typical Supercuts, for example, generates $290,000 in sales and $60,000 in operating cash flow. After transferring ownership, Regis will earn a 6% royalty, or $17,400. So before corporate overhead its annual earnings from that unit would be down roughly 70%.

Management tells investors that this shortfall will be more than offset by the purchase price received from franchisees, declines in corporate overhead and increases in store-front accessory sales. Our analysis indicates that's very unlikely. The purchase prices are very low, roughly 1x to 3x EBITDA. After making adjustments for some arcane purchase-accounting items, we estimate corporate overhead savings over the past 12 months were $6-8 million, versus almost $30 million in reduced EBITDA. The company is also investing in a number of initiatives – primarily for store remodels, increased marketing and technology – which makes it even more difficult for the math to work.

You mention adjusting for arcane purchase accounting items. Are there other accounting-related aspects to your thesis?

KM: The company points Wall Street toward – and unfortunately compensates management on – an adjusted EBITDA metric that includes a number of add-backs that we consider inappropriate or even misleading. One sanity check on that: they say they're earning $122 million in adjusted annual EBITDA, but the current cash flow from operations is negative. It's very difficult in our opinion for both of those numbers to be correct.

We also think it's suspect that Regis kind of sneaks some material disclosures into its filings. One example of that was a notice that the franchisee that near the end of 2017 bought the biggest number of Regis-owned stores, the Beautiful Group, filed for bankruptcy months after the asset sale. That was buried in the June 30, 2018 10-Q. We think this is indicative of how troubled this business and industry happens to be.

At today's $18 price, how expensive do you consider the shares?

KM: Given what we think is the dilutive nature of the asset sales, we expect the company to report worse-than-expected results for at least the next one or two years. Instead of the $122 million in annual EBITDA they say they're earning, we expect the real number to come in closer to $50-60 million. Applying what we'd consider a reasonable retail EV/EBITDA multiple of 7x, with 35 million shares outstanding and estimated net debt of $30 million, that would translate into a share price of around $10.

The biggest risk to your thesis?

KM: As is often the case with shorts, you always have to be concerned that someone with capital will show up and buy the company at a premium to what you think

INVESTMENT SNAPSHOT

Regis Corp.
(NYSE: RGS)

Business: Owns and franchises more than 8,000 hair salons worldwide; brand names include Supercuts, SmartStyle, Cost Cutters, Roosters and First Choice Haircutters.

Share Information (@12/30/19):

Price	**17.98**
52-Week Range	14.50 – 23.27
Dividend Yield	0.0%
Market Cap	$639.1 million

Financials (2018):

Revenue	$1.03 billion
Operating Profit Margin	(-0.8%)
Net Profit Margin	(-2.7%)

Valuation Metrics
(@12/30/19):

	RGS	S&P 500
P/E (TTM)	n/a	25.5
Forward P/E (Est.)	24.3	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Birch Run Capital	30.0%
BlackRock	10.5%
Dimensional Fund Adv	8.7%
Cramer Rosenthal McGlynn	7.5%
Vanguard Group	7.4%

Short Interest (as of 12/15/19):

Shares Short/Float	16.0%

THE BOTTOM LINE

Kristofer Medina believes the company's strategy to shift business risk to franchisees isn't making financial sense and certainly won't compensate for the secular decline in its core hair-salon business. Applying what he considers a reasonable 7x EV/EBITDA multiple on his estimates two years out, he expects the shares will trade at closer to $10.

Sources: Company reports, other publicly available information

it's worth. The original activist, Starboard Value, is out of the stock, but another one, Birch Run Capital, owns nearly 30% of the shares. They obviously will be working to realize value in any way they can. We just don't happen to believe the value is there to be realized.

Turning to another bear case, what do you think the market is missing in vehicle-component supplier Stoneridge [SRI]?

KM: The company designs and manufactures electrical-instrument systems for ground vehicles. The biggest end markets are automotive, which makes up roughly 40% of revenues, and commercial vehicles and trucking, which accounts for close to 33%. The remainder comes from "off-highway" markets, including agriculture and construction.

