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Value Investor INSIGHT

The Leading Authority on Value Investing

Affordable Quality

It sounds almost old-fashioned in today's day and age, but François Rochon's investing strategy since founding Montreal-based Giverny Capital hasn't wavered: "We're looking for 20 to 25 companies we can own for the long run that we believe can increase their intrinsic values by about twice the rate of the S&P 500," he says, "and we want to be prudent about what we pay for them."

Now managing $1.6 billion, he's executed on that deceptively simple premise quite well. His Global portfolio, typically 85% invested in the U.S., has earned a net annualized 14.2% since 1993, vs. 10.2% for the S&P 500. Today he's finding what he considers affordable quality in such areas as Internet services, insurance and used cars. See page 2

François Rochon
Giverny Capital

All In

Adam Wyden's investing style is not, using a baseball analogy, focused on hitting a steady stream of singles and doubles. He owns only a handful of stocks at a time. He seeks out opportunities where big company changes in strategy, execution or capital allocation are underway. "We'd rather hold cash than something that isn't a fantastic opportunity," he says. "That to us is how we'll generate a return independent of the market over time."

So far, so good. Wyden's ADW Capital since inception in 2011 has earned a net annualized 24.6%, vs. 11.2% for the Russell 2000 index. His concentrated bets today include those in waste disposal, commercial services, point-of-sale systems and hospitality. See page 7

Adam Wyden
ADW Capital

Ahead of the Curve

Despite South Korea's admirable economic growth and the continued success of its largest companies, the country's equity market has been stagnant for years. You wouldn't know that by Albert Yong and Chan Lee's success since they founded Petra Capital Management in 2009 to root out mispriced value among neglected small and mid-sized Korean companies. The firm's Value Equity Strategy since launch in 2009 has earned a net annualized 13.7%, vs. 5.4% for the MSCI Korea Small Cap Index.

As the market shows signs of waking from its slumber, Yong and Lee still see opportunity in classic Korean value plays like holding companies as well as in new-economy areas like renewable energy and semiconductors. See page 13

Petra Capital
Chan Lee (*l*), Albert Yong (*r*)

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Investor Insight: François Rochon

François Rochon of Giverny Capital describes what about his strategy makes it both timeless and timely, the mistake he wishes he could take back from last March, his latest views on top holding Berkshire Hathaway, the macroeconomic concern he considers most prominent, and why he's seeing mispriced value in Facebook, Progressive, Markel and CarMax.

Your strategy has proven nicely built for the long term. How has it been faring though the unusual series of short terms we've had over the past year?

François Rochon: Since I started managing my portfolio in 1993, I have never tried to predict where the market, the economy, politics or even our civilization was going to go in the short term. Our philosophy is to own 20 to 25 high-quality companies that we believe can increase their intrinsic value at twice the rate of the S&P 500 average. Knowing that there will be recessions along the way, we filter out companies that are unprofitable, heavily indebted, sensitive to commodity prices, highly cyclical and/or have high market valuations. In difficult times, the stock prices of such companies tend to suffer more.

Over the past 25 years we have tracked the growth of our portfolio companies' "owner earnings" – which consists basically of earnings per share adjusted for things like stock-option expenses and the amortization of intangibles – plus the dividend yield. It's not a precise measure, but we believe it is approximately correct. Through 2020, the market value of our companies has grown by almost exactly the same amount as their intrinsic value. We've outperformed the S&P 500 over the long run for the simple reason that our companies have grown their intrinsic values on average faster than the companies that make up the S&P 500.

To your specific question, our companies have fared well over the past year. Their earnings have come down at a lower rate than average – we estimate a decline of around 7%, compared to a 15% decline for the S&P 500. Close to half of our companies should report record earnings for 2020. If we're right about our holdings' ability to increase intrinsic value at a rate higher than the market, since the stock market ultimately reflects the fair value of companies over the long term, over time we should be rewarded as shareholders.

Are you finding your opportunity set expensive today?

FR: Our portfolio at the end of 2020 was trading at about 20x estimated earnings for 2021, which is at the high end of our historical range. But that's still lower than the S&P 500, at 22x, for companies we believe can grow at higher-than-average rates. In our opinion, they should trade at a premium and they don't.

I should also explain how important it is for us to be prudent about the price we pay for what we consider to be superior companies. If you pay too high a price, you can be right about the intrinsic value increase but not benefit from that because the valuation at some point contracts. Our discipline to address that is at purchase to look out five years and estimate a target price based on what we believe the company can earn and the P/E ratio we believe would be warranted for such a company at that time. We'll consider a stock as a new purchase candidate if the price today is no more than half our five-year target.

We don't believe the 40-50x P/Es on many growth companies today are sustainable, so it's not easy to find companies we want to own at reasonable prices. But we've always been able to find opportunity in areas that are less exciting and not so fashionable. That's true today as well.

We'll come back to that soon, but on the subject of 2020, were you active in buying and selling through the worst of the market turmoil?

FR: At the end of March there appeared to be some exciting opportunities for long-term investors. We're always fully invested, so for us it required weighing the extent of the new opportunities we saw against what had become increasingly attractive valuations in our current portfolio.

We did trim some existing positions we thought were a bit more negatively impacted by the pandemic to establish a position in Five Below [FIVE], the specialty retailer that has become very popular with pre-teens and teens. It's a stock I'd been following for years and I really liked the company, the concept, the management and the balance sheet. It also had significant room to grow. I almost bought it in late 2017 when the P/E was probably in the mid-20s. Then the stock went up a lot, the P/E ratio went to 40-50x, and it looked like we had missed it. In March the market gave us another chance and we took advantage of it – the window to act actually turned out to be quite narrow. [Note: Trading at around $125 at the beginning of 2020, FIVE shares went below $50 in March. They now trade at around $176.]

Berkshire Hathaway [BRK.B], one of your largest holdings, was hardly a standout performer for much of 2020. Did that make it more or less attractive to you?

FR: We were disappointed that Warren Buffett did not invest more of the cash on hand in March when opportunities were plentiful. But we understand his reasons: Mr. Buffett has spent his entire life as a good steward of capital and he didn't want to do anything that he thought would put the company and its employees at increased risk in a very uncertain time.

While we still think the stock is undervalued at present levels, we recognize that it will be hard for Berkshire to meet our intrinsic value growth targets if close to a quarter of the investable capital stays invested in assets like cash that yield next to nothing. We were encouraged that they stepped up share repurchases considerably in the third quarter – buybacks totaled $9 billion. If Berkshire can continue to buy

back shares at such high rates, eventually shareholders will be rewarded.

Used-car seller CarMax [KMX] has been a long-time holding of yours. Is it a good example of something you think the market is relatively neglecting today?

FR: It's a good example both of the type of company we're attracted to and of one we think is undervalued today. It is a leader in its industry, conservatively and well managed, with an extraordinary reputation among customers and a long runway for growth in an industry where scale often provides a competitive advantage.

It's also a business that has been disrupted. I can tell you when I first bought the stock I didn't imagine a time when people would be buying used cars entirely online. But the company has adapted by investing massively in its omnichannel capabilities and we think it is very well positioned to deliver whatever experience customers want, from all in-store, to all online and whatever is in between.

The comparison between it and online-only competitor Carvana [CVNA] is interesting. CarMax sells close to three times more cars than Carvana and should generate revenues of $22 billion or so this year, compared to $8 billion for Carvana, which by the way is still expected to be unprofitable. But the market cap of CarMax is around $19 billion, compared to $45 billion for Carvana.

Of course, a low relative valuation is not reason enough to own CarMax. We believe it's competitively advantaged, but it still has less than 3% total market share. It could double that market share over the next ten years. That doesn't mean Carvana can't prosper and challenge CarMax as the market-share leader. We think there's plenty of room for both to be successful.

To give you a sense of how we look at valuation, our scenario for CarMax is for same-store sales growth, store growth and share buybacks to pretty equally drive intrinsic-value growth of around 12% annually. That would result in earnings per share of around $10 by 2026 and with what we'd consider a reasonable P/E of 20x, the stock would trade at around $200. The stock has gone up strongly so far this year, but that's still nearly 70% above today's price [of just under $118].

What do you think the market is missing in Facebook [FB]?

FR: It sounds strange given how high-profile the company is, but we think people underestimate the strength of Facebook's business. It's almost a monopoly as a social media network and I would argue that it and Google have among the strongest and most durable moats I've ever seen. It has more than 2.7 billion monthly users – a third of the humans on the planet have an active Facebook account – and once you're signed on where all your family and friends are, there's no practical incentive to use another network. The service is free, so there's no economic incentive to change either. The importance of its position and of the role it plays has only been reinforced during the pandemic.

Facebook, also along with Google, should remain a primary beneficiary of the ongoing transition of marketing and advertising spending moving online, where messaging can be better targeted and more

INVESTMENT SNAPSHOT

Facebook
(Nasdaq: FB)

Business: Provider of advertising-supported social-networking products and services worldwide; key brand franchises include Facebook, Instagram, WhatsApp and Oculus.

