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Value Investor INSIGHT

The Leading Authority on Value Investing

Seeking Validation

Identifying cheap stocks is much easier than uncovering those that are truly mispriced. Harry Hartford and Causeway Capital have proven highly skilled at both.

While the significant majority of the more than $44 billion in assets managed by Causeway Capital are invested in non-U.S. securities, firm president and portfolio manager Harry Hartford considers that fact a distinction without a difference. With big firms in particular, "what matters is where and how the company competes," he says. "Where it's listed is increasingly irrelevant."

Causeway's clear-eyed global view has paid off nicely for investors. Its flagship Global Value Equity strategy has earned a net annualized 10.2% since its 2001 inception, vs. 7.2% for the MSCI World Index. Among areas Hartford and fellow portfolio manager Conor Muldoon find interesting today: defense systems, banking, auto manufacturing and steel. See page 2

INVESTOR INSIGHT

Causeway Capital Management
Harry Hartford *[l]*, Conor Muldoon *[r]*

Investment Focus: Seek companies with quantitatively cheap stocks that upon analysis also appear significantly mispriced for fixable or otherwise temporary reasons.

Special Situations

Index-hugging active investors are highly vulnerable to the rising tide of passive competition. That's one thing Adam Wyden needn't worry too much about.

INVESTOR INSIGHT

Adam Wyden
ADW Capital

Investment Focus: Seeks companies, even big ones, that he considers "orphaned" by the market despite attractive prospects to compound long-term value.

Every new business wants to get off to a fast start, but it's particularly important for investment managers. Building a business on great returns is relatively easy, especially compared to the alternative.

Adam Wyden has certainly cleared the first hurdle. Since starting ADW Capital at the beginning of 2011 – six months out of Columbia Business School – his fund has earned a net annualized 28.2%, vs. 13.0% for the S&P 500. "We're just trying to put one foot in front of the other," he says.

Targeting mostly "Joel Greenblatt-type special situations," he's finding opportunity in such areas as laundry equipment, Canadian restaurants, and mass-market and performance automobiles. See page 10

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INVESTMENT HIGHLIGHTS

Investor Insight: Causeway Capital

Harry Hartford and Conor Muldoon of Causeway Capital Management describe where around the globe they're seeing unwarranted differences in valuation, how they risk-adjust their return expectations, where they're investing in their firm's capabilities, and what they think the market is missing in Volkswagen, UniCredit, ArcelorMittal and Cobham.

You cast a wide net for bargains – how do you start out to cull the wheat from the chaff?

Harry Hartford: The starting point for us is always valuation. Using computer-driven tools we've refined over many years, we're identifying stocks that optically appear cheap on the basis of earnings, cash flow and/or dividend yield. Because we don't want to exclude industries at this point, our screening is on both an absolute basis as well as relative to the industry.

From that initial list we're digging into the first level of detail to determine first if the stocks really are cheap, and then beyond that the degree of mispricing we believe exists. To us the key issue is the validation of that mispricing. We have to have a view that is different at the company level or at the industry level, and a well-defined rationale for how that differentiated view coming true will help correct the mispricing.

What situations that create mispricings are of most interest?

HH: Companies and industries go through cycles, so it might be the cycle. We're not going to articulate the case that ArcelorMittal [MT:NA] is a great company, and it's a stretch of the imagination to say that the steel industry is a great industry. But there are points in the cycle in our view when a stock like this can become mispriced. We'll try to take advantage of that, as we are today with Arcelor.

Our largest position is in a large well-known German manufacturer of autos that has been in the news of late. We're cognizant that Volkswagen [VOW:GR] has issues, and that those issues have imposed an enormous financial penalty on the company. But therein lies the opportunity. It's not that we love the auto industry, with its high capital intensity and especially at this point in the cycle for companies with large U.S. exposure. But we'd argue there are reasons to believe, which we can detail later, why Volkswagen's actual prospects are not being well priced today by the market.

As far as situations go, it's often a combination of things. ABB [ABBN:VX], the Swiss-based industrial conglomerate that was long a stock-market darling, started underperforming because of what we considered cyclical issues in key markets such as energy, resolvable product issues in selling to the utility sector, and due to a cost base that in the boom years had expanded beyond what was necessary and reasonable. In our due diligence we came to appreciate that there was an earnings recovery at hand that was not adequately priced into the stock. With self-help and an improvement in the industry backdrop in a few key areas, we saw an earnings boost that would lead to a higher share price without relying on multiple expansion. We're starting to see that play out.