The market generally seems to believe that the company has a long-term growth story based on selling products that help OEMs convert to digital instrumentation and improve transportation safety. Wall Street is also very high on the prospects for their new MirrorEye backup-camera system, which is meant to replace mounted mirrors on Class 8 trucks, reducing the potential for blind spots while also cutting aerodynamic drag. Consensus EPS estimates for next year are for solid 10-11% growth.

Our basic view is that Stoneridge is still a cyclical vehicle-parts supplier facing a weak automotive cycle and a collapsing market for heavy-duty commercial trucks. At the same time, while MirrorEye may have solid long-term potential, we expect the ramp up for it to be much slower than people seem to expect and that it won't come close next year to offsetting the cyclical issues elsewhere.

It's unfortunately difficult to compare financials year over year because the company is constantly reshuffling items among segments and moving things into discontinued operations or "non-core" categories without much transparency. We think that's obscuring some of the challenges to the current business. Cutting through all that, we're expecting at best no growth in revenues, margins or EPS in 2020. That includes, by the way, roughly $50 million in incremental revenue from MirrorEye.

What impact would you expect that type of performance to have on Stoneridge's stock, now trading around $29.50?

KM: If this traded like a typical vehicle-parts supplier today, it might be lucky to earn a 10x earnings multiple, which would result in a $15 stock if we're right on our $1.50 per share earnings estimate for next year.

The wild card to us is MirrorEye. It does appear to be an innovative product, but we think it's going to have a tough time getting traction if the heavy-duty truck market is down 25% next year as many industry experts are projecting. We also don't think it's a no-brainer that it's a blow-out success long term. There are two competing technologies from much bigger competitors, Bosch and Continental, companies that spend far more on R&D every year than Stoneridge's market cap. If this is such a great opportunity, it's not obvious Stoneridge will be the big beneficiary.

All that said, we're tracking closely what's happening with the market adop-

INVESTMENT SNAPSHOT

Stoneridge Inc.
(NYSE: SRI)

Business: Designs and manufactures engineered electrical and electronic components and systems for the automotive, commercial, off-highway and agriculture vehicle markets.

Share Information (@12/30/19):

Price	**29.55**
52-Week Range	23.59 – 34.46
Dividend Yield	0.0%
Market Cap	$809.8 million

Financials (2018):

Revenue	$854.7 million
Operating Profit Margin	7.4%
Net Profit Margin	8.0%

Valuation Metrics
(@12/30/19):

	SRI	S&P 500
P/E (TTM)	12.4	25.5
Forward P/E (Est.)	17.4	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Dimensional Fund Adv	6.9%
BlackRock	6.4%
Vanguard Group	6.2%
T. Rowe Price	5.8%
Massachusetts Fin Serv	5.2%

Short Interest (as of 12/15/19):

Shares Short/Float	4.5%

SRI PRICE HISTORY

THE BOTTOM LINE

While the market appears enamored with the prospects for one of the company's new products, Kristofer Medina expects cyclical challenges in key automotive and truck end markets to have a far-larger and negative near-term impact on earnings. At what he considers a peer multiple on his 2020 EPS estimate of $1.50, the stock would trade at $15.

Sources: Company reports, other publicly available information

tion of MirrorEye. If we turn out to be wrong here, this product exceeding our expectations would likely be the primary reason why.

Describe your bullish investment case for Clearwater Paper [CLW].

KM: This is an example of a company we successfully shorted in the not-distant past that we now think is likely to significantly outperform the market consensus.

Clearwater operates in two segments, private-label tissue paper and paperboard packaging. The share price has fallen by nearly two-thirds over the past three years due to a litany of industry-related and self-inflicted issues. They lost a material portion of their private-label business with Kroger. They took on considerable debt to fund a five-year $700 million strategic capital-spending program that has yet to result in much tangible operating improvement. Pulp and paper prices rose 40% from 2016 to 2018, significantly increasing raw-material input costs. Over the same period realized prices for the company's retail tissues declined by 2% or so, hurt by competition from both branded and private-label peers.