Share Information (@1/29/21):

Price	**258.33**
52-Week Range	137.10 – 304.67
Dividend Yield	0.0%
Market Cap	$735.84 billion

Financials (TTM):

Revenue	$85.96 billion
Operating Profit Margin	38.0%
Net Profit Margin	33.9%

Valuation Metrics
(@1/29/21):

	FB	S&P 500
P/E (TTM)	25.6	40.9
Forward P/E (Est.)	23.2	22.1

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Vanguard Group	7.2%
Capital Research & Mgmt	6.0%
Fidelity Mgmt & Research	5.0%
BlackRock	4.4%
T. Rowe Price	4.2%

Short Interest (as of 1/15/21):

Shares Short/Float	0.8%

FB PRICE HISTORY

THE BOTTOM LINE

Armed with what François Rochon considers "among the strongest and most durable moats I've ever seen," the company should be able to navigate regulatory challenges and continue to prosper from broad secular trends in its favor, he says. At what he would then consider a reasonable 25x his 2025 earnings estimate, the shares would trade at $500.

Sources: Company reports, other publicly available information

impactful. That shift in spending may have temporarily accelerated during the pandemic, but it still has far to go before running its course. The growth potential outside the U.S. is even more pronounced. Facebook's average quarterly revenue per user is close to $54 in North America, but only $17 in Europe, $4 in Asia and less than $3 in the rest of the world. North America today makes up approximately 9% of Facebook's users, but represents 49% of revenues. That gap should narrow as the company steadily increases revenues per user outside the U.S. and Canada.

The big worry is that Facebook is a target of regulators around the world who dislike its monopoly-like characteristics, its privacy policies, and its control (or not) over controversial content. We don't profess to be experts on regulatory matters, but we do believe the company has shown the willingness and the ability to respond when challenged, and that it will continue to do so in a way that doesn't fundamentally change the execution or profitability of its business model. Even with all the public discussion around privacy and content, there's been little noticeable impact on user or advertiser engagement. There will continue to be controversy, we just believe the business is so solid that it can sustain some troubles here and there.

How are you looking at valuation with the shares now trading at around $258.30?

FR: The stock trades at 21.5x the $11 per share we believe the company can earn in 2021, adjusted for $21 per share in cash on the balance sheet. We think that multiple is quite reasonable given the quality of the earnings – everything that should be expensed is expensed – and the growth potential we see in revenue and profits.

Operating income hasn't always grown as fast as revenues in recent years as the company has invested in people and processes necessary to meet the increasing demands of users, advertisers and, in some cases, regulators and politicians. We believe that this year operating margins will start to stabilize and that revenue and profit growth will be more in sync. So as the number of users increases, as the switch from traditional media spending to online continues, and as revenues per user increase worldwide, we believe that can translate into 15-20% annual revenue and earnings growth over the next five years.

We estimate EPS could reach close to $20 in 2025. With a 25x P/E multiple, that would result in a share price of around $500. It's really a fairly simple premise: this is one of the strongest businesses in the world, with a clean balance sheet, conservative accounting, a large moat and an only average multiple that in our opinion undervalues its prospects.

ON REGULATORY ISSUES:

We believe the company will respond in a way that doesn't fundamentally change its execution or profitability.

Describe your investment case for car-insurer Progressive [PGR].

FR: I first started to research the company in 1994 when I read a recommendation for it in the newspaper by legendary investor Philip Carret, who was 97 years old at the time but still looking for interesting companies to purchase for the long haul. I followed it for five years before getting the chance to buy in after the stock fell by 60-70% when the market got concerned, in part, about its heavy investment to transition its direct-to-consumer business to what was then a nascent Internet. We did well with it over the next several years and sold at a point when we believed the growth rate was slowing enough to be a concern.

We always kept an eye on the company, and got interested enough to buy it again in 2019 as we saw earnings starting to grow more meaningfully. Tricia Griffith took over as CEO in 2016 and has done a great job of reinvigorating growth by investing in technology, which allows Progressive to set premium rates more efficiently, and adding a home insurance line that could be effectively bundled with car policies to drive incremental sales.

Progressive's main competitive advantages are its technology leadership and its ingrained culture of keeping costs low. They've been selling online longer than anyone and were also early adopters of telematics, which involves installing a device on a customer's car – with permission, of course – to track how he or she drives so premiums can be priced more accurately. The company consistently earns better-than-average combined ratios – 92-93% over the last few years, vs. closer to 100% for the industry – and returns on equity have been running better than 20%. Berkshire Hathaway's Geico and Progressive have consistently taken market share and are now the #2 and #3 car insurers in the U.S. We think both are likely to continue to take share.

Are you expecting any longer-term impacts on the company's business from the pandemic?

FR: One positive for car insurers would be if people as things return more to normal drive their own cars more rather than take Uber or public transportation. One negative would be if more people working from home results in fewer miles driven and puts pressure on premium levels. I would say in general we don't believe the long-term pandemic impacts will be that high, either because behavior doesn't ultimately change that much or because positives more or less offset negatives.

As for other secular trends, we don't see an issue for Progressive from electric cars. People will still be driving them and still need insurance to do so. The bigger worry would be if self-driving cars were to become pervasive and that resulted in a significant decline in the number of cars bought and in the incidence of accidents. I don't know when or if that happens on a large scale, but I am pretty confident that it happening at a level that would materially impact Progressive is likely many, many years away.

How inexpensive do you consider the company's shares at the current price of around $87.20?

FR: Earnings in 2020 were out of the ordinary due to the pandemic, but from 2019's base we think EPS can increase by roughly 12% per year over the next five years to about $10.75 in 2025. We expect that to be driven primarily by continued share gains, premium increases and reaching new customers who want to bundle their car and home insurance. The stock has historically traded at a 12-18x P/E, and if we assume 16x – which is slightly above the forward multiple on consensus earnings today – the shares would trade at $172.

This is a good example of what we're finding attractive in the current market. The growth maybe isn't as exciting as you can find elsewhere, but this is a much better than average company that we think can increase its intrinsic value by 12% per year – and we're getting that at a discounted multiple relative to the market. That's a dynamic that has historically worked quite well for us.

Sticking to insurance, why are you high on the prospects for Markel [MKL]?

FR: This is another company I've followed for more than 20 years and we've owned it for nearly eight. We know [Co-CEO] Tom Gayner and his team well and consider them excellent stewards of capital.

The company operates in a number of specialty insurance lines – like insuring summer camps or dental practices – that are less commoditized. It's proven strong over time at underwriting, with combined ratios frequently at or below 100. Like Berkshire, they invest the float more heavily in equities and have also built a Markel Ventures unit with independent operating companies outside of the insurance sector. Book value over a long period of time has increased at an 11-12% annual rate.

On top of that solid foundation, we believe the insurance pricing cycle has the potential to improve over the next few years as low interest rates and the relatively soft market in recent years has put increasing pressure on insurers to put through more substantive price increases and improve profitability. We never count on getting the timing of something like that right, but the messages we're getting from a number of our industry contacts are consistently more optimistic than usual about the pricing environment. Markel can do well either way, but a harder pricing cycle would be an added bonus.

The shares, now around $970, are still well off their 52-week highs. What upside do you see from here?

FR: We're basically assuming that all the elements are in place for the company to continue to increase its book value at 11-12% annually going forward. It will continue to generate underwriting profits, to invest the float competently, and to reinvest capital in both insurance-related and Markel Ventures acquisitions. If we're right in that basic assessment, it would mean that book value could reach $1,400 per share in 2025. At the stock's average multiple over the past ten years of around

INVESTMENT SNAPSHOT

Progressive
(NYSE: PGR)

Business: The third-largest automobile insurer in the U.S., selling both directly and through traditional agency channels; diversified into home insurance through acquisition in 2015.

Share Information (@1/29/21):

Price	**87.19**
52-Week Range	62.18 – 102.05
Dividend Yield	0.5%
Market Cap	$51.02 billion

Financials (TTM):

Revenue	$42.64 billion
Operating Profit Margin	17.3%
Net Profit Margin	13.4%

Valuation Metrics
(@1/29/21):

	PGR	S&P 500
P/E (TTM)	9.0	40.9
Forward P/E (Est.)	15.0	22.1

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Vanguard Group	7.8%
Wellington Mgmt	6.6%
BlackRock	5.1%
State Street	4.3%
JPMorgan Inv Mgmt	2.5%

Short Interest (as of 1/15/21):

Shares Short/Float	0.9%

PGR PRICE HISTORY

THE BOTTOM LINE

The company's technology leadership, marketing prowess and ingrained culture of keeping costs low should allow it to continue to take car-insurance market share in the U.S., says François Rochon. He expects earnings to grow at 12% annually over the next five years, and at a 16x P/E on his 2025 estimate the shares would trade at more than $170.

Sources: Company reports, other publicly available information

INVESTMENT SNAPSHOT

Markel
(NYSE: MKL)

Business: Specialty insurer known for its Berkshire Hathaway-like reinvestment strategy focused on public equities and, increasingly, independent operating companies.