ON PROCESS:

We're identifying stocks that optically appear cheap and first dig in to determine if, in fact, they really are cheap.

Conor Muldoon: I'll give you one more example where multiple issues can be at play. We had followed insurer Prudential PLC [PRU:LN] for years, and while we admired the company we always thought the stock traded expensively, primarily because of the company's high-growth and profitable business in Asia.

What fueled a derating in the stock was concern over two primary issues. First was the planned introduction of the fiduciary rule in the U.S. and the impact that might have on the sale of variable annuities and other products sold by the company's Jackson National subsidiary. Second was concern that increasingly strict capital controls would impact Prudential's Hong Kong insurance subsidiary, which does a lot of business with mainland-Chinese customers who like buying assets outside of mainland China to diversify risks.

We looked at both of those regulatory issues, making what we considered conservative assumptions about how the fiduciary rule would impact Jackson National, and concluding that the Hong Kong issue would have very little impact on the in-place book of business the company already had. In addition, the new Chinese regulations wouldn't ultimately impact the underlying growth story for the company in Asia, which is driven by powerful demographic trends and still-small market-penetration levels for most life- and health-insurance products.

Our initial purchase came in early 2016, and then of course came Brexit, which we used as an opportunity to add to our share position on the view that it wouldn't have nearly the effect on Prudential – which does maybe 25% of its business in the U.K. – that the market so quickly priced in.

With the stock now at £16.90, near its 2015 highs, has the story played out?

CM: We don't think so. The stock is back to its peak, but today at that price you get a company that has almost 30% more earnings and cash-flow power than it had two years ago.

How often, as with Brexit, is the opportunity created when the proverbial baby gets thrown out with the bathwater in a particular country or region?

CM: It certainly happens. Prudential, for example, trades at a significant discount to a peer like AIA Group [1299:HK], which is listed in Hong Kong. Even if we apply local multiples to Prudential's U.S. and U.K. businesses, we're paying much less for an Asian franchise whose quality is as good if not better than AIA's.

One of our holdings in the U.K. is Lloyds Banking Group [LLOY:LN], which is basically a regional retail and corporate bank with excellent market shares that in the medium term can generate 12-15% returns on tangible equity, has a great capital position and pays a nice dividend. If you look at a comparable or even inferior regional bank in the U.S., it would trade at closer to 2x tangible book value. Lloyds trades at only 1.2x tangible book. Obviously a U.S. bank doesn't have the overhang of Britain's exit from the European Union, but we're comfortable with Lloyds' financial strength to weather any tough periods and believe in the medium term a bank of its quality should trade with a significantly higher valuation.

Your global portfolio today is heavily overweight in Europe and underweight in the U.S. Is that further evidence that you're finding regional differences in how stocks are priced today?

HH: That's part of it – in Europe, earnings and equity markets have lagged relative to other developed markets around the world and we definitely see more value there relative to the U.S.

But I would point out that what's really relevant is what the company does and where it does its business, not where its shares are listed. In our International portfolio, for example, 70% of the companies are listed in Europe, but those companies derive less than 40% of their revenues from activities in Europe, with 25% from North America, which has zero representation in the MSCI EAFE index, and 15% from emerging markets. We own British American Tobacco [BATS:LN], which is listed in the U.K. but it actually doesn't sell cigarettes in the U.K. Its single-largest market is Brazil.

We spend a considerable amount of our research time, whatever the sector or geography, in trying to understand business models and industry dynamics. We own four telecom service providers – KDDI [9433:JP] in Japan, SK Telecom [017670:KS] in Korea, China Mobile [941:HK] in Hong Kong and Vodafone [VOD:LN] in the U.K. – and the primary reason three of the four happen to be in Asia is because those markets tend to have three primary cellular service providers and exhibit much more rational competition and revenue stability. (Vodafone is based in Europe, but a significant part of its business is elsewhere.) In markets with four service providers the smallest one ends up setting the pricing low for everyone, and that's even worse when there are five or more. As I said earlier, our starting point is valuation, but understanding industry dynamics and fundamentals is equally important.

ON JAPAN:

At the margin things are changing, but true change from the Abe administration's efforts has been very slow.

When we last spoke [*VII*, February 29, 2012] you mentioned having been underweight Japan since you started. Has that changed with the arrival of "Abenomics"?

HH: We have only been close to a benchmark weight in Japan coming out of the financial crisis in 2009. The benchmark today is about 24% Japan, and our international portfolio is roughly 15% invested there.