We now see a number of those dynamics reversing. Pulp and paper prices have fallen roughly 20% year-to-date. Branded tissue competitors like Kimberly-Clark and Procter & Gamble announced price increases at the end of 2018, which have been followed by the private-label players as well. We also believe the strategic capex program is likely to deliver considerably more of the upside it originally promised than the market seems to expect. The overall initiative was expected to deliver an additional $200 million in annual EBITDA – two-thirds or so from cost savings and one-third via additional production – nearly doubling the then annual level. Now the consensus 2021 EBITDA estimate is around $150 million. The market is saying the capex spending is not going to add any incremental benefit and that the overall business is structurally impaired and can't earn what it did five years ago. We think those assumptions are overly pessimistic.

Is the higher debt level you mentioned a concern?

KM: Frankly, yes. The company has just over $900 million in net debt, against EBITDA in the current year of roughly $155 million. That's very levered. But given the significant reduction in capital spending with the completion of the five-year plan, there is a clear path to deleveraging. We believe the company can generate its entire market cap in free cash flow over the next three to five years. That should reasonably allow it to reduce its leverage ratio to a much more manageable 2.5x to 3x by 2022. There are no debt maturities until 2023, so there should be ample time to clean up the balance sheet.

What upside do you see in the shares from today's price of just over $21?

KM: Looking two years out, with around $1.9 billion in revenues and 10-11% EBITDA margins, we think 2021 EBITDA is likely to come in at closer to $200 million. Including our estimates for debt reduction and applying a peer-level multiple

INVESTMENT SNAPSHOT

Clearwater Paper
(NYSE: CLW)

Business: Spokane, Washington-based manufacturer of consumer tissue sold primarily under retailer private-label brands, as well as bleached paperboard used for packaging.

Share Information (@12/30/19):

Price	**21.18**
52-Week Range	13.87 – 35.27
Dividend Yield	0.0%
Market Cap	$349.8 million

Financials (2018):

Revenue	$1.75 billion
Operating Profit Margin	2.1%
Net Profit Margin	(-11.1%)

Valuation Metrics
(@12/30/19):

	CLW	S&P 500
P/E (TTM)	n/a	25.5
Forward P/E (Est.)	25.5	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
BlackRock	14.9%
Dimensional Fund Adv	8.4%
Vanguard Group	6.2%
T. Rowe Price	5.5%
Private Mgmt Group	5.2%

Short Interest (as of 12/15/19):

Shares Short/Float	3.9%

CLW PRICE HISTORY

THE BOTTOM LINE

With some industry-related headwinds turning to tailwinds and the completion of a five-year capital-spending program, Kristofer Medina believes the company is likely to beat market earnings expectations over the next two years. Applying an 8x EV/EBITDA multiple to his 2021 estimates, he thinks the share price from today can more than double.

Sources: Company reports, other publicly available information

of 8x EV/EBITDA, the stock would trade at around $45.

This will likely play out in 2020. The company needs to show it can execute and generate the free cash flow we think it can. If it does, we expect the market to respond very favorably.

Turning to a non-U.S. idea, explain your interest in Finnish manufacturer Uponor Oyj [Helsinki: UPONOR].

KM: We first looked at this because it was a competitor to Mueller Industries. The company has been around for more than 100 years and its product line includes things like polyethylene (PEX) piping, radiant floor heating components, fire sprinkler systems and undersea sewer pipes. After many years of solid organic growth, this is another case where cyclical and what we think are transitory company-specific issues hurt earnings and market sentiment through much of 2018 and into the first half of 2019. While some of the clouds have started to lift, we think the market is still just extrapolating the recent past and is too negative on the stock.