Share Information (@1/29/21):

Price	**969.48**
52-Week Range	710.52 – 1,347.64
Dividend Yield	0.0%
Market Cap	$13.36 billion

Financials (TTM):

Revenue	$8.96 billion
Operating Profit Margin	9.8%
Net Profit Margin	5.4%

Valuation Metrics
(@1/29/21):

	MKL	S&P 500
P/E (TTM)	29.9	40.9
Forward P/E (Est.)	21.6	22.1

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Vanguard Group	8.3%
BlackRock	4.9%
Principal Global Inv	4.8%
Wellington Mgmt	3.6%
Akre Capital	3.4%

Short Interest (as of 1/15/21):

Shares Short/Float	0.6%

MKL PRICE HISTORY

THE BOTTOM LINE

François Rochon believes there's been a significant and unwarranted divergence over the past year in what's happened to the company and what's happened to its stock price. If it continues to increase book value by 11-12% annually and if its shares trade at their 10-year-average price/book ratio, he expects the stock price to reach $2,100 by 2025.

Sources: Company reports, other publicly available information

1.5x book, it would result in a $2,100 share price.

Over the past year there's actually been a pretty significant divergence in what's happened to the company and what's happened to the stock. We believe book value will probably have increased 6-7% in 2020, but the stock was down 15%. That's the opposite of what you see in a great number of cases today.

In an effort to learn from mistakes, you often examine what you consider your errors of omission. Can you share a recent example?

FR: One stock we almost bought at the same time we were studying Five Below was Floor & Decor [FND], a manufacturer and retailer of mostly tile residential and commercial flooring. We'd been a long-time shareholder of Mohawk Industries and had noticed how luxury vinyl tile has changed the flooring industry and Floor & Decor has been an important player in that change. It has an excellent business model and a strong track record of growth. The P/E on its stock had generally reflected that growth, so was too expensive for us. But when the pandemic hit the shares fell below $30, against the $1.50 or so in EPS we thought the company could earn in 2021.

I don't remember the exact day, but probably on a Friday in early April we decided to buy Floor & Decor shares on Monday. The stock went up $3-4 on Monday, so we decided to hold off and wait for it to come back down. We had done the homework and thought we knew the company very well. Given the upside we saw in the stock that $3-4 really didn't matter, but we couldn't pull the trigger. It's a natural thing for value investors to do and I've made similar mistakes many times, but we can be a bit wiser than that. It's rare to have confidence a company can grow its earnings at a 15-20% annual rate – if the price is still reasonable you shouldn't try to put too fine a point on it. [Note: Having fallen as low as $24 in March, FND shares currently trade at $92.]

What would you say is your biggest worry as an investor today?

FR: I mentioned that I avoid trying to predict the future when it comes to anything macroeconomic, but I do think any investor today should at least be thinking about what would happen to their portfolio holdings if interest rates went up. One of the only ways to justify some of the 40, 50 and 60x P/Es we see these days is if you assume interest rates will stay as low as they are for many, many years. In many instances, that results in what are in my opinion quite slim margins of safety.

I also ask what would happen to a lot of balance sheets and to profitability if interest rates rose even close to where they've been historically? What happens to valuations? I'm not forecasting higher interest rates, but I want to acknowledge the risks such an increase might create. We like owning companies like JPMorgan [JPM], Bank of America [BAC] and Charles Schwab [SCHW] that would likely benefit from higher rates. We like owning Berkshire Hathaway and other insurance companies that also would likely benefit from higher rates. We want to avoid companies with too much debt – that's always the case, but more so today than ever. VII

Investor Insight: Adam Wyden

ADW Capital's Adam Wyden and Jonathan Abenaim explain how they try to get an edge on their competition, their key takeaways from an unaccustomed period of adversity, what they did and didn't do when the coronavirus arrived last year, and what they think the market is missing in GFL Environmental, RCI Hospitality, APi Group and Par Technology.

You went through somewhat of a portfolio overhaul that was finished not long before the pandemic crisis hit. To start out, explain what prompted that.

Adam Wyden: We'd had a great run performance-wise since starting the firm in 2011, but had two lousy years in 2018 and 2019. In thinking through what happened and what to do about it I didn't see any reason to question our fundamental approach. We focus on small to midcap companies that are undergoing significant change and whose shares we think can dramatically revalue upward as that change plays out, independent of the prevailing economic environment. We concentrate the portfolio on the absolute best five to ten investment ideas we have at any given time and will hold cash if we can't answer why the fund absolutely needs to own a particular stock. We don't believe you can ever know too much about a business, so we try to obtain an edge through exhaustive primary research.

I'll spare you the gory details, but our takeaways from the mistakes we made in 2018 and 2019 had mostly to do with overstaying our welcome in companies we should have recognized were not very high-quality or were overly cyclical. We didn't pay enough attention to the trading liquidity in stocks that became very large positions. We also got hurt in cases where the people in charge weren't nearly as aligned as they should have been with our interests as public shareholders.

In the fourth quarter of 2019 we purged some holdings that no longer fit and added two new positions, RCI Hospitality [RICK] and APi Group [APG]. We also – fortunately as it turned out – had a lot of cash available coming into 2020. The common threads in everything we own now are highly incentivized owner/operator management teams. The businesses are largely acyclical, so we don't have to time entry and exit so precisely. In all cases there's significant growth potential that we don't think we're paying for, which again puts less pressure on having to nail exactly when to buy and sell. [Note: After falling a total of nearly 37% in 2018 and 2019, Wyden's portfolio last year rose nearly 120% after fees.]

ON MISTAKES:

We mostly overstayed our welcome in companies that were not very high-quality or were overly cyclical.

How did you put your cash to work when the pandemic hit?

AW: I'd like to say we perfectly timed the bottom, but we just didn't. But we did fairly early on add materially to all our core positions, in RCI, in APi, and in Par Technology [PAR], which we've spoken about before [VII, June 26, 2019]. We also added a new position in GFL Environmental [GFL], which we'd been researching in advance of it going public in early March.

In terms of trading around the market tanking, given our process it's difficult to act quickly on purely de novo ideas. From our knowledge of Par Technology, I had a thesis around fast-food restaurants that would benefit from increased drive-thru business. We looked at a few companies, including Jack in the Box [JACK], but before we got anywhere near the depth of research we like to do the opportunity seemed to have passed. Could we have put together a basket of quick-service restaurants? Maybe, and we would have likely done very well with it. That's just not the way I like to do things.

Let's dive into talking about ideas. Why does GFL Environmental fit the profile of what interests you?

Jonathan Abenaim: The company went public early in March at $19 per share and the stock proceeded to tank along with everything else with the pandemic. Today it's one of the largest players in the North American garbage-collection business, having been built from the ground up in 2007 by CEO Patrick Dovigi.

There are several things we like here. The business tends to be acyclical and relatively insulated from competition by long-term municipal contracts. GFL focuses more on secondary markets, where Patrick saw a particular opportunity to buy small competitors with overlapping routes and redundant assets and then eliminate those redundancies and give the local players access to capital, technology and additional services that allowed them to gain market share. They've usually been able to expand margins over time on acquired assets by roughly 500 basis points, which moves the needle a lot when you're acquiring something at 5-6x EBITDA.

The waste-collection business in North America today is about 60% consolidated and 40% is still mom and pop. A good percentage of those mom and pops are in more rural markets and GFL is really the only major player that seems to care about rolling up assets like those. We think the runway for them to keep doing what they've been doing is still very long.

AW: I would reinforce the importance of partnering with people like Patrick Dovigi. He started with one garbage truck and the company now earns in excess of C$1.5 billion in annual EBITDA. He takes a small salary, allocates capital like a true owner – which he is with a 6% economic stake in the company – and he's massively incentivized to create shareholder value

through an options package tied exclusively to stock appreciation. He's a winner, he still wants to win, it's not all about his ego, and he's only 41 years old. We want to play the game with people just like that.

GFL made two large-for-it acquisitions in the third quarter of last year, leveraging up to do so. Did the aggressiveness of that surprise you at all?

JA: Both were fully in line with the strategy and play to the company's strengths. The first was to buy assets that regulators required to be sold as a condition for approving the acquisition last year of Advanced Disposal by Waste Management. GFL was the only cash-ready bidder and we estimate got a good price in paying roughly 8.5x EBITDA. This expands the company's footprint in the U.S. Midwest, providing a new platform in a relatively untapped market to do tuck-in M&A.

The second deal, purchasing WCA Waste from Macquarie Group for $1.2 billion, also makes sense to us. It further expands the footprint in the U.S. Midwest and Southeast, in still-fragmented markets ripe for consolidation. They didn't overpay at what we estimate was around 9x EBITDA, and the deal was financed with cash and preferred stock that was convertible at $25 per share. The fact that outside private equity was willing to fund nearly half the purchase price effectively in equity – at what was then a 20% premium – speaks to their view of GFL's runway.

We're comfortable with the balance sheet leverage following the deals – roughly 4x net debt/EBITDA – and true to the historical playbook we expect there to be plenty of incremental cash flow generated to de-lever the balance sheet as they go. We also expect the company to take advantage of low interest rates and refinance a significant portion of the debt this Spring to bring down interest expense further.

The market seems to be warming to the company's potential in recent months. How attractive do you consider the shares at the current C$36.10 price?