Japan to us is a two-tiered market. It has some well-managed businesses with great balance sheets and good underlying global industry exposures. Then you've got a large number of companies that are poorly managed, where management doesn't understand how to allocate capital. The problem with the good capital allocators is that everybody recognizes them as good companies, scarcity value is attached to them, and it's only after something like a huge crisis that we find them cheap enough to buy.

CM: At the margin things are changing in Japan. There's now an index for which part of the criteria for inclusion is strong returns on capital. But true change from the Abe administration's efforts has been very slow to take hold. What's going on with Toshiba [6502:JP] is a great example. If this company were in the West it would very likely be going through bankruptcy proceedings and restructuring. But instead they're pursuing a "Japanese solution" with banks and certain competitors having to step up to help out. The whole process doesn't speak to a positive shift in governance in Japan as a whole.

Based on its position as the largest holding in your global mutual fund, why is Citigroup [C] your top U.S.-based holding?

CM: Citi is more of a global bank in nature. In the U.S. it's primarily a credit-card business and an investment bank, but it also has a global consumer business that has strong market positions in Asia and Latin America. The stock is very cheap, on a relative and absolute basis, partly because it has run up less than others because it's perceived to be less exposed to the post-Trump changes anticipated in U.S. interest rates and regulatory reform. But given the strength of its capital position, we think it actually has the most to gain from any increased flexibility in returning capital to shareholders. We just don't believe Citi has the profile of a bank today that should trade below book value.

Describe generally how you approach valuation.

CM: In a majority of cases we're trying to determine whether the company is facing permanent or temporary issues, with the goal of arriving at an estimate of more normalized earnings in the future that we can value. The second part of the equation is taking into consideration the time value of money. If we're investing in a steel company and we think the industry is going to be in the doldrums for 10 years, a cheap price may very well be appropriate because there is no timely upturn. Of course, we're trying to separate the value opportunity from the value trap.

To expand on that a bit: When you do the bottom-up analysis to build out your financial models – trying to determine if profits and profitability can revert – you obviously have to be very cognizant of the revenue drivers. At one time we owned a number of mobile telephony providers operating in Western Europe whose stocks looked cheap at 9-10x earnings and had big dividend yields. But at this point market penetration levels were close to 100%, so the volume angle wasn't there. At the same time, regulators were still encouraging new entry, so pricing power was likely decreasing rather than increasing. We ended up concluding that our original assumptions about cash-flow growth and increasing dividends no longer held and some of these cheap stocks were more than likely to stay that way.

You had good company in getting caught in the value trap that was giant U.K.-based retailer Tesco. Lessons from that?

HH: The stock indeed looked very cheap. We missed a few things that ended up invalidating our original investment thesis. The core of it was that we failed to recognize how the company's expansion by adding enormous amounts of square footage to diversify beyond traditional food retailing to a broad range of hard goods and clothing made it that much more vulnerable to new competition. When that new competition hit, both from online sellers and from predominantly German discount grocery retailers, that had a negative impact on sales per square foot. In a business where margins are tight to begin with, that's extremely bad news.

CM: Tesco was a classic case where we thought it was dealing with cyclical or operating issues that could be fixed, when in fact the issues turned out to be more structural in nature. The good news is that we have a formal review process when a stock goes against us by 10% or more, and in this case we were able to exit before the shares fell another 50%. It wasn't a good investment, but it could have turned out a lot worse.

ON VOLATILITY:

Price volatility correlates with how accurately we can predict what's going to happen with the business.

You tend to build positions slowly. Why?

HH: As value investors we're confident in our ability to calibrate what a business is worth, but we think the idea that we can bottom-tick the stock price is just wishful thinking. We're inevitably likely to be early, so we've learned from bitter experience not to shoot all at once. Of course if the stock continues to fall after you buy it, it's important to constantly assess whether your original thesis remains valid. But as long as the thesis holds, we're happy to have not been in a hurry to buy all of it at once.

Why are you typically fully invested?

HH: We also don't believe we have the skill set to time the market. The benchmark we're compared to is a 100%-invested benchmark, so we accept the task we are charged with, which is to actively invest in equities. We feel it's appropriate for our clients to make other allocation decisions themselves.

You speak a lot about quantitative tools you use to manage portfolio risk. Describe how those tools are employed.