Often with our ideas we don't have one big variant perception but rather believe a number of factors are going to result in incremental improvement. Here those include things like working through some product-quality missteps that resulted in missed sales in Europe, a positive lift in U.S. housing starts after a negative first half of 2019, and better-than-expected construction spending in Europe. We also see a normalization of currency headwinds that continues into 2020.

As opposed to analysts' consensus expectation that 2020 earnings stay roughly flat with this year's estimated €0.75 EPS level, we're expecting earnings next year to increase roughly 15%, to €0.87. While that may not sound like a lot, for a stock that appears to trade on such low expectations the upside if sentiment improves should be pretty attractive.

How are you looking at valuation with the shares currently trading at €11.65?

KM: The stock has a dividend yield above 4% and on our forward estimates trades at an 11% free-cash-flow yield, at 6.7x EV/EBITDA and at 13.5x earnings. Those multiples are on depressed results and are still 20-30% below the company's five-year average.

To keep it simple, if Uponor delivers the €150 million in EBITDA we estimate for next year, we think it would deserve at least the 11x average EV/EBITDA multiple it has earned over the last 10 years. That would get us to around a €20 share price. Even with the lousy current multiple, if we're right on earnings we'd make a nearly 20% return including the dividend.

We think we're solidly protected on the downside. Canadian and Spanish buyout precedents would suggest a share price of around €19, which is similar to the level if we apply the current valuation multiples of Finnish engineering and construction peers. On the other hand, if the stock fell 25% it would make Uponor the cheapest profitable company in Finland, which we don't believe is at all a distinction the business deserves. All in all, we think the risk/reward of this stock is dramatically imbalanced in our favor.

INVESTMENT SNAPSHOT

Uponor Oyj
(Helsinki: UPONOR)

Business: Finland-based supplier of plumbing and climate-control systems for residential and non-residential buildings; main operating subsidiaries are in Europe and North America.

Share Information
(@12/30/19, Exchange Rate: $1 = €0.89):

Price	**€11.65**
52-Week Range	€8.52 – €12.37
Dividend Yield	4.3%
Market Cap	€850.3 million

Financials (TTM):

Revenue	€1.12 billion
Operating Profit Margin	6.7%
Net Profit Margin	4.1%

Valuation Metrics
(@12/30/19):

	UPONOR	S&P 500
P/E (TTM)	18.8	25.5
Forward P/E (Est.)	16.4	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Nordea Inv Mgmt	6.1%
Keskinainen Tyo. Varma	5.3%
Mandatum Hen. Oy	2.8%
Keskinainen Ela. Ilmarinen	2.8%
Vanguard Group	2.0%

Short Interest (as of 12/15/19):

Shares Short/Float	n/a

UPONOR PRICE HISTORY

THE BOTTOM LINE

With a lift from U.S. housing starts, better-than-expected European construction spending and the normalization of currency headwinds, Kristofer Medina expects the company's 2020 earnings to be 15% higher than analysts' consensus. Applying a 10-year-average EV/EBITDA multiple on his next-year numbers would yield a share price close to €20.

Sources: Company reports, other publicly available information

To get a sense of your selling discipline, describe the rationale behind a recent portfolio sale.

KM: One interesting example would be Trinseo [TSE], which is a global supplier of plastics, latex binders and synthetic rubber to a variety of industrial and construction end markets. After a good run, the company's earnings started to decline in the second half of 2018 due to weak end-market conditions, margin volatility and some unexpected capacity outages. As a result, management reduced earnings guidance on multiple occasions and the stock by mid-August of this year went below $30, down 65% from its 52-week high and priced at about what Bain Capital Partners paid for it nearly a decade ago when it was bought out of Dow Chemical. We thought the resulting valuation – which translated into a 20% free-cash-flow yield on our numbers – made no sense given that Trinseo's earnings over that 10-year period had more than doubled and it had generated its entire market cap in free cash flow.