JA: Off its current base we think GFL can generate 7.5% or so organic annual top-line growth – from price and volume increases – which in turn should yield greater than 15% free cash flow growth per year for the foreseeable future. On top of that we expect continued accretive M&A.

At the current stock price you're paying 15x what we think the company can earn in free cash flow per share this year. That's a discount to the 25x free cash flow at which competitors like Waste Connections and Casella trade today. If the valuation doesn't change at all and we're right about the growth in cash flow, the stock should compound at 15% per year, plus whatever we get from further acquisitions. But we also believe the market will eventually recognize the quality of management, the growth potential and the differentiated business model and ultimately price the stock at least on par with less interesting peers. That could make it a multi-bagger over the next few years.

From waste collection to hospitality, describe what put RCI Hospitality on your radar screen?

INVESTMENT SNAPSHOT

GFL Environmental
(Toronto: GFL)

Business: Provider of waste collection and waste management services, with operations throughout Canada and in 27 U.S. states; came public through an IPO in March 2020.

Share Information
(@1/29/21, Exchange Rate: $1 = C$1.28):

Price	**C$36.10**
52-Week Range	C$16.85 – C$41.06
Dividend Yield	0.1%
Market Cap	C$11.78 billion

Financials (TTM):

Revenue	C$3.86 billion
Operating Profit Margin	(-1.9%)
Net Profit Margin	(-17.8%)

Valuation Metrics
(@1/29/21):

	GFL	S&P 500
P/E (TTM)	n/a	40.9
Forward P/E (Est.)	225.6	22.1

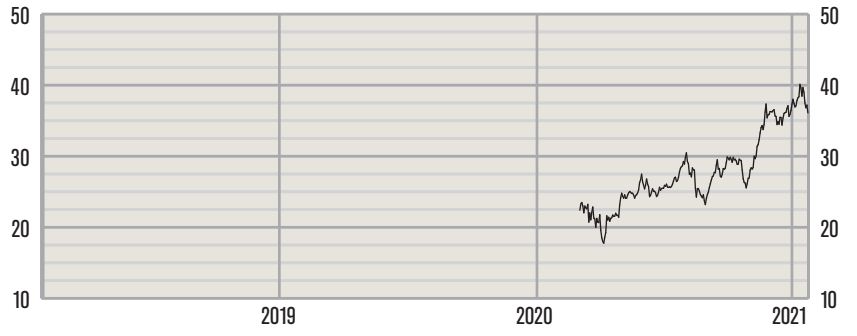
Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
BC Partners	19.9%
Ontario Teachers' Pension Plan	16.2%
GIC Private Ltd	9.6%
HPS Investment Partners	8.2%
Wellington Mgmt	3.4%

Short Interest (as of 1/15/21):

Shares Short/Float	n/a

GFL PRICE HISTORY



THE BOTTOM LINE

The company stumbled out of the gate in going public as the pandemic hit last year and the extent of its potential still seems to be eluding the market, says Jonathan Abenaim. Even without the benefit of future M&A and a re-rating of the stock, he believes the company's free cash flow – and shareholder value – can increase at least 15% annually.

Sources: Company reports, other publicly available information

AW: This is something we've followed for a long time. It started showing up after the financial crisis on screens as being quantitatively cheap and I'd hear other investors talk about how even though the business was kind of seedy – nightclubs with strippers – the CEO, Eric Langan, was a smart guy who really understood capital allocation. I never did anything with it but caught up on it once in a while to see what was going on.

Then in 2019 I had two investors I respect ping me and suggest I take a closer look. The company had a new restaurant concept that seemed to have a lot of potential, which could jumpstart growth and help diversify away from the nightclubs. The stock was trading at a low cash-flow multiple. Eric Langan was still in charge and very focused on creating shareholder value. I felt like I'd seen this video before. Let's use our expertise – in this case around real estate, retail and entertainment – and leverage the cash flow, infrastructure and systems in place to build a new business from scratch that no one is paying any attention to. It all came together, and following the carnage in March we established a position in the second quarter of last year.

Describe RCI's two main businesses.

AW: The traditional business is nightclubs, which is a high-quality business with attractive unit economics, 30%-plus operating margins and minimal capital requirements. The assets are mostly in Texas, Florida and New York and are generally regional oligopolies – only a few licenses are ever issued per municipality – so the barriers to entry are extremely high. It's also a fragmented market with a large continuing opportunity for M&A.

Bombshells is the restaurant concept, which is a military-themed restaurant and sports bar that is shooting to attract a broader universe of customers by both age and gender. The unit count is up to 10 company-owned stores, all in Texas, and same-store-sales growth has averaged in the low-teens since the concept was launched in 2013. The company has a franchise plan in place and in December announced its first deal for three franchised restaurants in San Antonio.

What else can you tell us about the CEO?

AW: We think Eric Langan is a tremendous operator with a great record of deploying capital at high rates of return for shareholders. He basically sold his baseball-card collection to buy a nightclub and went from there. He owns 800,000 shares, has never issued a stock option and as far as we can tell has never done anything to the detriment of shareholders. He wants to win and he's been at it since he was 19.

How do you arrive at what you think the shares, now at $38.50, are worth?

AW: On a run-rate basis going into Covid, the business was generating around $65 million in annual EBIT. We think nightclubs coming out of Covid can comp at 10%, which would add an incremental $12-15 million in operating income. Bombshells historically earned minimal EBIT prior to 2020, but we think it's at an inflection point and can generate an incremental $20 million in EBIT over the next year. So we're looking a year out at close to $100 million in EBIT, which after

INVESTMENT SNAPSHOT

RCI Hospitality
(Nasdaq: RICK)

Business: Holding company for two U.S. operating divisions, one focused on adult-entertainment nightclubs and the other on Bombshells-branded restaurants/sports bars.

Share Information (@1/29/21):

Price	**38.48**
52-Week Range	6.52 – 43.70
Dividend Yield	0.4%
Market Cap	$346.3 million

Financials (TTM):

Revenue	$132.3 million
Operating Profit Margin	10.0%
Net Profit Margin	(-4.6%)

Valuation Metrics
(@1/29/21):

	RICK	S&P 500
P/E (TTM)	n/a	40.9
Forward P/E (Est.)	23.2	22.1

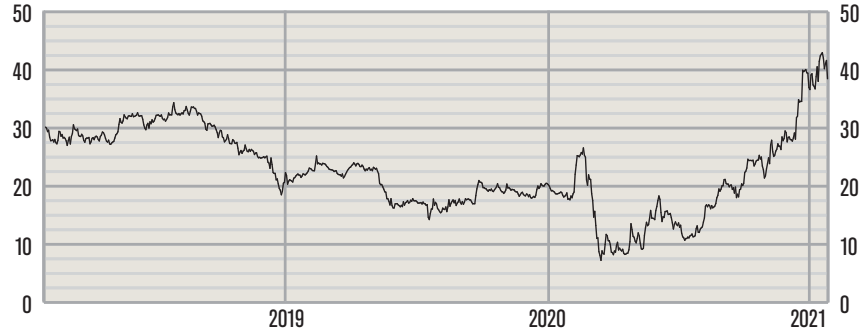
Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
ADW Capital	10.0%
Greenhaven Road Inv Mgmt	6.4%
BlackRock	5.5%
Dimensional Fund Adv	5.1%
Vanguard Group	4.5%

Short Interest (as of 1/15/21):

Shares Short/Float	6.5%

RICK PRICE HISTORY



THE BOTTOM LINE

While it's a company "maybe Wall Street has never been entirely comfortable with," says Adam Wyden, he expects that to change as it capitalizes on M&A opportunities coming out of the pandemic and expands a promising restaurant concept. On his forward one-year estimates, he believes the shares today trade at a 20%-plus free cash flow yield.

Sources: Company reports, other publicly available information

accounting for interest expense, taxes and maintenance capex would be $72-75 million in free cash flow. At today's market cap of around $350 million, you're paying less than 5x free cash flow.

Not only do we think a 20%-plus free cash flow yield is way too cheap for the existing business, but we're also not paying anything for incremental organic or M&A growth. RCI is the only acquirer of scale in the nightclub business with a public market currency, and we're expecting considerable opportunity to acquire distressed assets at low multiples of free cash flow as we exit the pandemic. For Bombshells, the potential to grow unit count and overall profit contribution is enormous. The company thinks it can open as many as 300 units over time – I don't know if they get there, but it's not an unreasonable goal and even falling short of that the restaurants could end up dwarfing the nightclub business.

This is a business Wall Street has maybe never been entirely comfortable with. But if the numbers explode like we think they can, it's pretty likely that will change.

Your next idea, APi Group, is a one-time British SPAC turned Minnesota-based industrial services company. What's the back story here?

AW: The predecessor company, J2 Acquisition Corp. was indeed a SPAC formed by Martin Franklin, a remarkable businessman who's best known for building Jarden Corp. from a $300 million jar maker into a $9 billion revenues consumer-goods conglomerate that was sold to Newell Brands in 2015 for $15 billion. Over his 15-year tenure with Jarden, the company delivered a 5,000% total return to investors, or about 30% a year. With J2 (for Jarden #2) he was looking to apply the same basic strategy – acquiring and building dominant niche brands with pricing power and great cash flow conversion – to services companies that were less susceptible to Internet-related disruption.