HH: The culmination of our research process on a security is to arrive at the value we believe the market will ascribe to the business within the next two years. Then using a risk model that has seven style factors and 80 region/sector factors, we take the absolute expected return and risk-adjust it to determine how the allocation of capital to that security would impact the overall volatility of the portfolio. That process then allows us to rank stocks on a risk-adjusted-return basis, which we use in making buy/sell decisions. Our objective is to have a level of portfolio volatility at or below the benchmark, with return expectations that beat the benchmark.

Say Conor is looking at banks. Without the risk model he wouldn't have a good understanding of how his stocks are interacting with everything else in the portfolio. If you manage the portfolio in a siloed, return-only framework, you won't be able to see the correlation or lack thereof between banks and the rest of the portfolio. We tie it into a single framework.

Why the emphasis on volatility?

CM: You're right that as long-term equity investors we shouldn't be so concerned about price volatility if we're right on valuation. But we believe volatility does correlate with our ability to accurately predict what's going to happen with the business. A business whose stock has a higher beta than the market generally is more volatile and there's a greater range of outcomes for it and its industry. We want to take that into consideration in determining how attractive the return profile is.

The number of stocks in your International Value mutual-fund portfolio tends to move between 50 and 80 over time. What drives that?

HH: We talked about our not attempting to time the market from a cash perspective, but one natural result of the way we adjust for risk is that when stocks are cheap and we're being paid to take more risk, we will typically have fewer, larger positions. That would be when we're around 50 or so holdings. When stocks are less cheap we should be reducing portfolio volatility because we're not being paid to take on that risk, which results in diversifying by increasing the number of securities usually to the 70-80 range. Today in the International Value fund we had just under 60 stocks in the portfolio at the end of the year. That says we're finding stocks to be OK from a valuation perspective. The absolute level of valuation maybe isn't that compelling, but we're able to find an opportunity set in both an absolute and relative sense that is fairly attractive.

Your interest in Volkswagen initially predated the emissions scandal. Describe what put it on your radar.

HH: Our original thesis was that investors were excessively penalizing the company on the expectation on a slowdown in China, where it earns about €3 billion in annual cash flow from its joint venture there. In addition, there was new management and we thought there was considerable upside for improvement in overall operating margins that were less than half those of a comparable global company like Toyota. When we ascribed what we considered fair values to the company's quite-profitable businesses like Audi and Porsche and trucks, we thought the Volkswagen and other European mass-market brands were deemed worth next to nothing, which we didn't consider reasonable.

We took a position and then along with everybody else find out the company has been cheating on diesel-emission tests and the share price tanks. We did what we always do in such cases, which is a lot of due diligence, specifically on what happened and how much it could cost to rectify the situation. Our fair-value estimate upon doing that went down, but because the share price had fallen so much the stock was still near the top of our ranking on risk-adjusted return, so we added more capital.

Is the rest of your thesis still intact?

HH: Despite all the noise around the company, when we assess the various nameplates we find a very impressive lineup of new models coming out around the world over the next three years. To give just one example, VW has 13 new SUV models coming to the market by 2020.

These new vehicles represent capital investments that have been made but not yet monetized, and should result in higher free cash flow going forward. Margins should also benefit as new models typically require fewer incentives to sell, and as management works to rationalize costs in manufacturing and in the supply chain. It's mind-boggling, for example, the number of VW Golf derivations manufactured around the world today, which is the type of thing the drives up average unit costs. All these operating initiatives are the key part of our investment thesis and we believe they're being largely ignored by the investment community because of the scandal.

Are you assuming little to no lasting brand damage from the cheating?

HH: We've found with auto manufacturers that damage to brand value from operational issues tends to wane over time. In fact, there is clear evidence that is already the case with Volkswagen, as the VW brand was the global leader in unit sales in 2016 for the first time ever.

What's your total estimate of liability from the scandal?

HH: The deceptive software was installed in 11 million vehicles globally and we

INVESTMENT SNAPSHOT

Volkswagen
(Xetra: VOW:GR)

Business: Global automobile manufacturer with a 12% share of the global car market, through brands including Volkswagen, Audi, Porsche, Bentley, Lamborghini and Skoda.

Share Information
(@3/30/17, Exchange Rate: $1 = €0.936):

Price	**€140.95**
52-Week Range	€116.05 – €157.40
Dividend Yield	0.0%
Market Cap	€70.15 billion

Financials (TTM):

Revenue	€217.27 billion
Operating Profit Margin	6.9%
Net Profit Margin	2.5%

Valuation Metrics
(@3/30/17):

	VOW	S&P 500
P/E (TTM)	13.7	24.5
Forward P/E (Est.)	6.2	18.3

VOW:GR PRICE HISTORY

THE BOTTOM LINE

The company's emissions-cheating scandal has diverted attention away from an impressive global pipeline of new models and the potential to rationalize costs in manufacturing and in the supply chain, says Harry Hartford. Assigning a high-single-digit multiple to his 2018 earnings estimate he arrives at a fair value for the shares today of around €200.