We got into the shares below $30, but recognized there was a realistic possibility near-term earnings would disappoint. But before that had a chance to happen, the stock went over $40 primarily due to some mergers-and-acquisitions activity in the competitive space. At that point we had to reassess if the margin of safety was sufficient if the company did report weaker numbers or guide below consensus. We decided it wasn't and took the short-term profit.

ON TODAY'S ENVIRONMENT:

There's been a lot of volatility in the factors driving earnings for our type of company. That's a positive for us.

In November the company actually pre-announced a larger-than-expected restructuring and then downgraded guidance again, which sent the stock from $45 to $35. [*Note*: Trinseo's stock currently trades around $36.50.] We're constantly revisiting ideas and this is one we're following pretty closely.

Is there anything about today's investment environment that's either positive or negative for your approach?

KM: It's probably not a surprise that we're finding it a bit harder to find high-conviction ideas on the long side, but one thing I mentioned earlier that has been a positive is that there's been quite a lot of volatility in the factors driving company earnings. Even with the broader upturn in the economy, we've seen a number of mini-recessions in many of the end markets that matter to us, like autos, trucking, construction, machine tools and transport. Industrial commodity prices have also been fairly volatile, which can have a big impact on the earnings of our type of company. All of that increases the likelihood that market expectations are materially wrong, which is exactly what we try to take advantage of. VII

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In the Bag?

After booming then busting, the parent company of Michael Kors has refashioned itself for the changing retail as well as luxury-goods marketplaces. Is the market right in taking such a pessimistic view of the company's prospects?

Investing in fashion-oriented companies can be no picnic. They get hot, they overexpand, consumer tastes evolve and then they need to retrench. Next comes the plan to recapture former glory, which is sometimes successful, sometimes not. Investment opportunities may present themselves, but it's rarely a smooth ride.

Pieter Hundersmarck of Flagship Asset Management argues the ride is worth taking today in Capri Holdings, which owns the Michael Kors, Versace and Jimmy Choo brands. The company, at the time just Michael Kors, was a moon-shot success earlier this decade on the strength of its line of "affordable-luxury" handbags and watches. Sales more than tripled between 2013 and 2015 as it dramatically expanded both company-owned stores and wholesale and outlet distribution to capture seemingly insatiable demand.

Almost on cue Kors' sales growth slowed to less than 10% in 2016 and turned negative in 2017. Operating margins, 30% in 2014, were half that three years later. To right the ship, long-time CEO John Idol – Michael Kors is the Chief Creative Officer – mapped out a back-to-basics operational plan while also looking to diversify through acquisition. Kors' wholesale and outlet distribution has been scaled back and it has spent heavily on product R&D and e-commerce capabilities. It also shelled out a total of $3.3 billion to buy shoe designer Jimmy Choo in 2017 and fashion house Versace in 2018.

Hundersmarck says the company's rejuvenation efforts are starting to bear fruit. After 17 quarters of declining same-store sales, comps for the Kors brand – which account for 75% of total sales – turned positive in the quarter ending in June. Gross margins are a still-high 60%-plus, and operating margins have stabilized. While he isn't counting on big things from Versace and Jimmy Choo, he expects them to earn much more than they currently do and sees upside from having multiple brands at hand. The Kors brand, for example, has had far more success selling accessories than the other two brands, which might benefit from the in-house expertise.

Are changing consumer attitudes toward luxury goods a risk? "Younger generations are defining themselves differently, placing increasing emphasis on experiences and brands that speak to their causes and beliefs. This is a challenge for incumbent brand owners, who need to show that they remain relevant and aspirational for younger consumers," he says. "Based on our research – and recent results – we're confident the Capri brands are successfully maintaining their cachet."

To arrive at what he thinks the shares are worth, Hundersmarck estimates annual revenue growth (3.5% to 4%), operating margins (around 17%), the tax rate (20%) and shares outstanding (158 million) out to fiscal 2025, and then applies an 11.2x multiple to the resulting net operating profit after tax. Adjusting for net debt and dividends and discounting back at an 11.5% discount rate, he pegs the shares' current fair value at $53. VII

INVESTMENT SNAPSHOT

Capri Holdings
(NYSE: CPRI)

Business: Designs, markets and sells apparel and accessories under such brand names as Michael Kors, Versace and Jimmy Choo.