In September of 2019, J2 announced the acquisition of APi, an industrial-services conglomerate built by another remarkable businessman named Lee Anderson. The company's largest division – accounting for 70% of EBITDA – is called Safety Solutions, which installs, repairs and services commercial fire-safety, security, sprinkler, HVAC and other systems. The next-largest business – at roughly 20% of EBITDA – is called Specialty Services and provides mostly infrastructure-building services, like laying out fiber-optic systems for telecom companies or building and maintaining wastewater systems for municipal governments. The company has been built over time with very much of a Danaher-style culture of operating excellence, leadership development, employee ownership and personal accountability.

Lee Anderson didn't want to sell to private equity and have the company sliced and diced, so when Martin Franklin came along offering a cash deal with no earnouts and a desire to keep the management and culture in place, he took it. J2 paid roughly 7.5x EV/EBITDA, which was certainly less than what the highest private-equity bidder was willing to pay.

Because J2 was originally listed in London, it took some time to get the shares listed on the New York Stock Exchange, which happened in April of last year. They

INVESTMENT SNAPSHOT

APi Group
(NYSE: APG)

Business: Provider of a broad range of industrial services, including the installation, maintenance and repair of commercial fire-safety, security and heating/cooling systems.

Share Information (@1/29/21):

Price	**17.91**
52-Week Range	8.84 – 19.17
Dividend Yield	0.0%
Market Cap	$3.39 billion

Financials (TTM):

Revenue	$3.54 billion
Operating Profit Margin	(-20.0%)
Net Profit Margin	(-23.4%)

Valuation Metrics
(@1/29/21):

	APG	S&P 500
P/E (TTM)	n/a	40.9
Forward P/E (Est.)	14.6	22.1

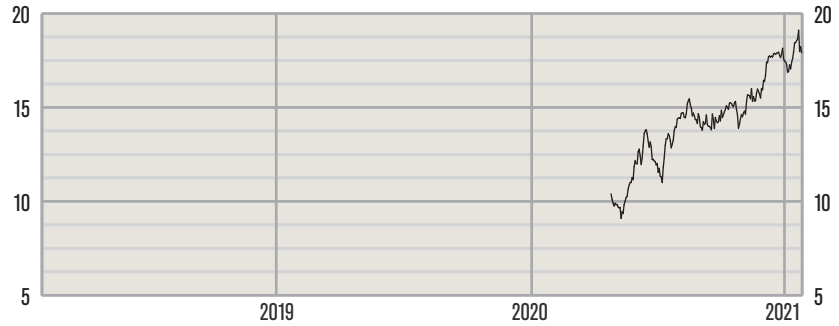
Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Viking Global Inv	19.6%
Fidelity Mgmt & Research	7.2%
Vanguard Group	6.9%
BlackRock	4.6%
Permian Inv Partners	3.2%

Short Interest (as of 1/15/21):

Shares Short/Float	5.6%

APG PRICE HISTORY



THE BOTTOM LINE

The company's shares are significantly undervalued relative to public comps, says Adam Wyden, which says to him that today's shareholder is paying less than nothing for potential organic growth, margin expansion and the M&A acumen of Co-Chairman Martin Franklin. At a peer multiple of his 2021 free cash flow estimate, the stock would double.

Sources: Company reports, other publicly available information

first started trading in the U.S. on the pink sheets, with one analyst following it. That's how we bought it originally, when it was kind of an orphan.

How has the business held up through the pandemic?

AW: These types of businesses tend to be very resilient, providing non-discretionary services that require skilled maintenance and repair and generate highly recurring revenues. In the 2008 recession when APi had a more unfavorable revenue mix – with more new-build versus service – the company's EBITDA stayed largely flat.

In Safety Solutions, while installations of new systems are a large portion of revenues, the company prices new installs at low profit margins to help drive higher-margin service contracts. So while new installs were impacted in the second quarter of last year, the more profitable service side held up well. You have to maintain your fire-safety system regardless of what's going on with occupancy or tenants. In Specialty Services it was almost business as usual. These are truly essential services for water and sewer companies, utilities and telecoms, who have to get the work done. The overall comparisons are difficult because of the company's short history in its current form, but management at the end of last year ended up increasing its guidance for adjusted 2020 EBITDA because performance in the latter part of the year was tracking ahead of projections.

In our view, the virus will have no long-term decremental impact on API's economics or growth prospects. In fact, we believe API will take market share coming out of this from smaller, poorly capitalized mom and pop competitors. We'd also expect M&A opportunities to increase as these same competitors are increasingly open to indications of interest from a stronger, advantaged company like APi.

Now trading at just under $18, how are you valuing the stock?

AW: Any way we come at it we think the shares are very cheap. Keeping it simple, we expect APi to generate in excess of $2 per share in free cash flow this year. Based on public comparables of specialty industrial businesses like Honeywell or Johnson Controls, the stock would trade at $35-40. To our mind, we're paying nothing for the organic growth of the business – which has historically been 8-10% on the top line per year – for margin expansion as the business scales, or for the M&A acumen of Martin Franklin and his team. If all that kicks in as we think it can, the stock would be much more than a double from here.

Par Technology has done very well since we spoke about it 18 months ago. Why do you think the story still has room to run?

AW: This is a position we first put on in early 2018. We saw a number of things we thought could improve from an operational, capital allocation and corporate governance standpoint, and we thought the company had a transformative hidden gem in its Brink cloud-based point-of-sale system for quick-service restaurants. We played an important role in bringing in a new CEO, Savneet Singh, to enact change, and he's done an excellent job so far. He's improved the balance sheet, cut costs, strengthened the management team, invested in product innovation and made two bolt-on strategic acquisitions.

The core of the thesis still revolves around Brink, which is at the center of Par's software-as-a-service transformation. We believe Brink is by far the best and most proven cloud POS system on the market – the main competitors are Oracle-owned MICROS Systems and NCR's Aloha – and that it is ideally positioned to benefit as the industry moves from on-premise to cloud platforms. The POS is central to every transaction in a restaurant and it interfaces with more than a dozen other operational functions an operator must navigate, including things like payments processing, analytics, accounting, inventory management and human resources. So in addition to adding new customers to the platform at a rapid clip, there's also a tremendous opportunity to expand the

revenue per customer by building, buying or partnering to include additional functionality in a single integrated offering.

The stock got slammed in March of last year and we substantially increased our position, believing the pandemic would pull forward demand as large chains increasingly gave up on antiquated legacy systems and there were more and more use cases showing that Brink would save them money and improve customer service. Par's main customers are chain quick-service restaurants like Arby's, DQ and Five Guys, mostly all of which are well-capitalized and are likely to come out of the pandemic competitively stronger against table-service restaurants or small restaurants of any kind that have been hurt by it.

The market seems to be taking notice. How are you looking at valuation from today's price of $62.25?

AW: The company still has an unrelated defense business and a legacy point-of-sale hardware business, both of which are actually pretty healthy and generating solid cash flow. Using relevant public-company comps, we value those two businesses at around $350 million. If you back that out and adjust for $55 million in cash on the balance sheet, at today's stock price you're paying roughly $900 million in market cap for a software-as-a-service business which should exit the year with over $80 million in annual revenues that are growing 50-100% per year. That's extremely low for a SaaS business like this – comps tend to trade at 15-20x revenue.

The real upside here is in growth. We think it's possible that by year-end 2025 that Brink can have 50,000 units on the platform – up from roughly 12,000 today – and that it can more than double its revenue per unit to closer to $6,000. At that point it would be generating annual run-rate revenues of $300 million. Put a 10-20x revenue multiple on that and there's $3 billion to $6 billion in value just for Brink. That's against a market cap today of $1.3 billion. If the wallet share turns out to be significantly more than $6,000, which we believe is entirely likely, the upside is much higher.

You've come roaring back after a period of adversity. Do you think you're a better investor as a result?

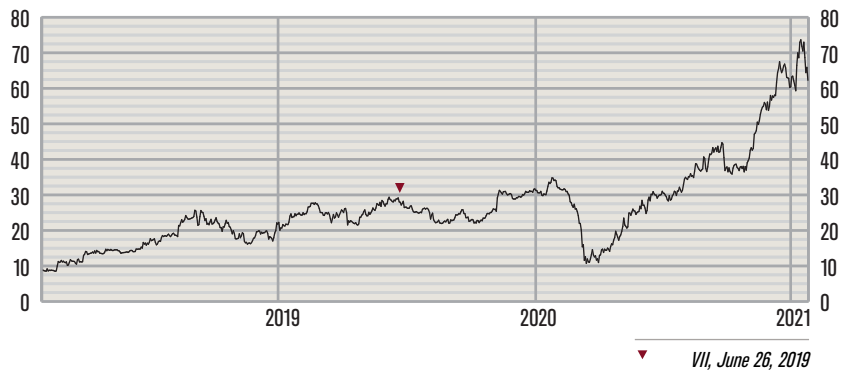
AW: I hope so. I really love what I do and I think I'm pretty good at it. But the market is a great equalizer and I've learned pretty clearly that you're not good at it all the time, and that you can never rest on your laurels. If you want to stay in the game, you have to continuously improve and evolve with the ever-changing rules of capitalism and public markets. In the NBA if you want to make it as a big man today you have to be able to run the court, essentially play every position, and even learn how to shoot three-pointers. The speed and complexity of the game has changed.