Sources: Company reports, other publicly available information

estimate the total liability related to that at €28 billion, €20 billion of which is in the U.S. and €8 billion outside the U.S. (The issue is a bit less serious outside the U.S. because the company has not been charged with fraud.) These estimates combine already agreed upon settlements, our assumptions of the cost to support brand residual values globally, and our assumptions of the cost of shareholder claims in Germany. This will be a long legal process and we think the company's large net-cash position and its free-cash-flow generation should be sufficient to not only meet future claims, but also to continue to fund the roll-out of new models and their requisite financing.

What upside do you see in the shares, now trading around €141?

HH: We estimate the company can double its mass-market-brand margins to about 4% by 2020, driven by new models and reductions in manufacturing, labor and R&D costs. Coupled with modest revenue-growth assumptions and assuming only a high single-digit earnings multiple on our 2018 earnings estimate, we believe the stock today has a fair value of about €200 per share.

People worry about the potential peaking of the auto cycle in the U.S., but VW should be somewhat insulated from that. The much bigger market for it is Europe, which is still in recovery mode.

In our last interview you characterized the downside of Italian bank UniCredit [UCG:IM] as "incalculable." Seeing that you now own it, what's changed?

CM: This is the largest bank in Italy, where it derives 40% of its revenues, and it also has broad commercial, retail and investment-banking exposure in 16 other countries across Western, Central and Eastern Europe. The stock for some time passed our valuation screens but we avoided it for just the reason you mentioned. Unlike in the U.S., there has been an unwillingness in parts of Europe – and especially in Italy – to correctly mark non-performing loans to market, which has resulted in a severe drag on economic growth. Banks have been restrained in lending and the capital available to do so hasn't been readily available.

What appears to have changed is that European regulators and the banks themselves have finally begun to address restoring the health of the banking system. In Italy, for example, the government recently created a €20 billion fund to assist smaller Italian banks that don't have enough capital to properly mark bad loans. We believe this step will facilitate lending capacity and improves the overall prospects for the Italian economy.

UniCredit, under new CEO Jean Pierre Mustier, is also shoring up its balance sheet. The company raised €20 billion in capital from a rights issue and the sale of non-core assets. This allowed it to significantly mark down its non-performing assets while lifting capital ratios about 200 basis points above regulatory minimums. It also securitized a large portion of the assets subject to markdowns, selling about half of the resulting tranches to Fortress Investment Group, an experienced buyer of distressed loans. While UniCredit must still work through these bad loans over the next few years, we think the Fortress transaction helps validate the bank's net asset value.

These changes haven't gone without notice by the market. At a recent €14.25, how are you looking at the potential for the stock today?

INVESTMENT SNAPSHOT

UniCredit
(Milan: UCG:IM)

Business: Italian-based provider of commercial and retail banking services located in 17 countries across Europe, and of investment banking operations that extend globally.

Share Information
(@3/30/17, Exchange Rate: $1 = €0.936):

Price	**€14.28**
52-Week Range	€8.53 – €18.32
Dividend Yield	4.4%
Market Cap	€8.70 billion

Financials (TTM):

Revenue	€5.69 billion
Operating Profit Margin	(-155.7%)
Net Profit Margin	(-207.4%)

Valuation Metrics
(@3/30/17):

	UCG	S&P 500
P/E (TTM)	n/a	24.5
Forward P/E (Est.)	n/a	18.3

UCG:IM PRICE HISTORY

THE BOTTOM LINE

Conor Muldoon believes that both European regulators and the bank itself – finally – are taking the right steps to restore collective and company-specific financial health. Even if the company falls short of its return-on-tangible-equity goal, he sees 15% upside for the stock. If it hits the goal of a 9% ROTE, he'd expect another 25% rise in the share price.

Sources: Company reports, other publicly available information

CM: We value the stock by assigning a multiple of book value that is appropriately aligned with our estimate for return on equity. Management's stated goal is through cost cuts and operating improvements to attain a 9% return on tangible equity, which we believe is roughly in line with the bank's cost of capital of 10%. If that goal is achieved – and compensation for the bank's top 120 employees is heavily dependent on it – we think that would justify a stock valuation of 0.9x to 1x tangible book value.