Share Information (@12/30/19):

Price	**37.55**
52-Week Range	25.24 – 50.00
Dividend Yield	0.0%
Market Cap	$5.69 billion

Financials (TTM):

Revenue	$5.57 billion
Operating Profit Margin	14.3%
Net Profit Margin	6.0%

Valuation Metrics
(@12/30/19):

	CPRI	S&P 500
P/E (TTM)	16.9	25.5
Forward P/E (Est.)	7.1	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Vanguard Group	10.2%
Eminence Capital	8.9%
Invesco Adv	7.0%

Short Interest (as of 12/15/19):

Shares Short/Float	8.6%

CPRI PRICE HISTORY

THE BOTTOM LINE

While the 7x forward earnings multiple on its stock would indicate the market envisions a bleak future, Pieter Hundersmarck thinks the company has righted its ship and that its brands remain relevant and aspirational. His estimate of current fair value per share: $53.

Sources: Company reports, other publicly available information

Nothing Ventured, Nothing Gained

People rarely think about banks as growth companies, but Gator Capital's Derek Pilecki says a number of banks in the U.S. fit that bill and some appear quite undervalued. One representative example: Silicon Valley's SVB Financial.

As a value investor in financial-services stocks, Derek Pilecki of Gator Capital Management [**VII**, August 31, 2017] has often looked from afar at a subset of his universe he calls growth banks. These unique beasts, often as a result of a specialized focus and a willingness to pay up for talent, have over long periods generated strong and profitable organic growth funded by low-cost deposits. "These are companies I admire and wanted to own," he says, "but the multiples were too high.

Pilecki saw that dynamic start to change in late 2018, as the stocks of such banks started to be hit by fears of lower interest rates and credit-risk woes, as well as neglect as investors chased momentum in sectors deemed more interesting. Average earnings multiples for 14 growth banks he tracks fell from 15x to below 11x.

While the worst fears have subsided, he still sees mispriced value in banks such as SVB Financial, the parent of Silicon Valley Bank. The company specializes in serving the commercial and private banking needs of the U.S. venture-capital community, including VC firms, venture-backed companies and the executives at each. Fueled by its long target-market focus and the nurturing of a self-reinforcing network its customers highly value, the company has grown deposits and loans at a 14%-plus annual rate since Pilecki started following it 20 years ago. Growth has been even faster over the past five years, and returns on equity are consistently 20% or better.

At a time when consumer-packaged-goods companies with low-single-digit annual growth earn mid-20s P/Es, SVB's stock at a recent $250 trades at 12.7x consensus 2020 EPS estimates of $19.50. Pilecki attributes the lack of market enthusiasm to concerns over "peak venture capital," which could signal risks to lending volume, credit quality and even income from equity warrants awarded from client companies. With a preponderance of floating-rate loans and already rock-bottom deposit costs, investors also seem worried the company will be incrementally hurt if interest rates stay so low or go lower.

He counters that while prospective venture-capital returns may not match those of the recent past, he believes the volume of VC activity – which is what is most important to SVB – will remain high. He's confident the company's credit underwriting is as conservative as ever. As for risks to net interest margins, he says that's less important when banks grow. "For a bank growing 15% a year over five years, the value of the stock in year five is driven by the growth, not whether the net interest margin is plus or minus 10%," he says.

Assuming loan and deposit growth of 12% per year, he believes the company can earn $27 in EPS by 2023. Applying a 15x forward P/E – the lower end of the ten-year historical range of 11x to 25x – would result in a stock price in three years of over $400, 60% above today's level. "You hear this mentioned as a short because of the 'peak-venture' angle," he says. "While that's maybe thought provoking, I also think it will turn out to be wrong." VII

INVESTMENT SNAPSHOT

SVB Financial
(Nasdaq: SIVB)

Business: Parent of Silicon Valley Bank with primary franchise in serving venture-capital firms and venture-backed companies.