What we think really differentiates us is that in striving to evolve we've narrowed our focus to only seeking out opportunities that we believe can return 5-10x our capital while protecting our downside. There are many market participants today who don't have the duration for the big-game hunting that we do. That requires having investors who understand our approach and are with us for the right reasons, and we're very fortunate to have that. VII

INVESTMENT SNAPSHOT

Par Technology
(NYSE: PAR)

PAR PRICE HISTORY



Share Information (@1/29/21):

Price	**$62.26**
52-Week Range	9.63 – 75.89

Valuation Metrics (@1/29/21):

	PAR	S&P 500
Trailing P/E	n/a	40.9
Forward P/E (Est.)	n/a	22.1

ORIGINAL BOTTOM LINE – June 26, 2019

Adam Wyden expects the company's new CEO to capitalize on what he sees as the home-run potential of its software-as-a-service restaurant management system. On his sum-of-the-parts valuation, he thinks the stock can at least triple over the next few years.

NEW BOTTOM LINE

While the success of the company's cloud-based point-of-sale system for quick-service restaurants is less "hidden" than it was, Adam Wyden believes it can grow users and per-user revenues dramatically beyond the expectations built into the current share price.

Sources: Company reports, other publicly available information

Investor Insight: Petra Capital

Petra Capital Management's Chan Lee and Albert Yong describe why now is a particularly interesting time to be investing in South Korea, why they consider flexibility one of their most important traits as investors, where they're spending the most time today looking for new ideas, and what they think the market is missing in Daou Technology and Soulbrain.

You've done very well over a long period in which the Korean market has gone mostly sideways. To what primarily do you attribute that?

Chan Lee: This may be less true today than it once was, but to a certain extent we've benefitted from a level of competition when it comes to value hunting that is much lower in Korea than in other advanced equity markets like the U.S. There just aren't as many truly long-term investors who are sophisticated and experienced enough to correctly assess intrinsic values of Korean companies. Our ability to do that in an ever-changing economic environment and in difficult-to-analyze sectors or industries has so far proven to be somewhat of an edge.

We also think that we have an edge investing in small and mid-cap stocks that are not covered by many sell-side and buy-side analysts and that don't attract much interest from foreign institutional investors. Roughly 30% of the total equity market in Korea is held by foreign institutions, but many will not look at companies below a certain size, say around $2 billion in market cap. That all makes it more likely for us to find mispricings in smaller-cap companies.

Albert Yong: Another reason we've had some success is that we have an open mindset when it comes to opportunities. We haven't deviated from our core principle of buying stocks trading at significant discounts from their true values, but we're flexible about the type of company or situation in which that can be the case. Maybe it's more of a Ben Graham-type cigar butt. Maybe there's a significant holding-company discount compared to the sum-of-the-parts value. Maybe there is a growth opportunity that the market just isn't recognizing. Maybe there's a rising champion from Korea that most investors have not yet heard of. In a dynamic economy like Korea's, we think it's important to not be overly rigid about where we look for value.

After a long slumber, the Korean market came back very strongly in 2020 to be one of the better performing markets in the world. Is there a chance you'll have the wind at your back in the domestic market for a change?

CL: Part of that was that the pandemic relative to most countries has had a relatively minor economic impact. But the market was also very cheap prior to the pandemic, unlike the U.S., so there also might have been some pent-up demand when the economy turned out to be not as impacted as feared. We're also seeing the same kind of increase in retail investor activity as in other countries that seems to be driving a lot of the move up.

ON FLEXIBILITY:

In a dynamic economy like Korea's, it's important not to be overly rigid about where we look for value.

From a valuation perspective, Korea is still one of the cheapest equity markets in the world despite the rally from its March lows. Using Bloomberg data, as of the end of 2020 the market index was trading at a Price/Book ratio of 1.1x and a P/E of 14x. In Japan those numbers were 2.1x and 22x. In the U.S. the price to book was over 4x and the P/E on forward earnings nearly 23x. We're still dumbfounded by the fact that MSCI classifies Korea as an emerging market – along with places like Argentina, Turkey, Russia, Nigeria and Pakistan – but the case can be made that the country is the safest place to invest among emerging markets and that combining that with the current valuation levels could result in the market doing very well as the world fully recovers from the Covid-19 crisis. As we've already discussed, we don't count on things like that, but we do think it's a real possibility.

Did you actively reconfigure your portfolio much during the market's free fall early last year?

CL: We have a variety of different kinds of ideas in the portfolio, but I would say that even before the pandemic we had been shifting more emphasis to what might be considered "new age" companies. Korea is known for its heavy manufacturing and industrial base, but we started to increasingly find growing companies in areas like Internet services, e-commerce, renewable energy and digital media that below a certain market cap size were still trading at surprisingly cheap prices.

Given that we'd already positioned ourselves in more of these new-economy stocks, we didn't trade much at all as everything came down during the March crash. We felt the companies we owned for the most part were in the right areas and that, if anything, they could benefit from an acceleration of pre-existing economic trends that were already working in their favor. As it turns out we were right to not change our portfolio much because these types of companies ended up recovering faster and further.

AY: I can't say it's the best value at the moment, but CS Wind [Seoul: 112610] would be a good example of the dynamic Chan just described. The company manufactures the towers that support the turbines made by companies like Siemens, Vestas and GE to produce energy from

wind. It has an excellent reputation for quality, a global production footprint, and is one of a very small number of providers of towers to best-in-class partners building onshore and offshore projects.

You wouldn't think such a company in a hot global sector would be ignored in the Korean market, but we thought that was exactly the case prior to the pandemic. Part of that may have been because we don't have much of a wind-power market in Korea, but whatever the reasons, the shares had been going nowhere and we were able to buy them at close to 10x earnings. When the pandemic first came the stock got hit even a bit harder as oil prices fell so sharply and people thought that might have an incrementally negative impact on demand for wind power. That all changed relatively quickly and investors finally discovered CS Wind and started to recognize its long-term potential. [Note: That's putting it mildly – trading at around ₩35,000 at the beginning of 2020, CS Wind's shares fell as low as ₩15,000 in March. The stock currently trades at ₩160,000.]

When we last spoke [VII, September 30, 2018] you described mobile-gaming company Com2uS [Seoul: 078348] as an example of an idea with strong growth prospects that the market seemed to be ignoring. The stock is up modestly since – are you still interested?

AY: Yes we are. Our thesis for the company was that its flagship game, which is called Summoners War, would have a much longer lifespan than people seemed to expect and that the cash it generated could be put to good use by reinvesting in new mobile games both developed in-house and acquired from others. Even with significant investment spending on growth, there was enough cash on the balance sheet that some of it could also be returned to shareholders.

While Summoners War has continued to do well, there hasn't been much tangible progress on the capital-allocation front. The company started paying a small dividend. They've announced launch dates this year for two new games based on Summoners War intellectual property. They say they're looking to use cash for accretive acquisitions, but just haven't found the right fit yet.

We remain optimistic and think management will eventually prove to be good stewards of shareholder capital and build the company's value over time. And the stock still trades at less than 10x earnings if you exclude the cash. The pace at which things change can be frustrating at times for investors, but we need regularly to be patient and we've learned that patience is often rewarded.

Why do you believe IT-services holding company Daou Technology [Seoul: 023590] is mispriced?

CL: This is a classic example of a holding company whose market value is too far below the sum of its component parts. It's not so common in the U.S. for a public parent company to also have publicly traded subsidiaries, but it happens often in Korea. In Daou's case the company was founded in 1986 as an information-technology services provider and over the years has created a number of somewhat IT related businesses that have been suc-

INVESTMENT SNAPSHOT

Daou Technology
(Seoul: 023590)

Business: Holding company whose traditional business is in IT services, but that also owns public stakes in Internet-focused brokerage, job listings and certification subsidiaries.

Share Information
(@1/29/21, Exchange Rate: $1 = ₩1,118):

Price	**₩26,600**
52-Week Range	₩11,550 – ₩28,950
Dividend Yield	1.5%
Market Cap	₩1.15 trillion

Financials (TTM):

Revenue	₩5.01 trillion
Operating Profit Margin	16.7%
Net Profit Margin	5.6%

Valuation Metrics
(@1/29/21):

	023590	S&P 500
P/E (TTM)	4.3	40.9
Forward P/E (Est.)	4.0	22.1

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Daou Data	46.7%
Orbis Investment	9.4%
National Pension Service of Korea	7.1%
GMO	5.3%
International Value Adv	5.0%

Short Interest (as of 1/15/21):

Shares Short/Float	n/a

DAOU PRICE HISTORY

THE BOTTOM LINE

Chan Lee considers this a classic example of a Korean holding company whose market value is too far below the sum of its component parts. Summing his estimated values for its operating business and its publicly traded and private subsidiaries, he values the company (in U.S. dollars) at $2.6 billion, vs. its current market cap of just over $1 billion.