We think management's cost-reduction estimates, primarily through branch closures and reductions in headcount, are credible and will enable profitable operations in a low-revenue-growth environment. We aren't as optimistic as management is on rate hikes in Europe, however, so we've tempered our revenue assumptions relative to the company's. As a result we're looking more at a 7-8% return on tangible equity, which supports a valuation of 70-80% of tangible book value. That would yield a roughly 15% total return from the current share price. If management meets its 9% ROTE goal, there's maybe an additional 25% upside from that. We also believe that if the bank's recovery progresses over the next few years its cost of capital could decline 100-200 basis points, which would justify multiple expansion beyond what we expect today.

Describe in more detail the cyclical appeal you see in ArcelorMittal.

CM: ArcelorMittal is the world's largest steel company with roughly 110 million tons of annual production capacity. It is also vertically integrated in producing iron ore and coking coal, the two main ingredients for steel. Arcelor was the product of European steel-industry consolidation, while Mittal was a combination of U.S. steel-manufacturing assets that came out of bankruptcy. The two companies have been together since 2006.

There is a global glut of steel supply, driven by excess capacity in China, which in the last 17 years has evolved from consuming very little steel to now being the world's largest producer and consumer of steel. As growth in Chinese consumption waned in recent years, Chinese producers began dumping product on the global market, helping drag Arcelor's EBITDA per ton down to $40, compared to historical levels of $70-$80. That put stress on its balance sheet. In early 2016 the company completed a rights offering to reduce leverage and announced a plan to improve its operating-cost profile in order to withstand a very tough revenue environment. That led to our initial investment.

Since then we've seen trade policy action targeted at insulating U.S. and European steel producers from the effects of excess Chinese supply. Tariffs as high as 250% are being imposed on Chinese steel for the next five years. Steel prices as a result of that and of better demand in China have since recovered, pushing Arcelor's run-rate EBITDA per ton back to around $75 at the end of 2016.

Does your optimism on the stock, now around €8, rest on improvements in the operating-cost profile from here?

CM: We think the shares reflect increased steel prices to date, but they don't price in the company delivering on its restructuring plan, which targets EBITDA per ton of greater than $85. Part of that comes from anticipated labor-cost reductions, but also through emphasis on more attractive end markets like the auto industry, which require premium-grade steel and a standard of quality control that helps protect Ar-

INVESTMENT SNAPSHOT

ArcelorMittal
(Amsterdam: MT:NA)

Business: Largest steel producer in the Americas, Europe and Africa, with operations in 18 countries; vertically integrated, producing both iron ore and coking coal as well.

Share Information
(@3/30/17, Exchange Rate: $1 = €0.936):

Price	**€7.98**
52-Week Range	€3.79 – €8.84
Dividend Yield	0.0%
Market Cap	€24.40 billion

Financials (TTM):

Revenue	€56.79 billion
Operating Profit Margin	5.5%
Net Profit Margin	3.1%

Valuation Metrics
(@3/30/17):

	MT	S&P 500
P/E (TTM)	12.9	24.5
Forward P/E (Est.)	9.1	18.3

MT:NA PRICE HISTORY

THE BOTTOM LINE

While its shares reflect recent steel-price increases, Conor Muldoon believes there's further upside as the company delivers on its restructuring plan, emphasizes higher-value-add markets, and if China follows through on reducing redundant production capacity. He believes a 20% increase in EBITDA per ton could result in a share price of €11.

Sources: Company reports, other publicly available information

celor from cheap imports. The unit economics would improve further if China follows through on announced plans to mothball some redundant capacity, which would likely take steel prices higher. If that happens, Arcelor's EBITDA per ton could move closer to $100 and signal increased health in the industry that might lead to multiple expansion.

Because of financial and operational leverage, we estimate that a 20% increase in EBITDA per ton from $75 to $90, coupled with some recovery in volumes, would increase normalized EBITDA by closer to 30%. With no multiple expansion, that would result in a stock price closer to €11.

U.K. defense contractor Cobham [COB:LN] hasn't exactly been firing on all cylinders. What's your contrarian take?

HH: The company produces systems focused on aerial refueling, navigation and communications for both defense and commercial original-equipment aircraft manufacturers. About two-thirds of its revenue is related to defense, primarily in the U.S. and the U.K.