Share Information (@12/30/19):

Price	**249.82**
52-Week Range	183.04 – 259.95
Dividend Yield	0.0%
Market Cap	$12.88 billion

Financials (TTM):

Revenue	$3.07 billion
Operating Profit Margin	53.7%
Net Profit Margin	37.1%

Valuation Metrics
(@12/30/19):

	SIVB	S&P 500
P/E (TTM)	11.6	25.5
Forward P/E (Est.)	12.7	19.8

Largest Institutional Owners
(@9/30/19 or latest filing):

Company	% Owned
Vanguard Group	10.8%
Capital Research & Mgmt	5.5%
State Street	5.2%

Short Interest (as of 12/15/19):

Shares Short/Float	1.8%

SIVB PRICE HISTORY

THE BOTTOM LINE

Its specialty serving the venture-capital community is giving the market pause, but Derek Pilecki expects the company to continue its long record of strong and profitable growth. At 15x his 2023 earnings estimate, the stock within three years would trade at over $400.

Sources: Company reports, other publicly available information

The Market as Teacher

On the first day of class each semester for the *Value Investing: Principles and Practice* class I teach at the University of Alabama, I ask students to come up with a stock idea they think is a good buy. We assemble the ideas into a class "portfolio" that we track over the course of the 13-week semester and those picking the top three performers are awarded prizes on the last day of class. (The first prize: a gift certificate through Stockpile.com redeemable for a given dollar amount of Berkshire Hathaway shares.)

The class for many is their first real exposure to fundamental equity investing and I'm hoping to give the students a small taste, if they haven't had it, of the excitement (fear?) of making stock investment decisions and then following how they're working out. Early on we focus on idea generation – what are the infrequent but reliably recurring reasons a stock might be mispriced? – but before we get to that it's interesting to hear about and discuss why they pick what they do. While the semester is too short to make any grand conclusions about the results, it's also fascinating to track the ups and downs over the 13 weeks and try to draw out some lessons.

The rationales behind the 40 picks in my latest class were as varied as you might expect. Some students seemed to bring some experience to the table. One chose Alnylam Pharmaceuticals because it had a number of treatments in late stages of the FDA approval process and there was a chance of big positive news soon. Another chose oil-services firm Transocean, whose stock price has been decimated since the financial crisis but can swing widely on oil-price news. These types of ideas also have a gaming-the-system element to them: when you don't have real money on the line and the time period is short, why not swing for the fences?

Other students exhibited value-investor instincts. One bet on upside in Teva Pharmaceutical, struggling with weak generic-drug prices and under an opioid-crisis-litigation cloud, but trying to turn itself around under the direction of CEO Kare Schultz (who happens to be Danish, as was the student). Another thought things had hit bottom at General Electric and that new CEO Larry Culp was doing the right things to bring the company back.

Most ideas, however, were rather more personal in nature than analytical. My dad works for Verizon so I chose it. I love videogames, so I'm going with Activision Blizzard. Elon Musk is a genius, give me Tesla. One student had great conviction in recent IPO Beyond Meat, while three went for cannabis plays in Canopy Growth, GW Pharmaceuticals and HEXO.

In a nice bull market, our portfolio fell short of the market's return but still earned a respectable 6.4%. One thing that still surprises me is how much stocks can move in a relatively short period of time. The *average* share-price movement from low to high over the 13 weeks was nearly 43%. The big winners: Tesla (+56%), Teva (+54%) and Alnylam (+48%).

As for the four biggest losers, I couldn't have asked for better lessons about the importance of not getting caught up in hype and of paying prices that leave you with a margin of safety. The three pot stocks were down an average of 30%. Beyond Meat, whose shares in August were up more than 500% from their May offering, fell an unappetizing 53%.

Here's to a 2020 with only the best investing lessons! VII

John Heins

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