Sources: Company reports, other publicly available information

cessful in their own right. Kiwoom Securities [Seoul: 039490] is by far the largest, having become the leading online brokerage in the country, patterned after Charles Schwab or E*Trade in the U.S. Saramin HR is one of Korea's leading online job-listings companies. Korea Information Certificate Authority is the leader in providing certification and authentication services that facilitate online communications and transactions, not dissimilar to Verisign in the U.S. There are other still-private subsidiaries as well, but these three companies are all publicly traded and Daou retains a controlling equity share.

The valuation math here is relatively straightforward. Daou Technology's market cap in U.S. dollars is around $1 billion. Against that you have the company's 42% stake in Kiwoom Securities, which is worth nearly $2 billion based on its current public valuation. The equity stakes in Saramin HR and Korea Information Certificate Authority are collectively worth around $250 million or so, and we value the other privately held companies at about $50 million. Then there's the traditional IT business at the parent company level, which makes $25 million a year and at a 12x multiple would be worth another $300 million. Add those up and we arrive at $2.6 billion in value for Daou, which is more than 2.5x the current market cap.

How does something like this happen?

CL: Holding company discounts of 20-25% are not unusual, but it happens sometimes in smaller companies that the market is very slow to recognize changes in the sum-of-the-parts value. Because so much of its value comes from its Kiwoom Securities stake you would think the two stocks would move more in concert, but that is not always the case. Last year, for example, Kiwoom's stock went up almost 60%, while Daou's was up only 15%.

For non-Korean or less-sophisticated investors, Korean-style holding companies can be a bit difficult to analyze at a first pass. Under the IFRS accounting standards, for subsidiaries in which the parent company owns more than a 50% stake or exercises de facto management control, the entire financial activity of the subsidiary companies is reported in the parent's numbers. Although you can get all the component detail as well, the consolidated numbers can provide a somewhat distorted picture.

ON HOLDING COMPANIES:

Sometimes in smaller companies the market is very slow to recognize changes in the sum-of-the-parts value.

Are there any catalysts to narrow the discount here?

CL: We have on several occasions tried to be our own catalyst in working with companies to help bring out unrealized value. Here it's relatively difficult. The Founder/CEO owns more than 40% of the company through a family-controlled entity and is a real entrepreneur who is focused on investing and growing the business. So there's maybe not much an activist can or should do right now.

In our experience, sooner or later the market should recognize the value it's missing and that eventually will be reflected in the parent firm's stock price. As Albert said earlier, we need to be patient, and we expect that patience to be rewarded.

From a parent holding company to an operating-subsidiary spinoff, describe why you're high on the prospects for Soulbrain Co. [Seoul: 357780].

AY: The company was originally established in 1986 as a producer of specialty chemicals and materials used in the semiconductor manufacturing process. As you mentioned, the operating company was spun off as a subsidiary in August of last year and the original entity became a holding company. We believe Soulbrain Co. is significantly undervalued given its growth potential and profitability.

The business today is focused primarily on etchants and other materials that are used in the semiconductor deposition process and also in the manufacture of LCD and OLED displays. In its niche markets it has very strong market shares in Korea – as high as an 85% share in semiconductor etchants and roughly 40% in display etchants.

Traditionally, big Korean semiconductor manufacturers like Samsung Electronics and SK Hynix have bought more of their input materials from outside Korea, especially Japan. In 2018, Korea had a small trade war with Japan and the Japanese government blocked for a time the export of a number of materials used to make semiconductors. This provided an opportunity for domestic materials companies, including Soulbrain, to step in and take market share. We think this trend will continue, resulting in increasing revenues and profits for the company. Its return on equity is nearly 40% and its return on invested capital is over 30%. This is not a stock that should trade at 12x earnings.

We are also bullish in general on the semiconductor industry. Samsung is Soulbrain's largest customer and its memory chips are vital in many areas of the new economy, including cloud computing, driverless cars and artificial intelligence. At the same time, the supply side of the business has become more concentrated as the capital costs to compete grow ever higher, scale is more important, and the complexity of the manufacturing process increases. We think that sets up for a very positive outlook for the big manufacturers that Soulbrain can supply. While its focus is now in Korea, we think it will have the opportunity to supply large manufacturers in Taiwan and elsewhere as well.

Trading today at around ₩269,000, what upside do you see in shares from here?

AY: As the company continues to improve its market share in a nicely growing market, we believe earnings can increase 15-20% annually over the next several years. Even if the valuation multiple stayed the same – 12x estimated 2021 earnings of around $170 million [₩188 billion] – we think the shares should provide an attractive return. But on top of that there is also significant potential for P/E expansion. The company's market cap is in the range of $2 billion, which means it's likely to start to get noticed by more institutional investors from outside Korea.

Where are you spending your time looking for new ideas today?

CL: One theme we've been exploring is Korean consumer-brand companies expanding more aggressively outside the domestic market. Korean pop culture – including K-pop music, movies and TV dramas – is becoming increasingly popular in Asia and even in the U.S. If you hear Netflix describe its rapid growth in Asia, one key factor it cites is its emphasis on acquiring much more Korean content that has helped drive subscriptions.

We have always tried to find high-quality companies that start out domestically and have a strong growth runway ahead through expanding regionally and then even globally. As Korean pop culture finds a broader audience, we think it's possible that a number of innovative branded food, beverage, fashion and lifestyle companies can take advantage of that and build their businesses overseas. We still need to do more research to separate the fads from the real opportunities, but as a value investor you want to get there before other investors figure it out. This is one big reason why we think it's actually an exciting time to be investing in Korea. VII

INVESTMENT SNAPSHOT

Soulbrain Co.
(Seoul: 357780)

Business: South Korea-based producer of specialty chemicals and materials that are used primarily in the manufacture of semiconductors and of LCD and OLED displays.

Share Information
(@1/29/21, Exchange Rate: $1 = ₩1,118):

Price	**₩268,700**
52-Week Range	₩201,100 – ₩328,000
Dividend Yield	0.0%
Market Cap	₩2.09 trillion

Financials (TTM):

Revenue	₩992.00 billion
Operating Profit Margin	23.5%
Net Profit Margin	16.0%

Valuation Metrics
(@1/29/21):

	357780	S&P 500
P/E (TTM)	15.0	40.9
Forward P/E (Est.)	12.3	22.1

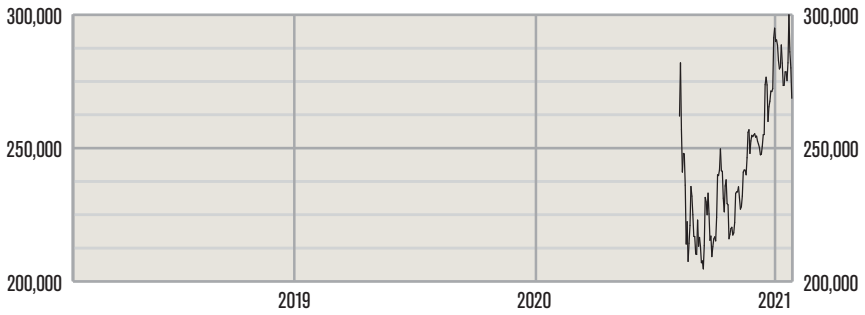
Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Soulbrain Holdings	46.5%
Mirae Asset Global Inv	1.7%
Vanguard Group	1.4%
Victory Capital Mgmt	1.2%
RAM Lux Systematic Funds	1.2%

Short Interest (as of 1/15/21):

Shares Short/Float	n/a

SOULBRAIN PRICE HISTORY



THE BOTTOM LINE

The market in pricing the company's shares at 12x forward earnings is significantly undervaluing its potential growth in supplying a dynamic semiconductor-manufacturing market, says Albert Yong. From market-share gains in a high-growth market, he believes the company's earnings per share can increase at 15-20% annually for several years.

Sources: Company reports, other publicly available information

What's In Store

Those trading Bed Bath & Beyond shares over the past week probably haven't been thinking too hard about the company's fundamental outlook. Call us old-fashioned, but why not check in with someone who is to see what they think?

You may have noticed that stocks with high short interest have been, ah, a bit volatile of late. Shares of home-furnishings retailer Bed Bath & Beyond, for example, closed on January 20th at $25. A week later they were at $53. On Thursday they fell 36%. On Friday the shares rose 5% to close at $35.33. The head spins.

While fundamentals have likely had little to do with the recent price action, there is a fundamental bull case for Bed Bath & Beyond's business, says Joseph Chin of Cambiar Investors. The high short interest, he believes, reflects the company's pariah status among investors after going from category killer to "share donor" over the past several years under recalcitrant and inept management. Led by Target alum Mark Tritton as CEO since late 2019, he argues better days are finally ahead.

Tritton is playing many of the cards in the turnaround deck. He replaced most of the company's top management. He's selling off non-core retail concepts. He's in the process of closing 200 underperforming Bed Bath & Beyond stores and remodeling many of the remaining 800. He's restructuring the balance sheet.