Cobham has extensive, deep relationships with U.S. Department of Defense suppliers to provide things like supplier hoses for Boeing refueling tankers and communications equipment that connects a range of aircraft, ships and guided missiles. But the company has stumbled through five profit warnings in the last 15 months and is behind schedule and over budget on several contracts, including a key one for Boeing refueling tankers.

There have also been balance-sheet issues, largely the legacy of a poorly timed acquisition by the previous management team of a communications-equipment firm called Aeroflex at the peak of the market in 2014. That $1.5 billion acquisition was funded with dollar-denominated debt, which has become more expensive and threatened a covenant breach thanks to the 20% decline in the value of the British pound vs. the dollar. In response, the company raised capital last year but simultaneously issued a dividend, which was a total head-scratcher to us.

The thesis in this case is fairly straightforward. We believe the company's new management team is addressing the balance sheet and operational issues, which will allow it to fully benefit from anticipated increases in defense spending in the U.S. and Europe.

Is there evidence of progress yet?

HH: The company is in the process of raising additional capital and it has eliminated the dividend. We're also encouraged by the aggressive focus being placed on the problem contracts and by the fact that the company has taken provisions to better account for cost overruns. It's still early, but we think it's very much on a path to improved profitability.

From today's £1.35, how do you see that translating into upside for shareholders?

HH: If the company can recover to two-thirds of its historical peak operating margins, revenues stabilize, and the shares receive a reasonable 12-13x earnings multiple, we estimate fair value at around £1.80. That doesn't include any generalized increase in military spending, but just assumes already committed programs basically proceed as planned.

Speaking generally again, how do you process the rhetoric around global trade?

HH: First off, I scratch my head when I hear a lot of it. The world is better off as a consequence of trade and will be worse

INVESTMENT SNAPSHOT

Cobham
(London: COB:LN)

Business: Provides to defense and commercial original-equipment manufacturers equipment and systems focused on aerial refueling, navigation and communications.

Share Information
(@3/30/17, Exchange Rate: $1 = £0.801):

Price	**£1.35**
52-Week Range	£1.02 – £1.85
Dividend Yield	0.0%
Market Cap	£2.29 billion

Financials (TTM):

Revenue	£1.94 billion
Operating Profit Margin	(-39.8%)
Net Profit Margin	(-40.9%)

Valuation Metrics
(@3/30/17):

	COB	S&P 500
P/E (TTM)	n/a	24.5
Forward P/E (Est.)	16.3	18.3

COB:LN PRICE HISTORY

THE BOTTOM LINE

While the company has stumbled through multiple profit warnings, operational mishaps and poor financing decisions, Harry Hartford believes it is righting its ship and can benefit from anticipated defense-spending increases. Assuming it can earn two-thirds of historical peak margins with stabilized revenues, he estimates fair share value at around £1.80.

Sources: Company reports, other publicly available information

off if we get into trade wars. There will be winners and losers in any event – our job is to interpret the information available to us in a way that allows us to gain exposure to the winners and avoid the losers. The ultimate loser if we clamp down on free trade is going to be the consumer.

We expect the ongoing discussions to create volatility, which can create opportunity. For example, the significant rhetoric around the free flow of trade between the U.S., Canada and Mexico has adversely affected the shares of Kansas City Southern [KSU], a monopoly-type railroad franchise with routes connecting the three countries. We're going to look at everything on a case-by-case basis and try to take advantage when we think the market is getting it wrong.

To what extent do you think the rise of passive investing has changed the game for fundamental active investors?

HH: The biggest challenge from a business perspective, of course, is that passive options tend to be extremely cheap. You always had to generate competitive returns, but the threat to your business model if you don't has never been greater.

Because so much passive money is valuation indifferent, there should be greater opportunity down the road for the active manager. That clearly doesn't work in our favor when markets are going up and up, but valuation-indifferent sellers when that's not the case should provide an extraordinarily rich opportunity set for us.

ON PASSIVE INVESTING:

It's leading to money moving in and out more quickly over short time horizons. That volatility can be helpful to us.

CM: In general we find that the increased prevalence of factor-based and industry-specific equity-investment strategies is leading to money moving in and out more quickly over short time horizons, often for macro reasons. That may not be quite so evident at the index level, but if you drill down to the security and industry levels you see very significant swings. With utilities and REITs, for example, they tend to all move together very quickly when the market decides interest rates are going up or down. That type of volatility based on macro factors can be helpful to us as value investors looking at fundamentals and sensitive to valuation.

Is there now an even greater premium on being prepared to act?