The company is also finally addressing basic operating and strategic deficiencies that have plagued it for years. On the operating side, Tritton is going after what he calls "fruit lying on the ground" in implementing best practices. The company is upgrading systems and cross-departmental communication to lower shockingly high out-of-stock ratios in certain product categories. It's reducing product sprawl, slashing the number of stock-keeping units after seeing that the bottom-selling half of the 5,000 available SKUs accounted for only 10% of sales. Private-label products, long an afterthought despite their higher profitability, are targeted to account for 30% of revenues within three years.

Strategically, the company is investing heavily to bolster its omnichannel selling capabilities. CEO Tritton was Target's Chief Merchandising Officer during its embrace of e-commerce in the mid-2010s, and he's made it clear by word and deed that Bed Bath & Beyond will do the same. "Buying online and picking up in store is the highest margin sale for retailers today," says Chin. "Failing to be 100% omnichannel competitive is not an option."

The potential payoff for investors? Assuming same-store sales growth rising from zero to 3% over the next three years and operating margins reaching management's target of 7-8%, Chin believes the company can earn close to $3 per share in earnings and free cash flow for the fiscal year ending in February 2024. At a peer-group multiple in the mid-teens, that would translate into a share price of around $45. "The key will be if they can get comp sales growing again," he says. "They haven't done that in a long time, but if they do the market is likely to look at the company in a different light."

As for whether that fundamental outlook is attractive enough from an investment standpoint, at the moment that probably depends on which day you ask. VII

INVESTMENT SNAPSHOT

Bed Bath & Beyond
(Nasdaq: BBBY)

Business: Specialty retailer selling a variety of merchandise for the home, including bedding, bath items, kitchenware and furniture.

Share Information (@1/29/21):

Price	**35.33**
52-Week Range	3.43 – 53.90
Dividend Yield	0.0%
Market Cap	$4.28 billion

Financials (TTM):

Revenue	$9.72 billion
Operating Profit Margin	(-0.6%)
Net Profit Margin	(-2.3%)

Valuation Metrics
(@1/29/21):

	BBBY	S&P 500
P/E (TTM)	n/a	40.9
Forward P/E (Est.)	27.6	22.1

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	14.9%
BlackRock	14.0%
Vanguard Group	9.7%

Short Interest (as of 1/15/21):

Shares Short/Float	65.5%

BBBY PRICE HISTORY

THE BOTTOM LINE

The specialty retailer's CEO over the past year is playing many of the cards in the turnaround deck, says Joseph Chin, who believes he will end up with a winning hand. At 15x Chin's earnings per share estimate three years out, the stock would trade at around $45.

Sources: Company reports, other publicly available information

The Three Most Important Words

"The function of margin of safety is not that of rendering unnecessary an accurate estimate of the future," argues Robert Vinall of Switzerland-based RV Capital, "but instead of minimizing the damage of an inaccurate one."

Editor's Note: *RV Capital's Robert Vinall takes to heart Will Rogers' oft-quoted admonition about getting stuck in your ways: "Even if you are on the right track," Rogers warned, "you'll get run over if you just sit there." To our benefit, Vinall writes often about how to avoid getting stuck in one's ways as a value investor, most recently in his year-end investor letter on the subject of margin of safety, one of the most sacrosanct value-investing tenets. While he's a firm believer in the importance of the general concept of margin of safety, his "beef is with the way the concept is applied." The excerpt below explaining why is shared with his permission.*

Questioning key tenets of value investing has been a rich vein for me to mine in my letters over the years. I do not do this to discredit value investing. To the contrary, I am a fully paid-up value investor. I am convinced that the core idea of value investing – the intrinsic value of a company is the sum of all cash flows between now and eternity discounted at an appropriate rate – will be as close to a law of nature as we will ever get in what is ultimately a non-scientific discipline.

The reason I do it is because value investing has accumulated considerable baggage over the years, some of which has enriched it, but much of which has simply confused it. In the latter bucket, I would place the ideas that "tech (in the broad sense) is outside a value investor's circle of competence," "only a low-multiple company is a cheap company," or "tangible assets are more valuable than intangible assets." These were topics in my 2016, 2018 and 2019 letters, respectively. I am not sure it is controversial to question these ideas now, but it may have been then.

It is in this spirit I want to poke some holes in the idea of "margin of safety."

Margin of safety can be understood as the difference between the intrinsic value of a security and what an investor pays for it. The greater the discount to intrinsic value, the higher the margin of safety. The idea was coined by Ben Graham.

In The Intelligent Investor he writes: "The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price."

Graham's idea is a core tenet of value investing. Warren Buffett frequently refers to it. Investing legend Seth Klarman named his highly sought-after book Margin of Safety and wrote that they are the "three most important words in investing."

ON FORECASTS:

I believe the single most-important task for an investor is to form as accurate a view about the future as possible.

I do not disagree with Graham. Clearly, the lower the price of a security, the more attractive it is, or to stick with the parlance, the higher the margin of safety. My beef is with the way the concept is applied.

Consider the following quote by Graham: "The function of margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future." At face value, this seems like sensible advice: "Just pay a low enough price, and the investment will take care of itself!"

The problem is that the conclusion many traditional value investors seem to have drawn is that it is a fool's errand to spend too much time thinking about the future. Instead, they focus on things firmly anchored in the past and present such as a company's assets, its historical earnings power, and its existing moat.

This philosophy is reflected in Bruce Greenwald's book, Value Investing: From Graham to Buffett and Beyond. Greenwald describes a hierarchy of valuation methodologies with an "asset-based valuation" at the pinnacle, followed by a current "earnings-power valuation," with the "growth valuation" at the bottom as the least certain and, by implication, least important valuation methodology.

I strongly disagree with the idea that the future is of subordinate importance. To the contrary, I believe the single most-important task for an investor is to form as accurate a view about the future as possible. If a company's intrinsic value is the sum of its future discounted cash flows, how can you even know whether you have a margin of safety without forming a view on the future?

Many investors would perhaps agree on the importance of the future but take issue with the idea of striving for an accurate forecast. Given the inherent uncertainty of the future, they might argue that a broad brush, ideally conservative forecast is more desirable than an accurate forecast. Here too, I disagree.

The importance of striving for as accurate a view of the future as possible was brought home to me in a discussion with Wolfgang Grenke around how Grenke [Frankfurt: GLJ] approaches underwriting credit risk. Wolfgang told me that Grenke does not try to be conservative in forecasting default risk. It tries to be accurate. Only by pricing risk more accurately than its competitors can it earn economic profits from underwriting. There are no prizes for being inaccurate even if the inaccuracy always errs towards overestimating rather than underestimating credit risk. It is not just the lender that continually underestimates default risk that will go bust; the one that structurally overestimates default risk will too. It will miss out on attractively priced loans, thereby ceding a competitive advantage to competitors. It will also expose itself to negative selection as the more good loans it misses, the more bad ones are remaining in the pool.

This is not to say that Grenke (or other good lenders) do not aim to be conservative. It is just that conservatism is built into the business model in other parts of the stack, for example the amount of capital, the proportion of higher-risk loans, or the excess cash relative to funding needs.

If I look back at some of the best investment opportunities I have missed, it strikes me that when I thought I was being conservative, I was in fact being inaccurate. A good example of this is attaching little or no value to promising but early-stage investments at companies with a proven track record of delivering innovations. It is not conservative to view a promising new product or market entry as a "free option." It is inaccurate.

Investors who attach no value to free options commit the same sin as a lender that overestimates risk. They cede a competitive advantage to investors who do value them and expose themselves to negative selection by fishing in a pool drained of the best investment opportunities.

There are many more examples I could give where I have confused being conservative with being inaccurate – preferring established businesses to younger businesses, lower revenue growth to higher revenue growth, tangible assets to intangible assets, and so on. The point is that each of these situations needs to be thought through on merit. Companies whose intrinsic values are predicated on strong growth can have a margin of safety if bought at a sufficient discount to their intrinsic value, just as slower growing companies can too.

ON APPLICATION:

The wrong place to apply it is in assessing a business, its competitive dynamics and ultimately its cash flows.

In my view, the wrong place to apply margin of safety is in the assessment of a business, its competitive dynamics and ultimately its cash flows. All these elements need to be forecast as accurately as possible, not as conservatively as possible.

The correct place to apply the concept of margin of safety is in the price paid relative to an accurate assessment of a company's intrinsic value. The higher the margin of safety – relative to the comparable opportunities – the better. This is, of course, not the only place that thinking about margin of safety is appropriate. For example, diversification needs to be sufficiently high that a failure in one part of the portfolio does not lead to the whole edifice collapsing. It strikes me as the most important one though.

At the risk of being accused of trying to improve upon perfection, I would propose the following light edit to The Intelligent Investor: The function of margin of safety is, in essence, not that of rendering unnecessary an accurate estimate of the future, but instead of minimizing the damage of an inaccurate one.

Applying margin of safety is no substitute for developing as accurate a picture of the future as possible. To the extent margin of safety is used as an excuse not to think about the future, it increases the chance of losses – the precise opposite of what it is intended to do. VII

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