HH: We would agree with that. That's a key reason we have continued to invest in our research capability both on the fundamental and quantitative sides. When we get these mispricings due to valuation-agnostic or macro-factor-based investing, we need to have done the due diligence and be prepared to respond. VII

Investor Insight: Adam Wyden

ADW Capital's Adam Wyden explains how he believes he differentiates himself from other investors, how growing up in a political household has impacted his investing style, why he significantly concentrates his investment bets, how he combats hubris, and why he sees mispriced upside in Imvescor Restaurant Group, Fiat Chrysler, Ferrari and EnviroStar.

Coming out of business school we imagine you thought about going the traditional buy-side route before deciding right away to start your own firm. What went into that decision?

Adam Wyden: I had spent a summer during college working for a big hedge fund where I learned a lot, but where one of my primary jobs was to go through quarterly earnings estimates of Wall Street analysts and identify the deviations from consensus in each report. I wrote it all up and turned it in and never really knew what they did with the information. It kind of hit me then that I wanted to invest in small companies I knew very well and where I thought I could make multiples of my money over a multiyear period, not just try to arbitrage consensus earnings estimates. That was the strategy I employed in my personal account with good success and I felt like working at a big firm would distract me from that and force me to look at ideas I had little interest in.

Describe the companies you target.

AW: Most tend to be Joel Greenblatt-type special situations, orphaned by the market because they're too small, or they've just been spun off, or they've just been reorganized, restructured or refinanced. Management is key – I'm looking for entrepreneurs with fire in their bellies, a lot of skin in the game and a demonstrated track record of success. I will look at asset plays where the existing assets in my estimation are worth some multiple of the current market value, but I'm putting more emphasis as I go along on the ability of the business to reinvest cash flow and grow.

Case studies would appear to be in order.

AW: One of the first things I invested in was a company called Lorex Technology, a Canadian microcap that traded in Toronto. It specialized in do-it-yourself video home security systems, offering what I thought was a differentiated product in a business with nice growth potential. But the stock was trading at something like 1x EV/EBITDA, with no debt, and it wasn't that difficult to understand why. There was zero institutional interest in the company, it had run operating losses for years, it had just come off a dilutive recapitalization, the shares were extremely closely held, investor communications was bad, and one of the brothers who owned a lot of the stock had just taken over as CEO from the other brother who passed away after a long bout with cancer.

> **ON MANAGEMENT:**
>
> **I'm looking for entrepreneurs with fire in their bellies, skin in the game and a demonstrated record of success.**

As management got the business on track, we concluded the company was better off selling itself to a bigger player who could invest in the growth potential we saw. At the time we wrote a letter to the board detailing that in April 2012, we owned almost 10% of the shares outstanding. In the end the company in late 2012 agreed to be acquired by FLIR Systems. We began buying in at around 25 cents per share and the deal closed at around $1.30.

Tell us at least the condensed version of your IDT Corp. investment story.

AW: One core holding today is IDW Media [IDWM], a subsequent iteration of an investment I made in IDT near the end of 2009, pre-dating the launch of my fund. Your readers may remember IDT, a media/telecommunications firm that had been built by Howard Jonas, a serial entrepreneur who while at Harvard was selling Venus flytraps out of his dorm room and ran a travel-brochure business. He had sold a number of IDT assets at full prices to big industry players like John Malone and AT&T, and had turned the company prior to the financial crisis into sort of an incubator for new-venture ideas that had costs that far exceeded revenues. Coinciding with this strategy change, Howard stepped back from the CEO role to just serve as the company's Chairman and to focus on certain philanthropic efforts.

The 2008 crisis was not kind to IDT. Losses mounted, investors bailed and the shares declined almost 95%. Howard came back as CEO and immediately cleaned house, shrinking personnel and selling many non-core assets. I ended up taking a significant stake in my personal portfolio at about $3 per share, at a time when the company had $10 per share in cash and marketable securities, $10 in tax-loss carryforwards, and a variety of other hard assets and intellectual property. Out of favor, to say the least.

In Howard's quest to restore value in IDT – which paid off tremendously, by the way – he spun off on the pink sheets a subscale holding company called CTM Media Holdings, which consisted of the same travel-brochure business he started in college and a comic-book business that had its own intellectual property and was doing licensing work for Hasbro, Star Trek, GI Joe and others. That too has been a homerun since we bought it in 2011, primarily due to the expansion of the comic-book business beyond print into the production and distribution of TV shows, movies and videogames. We still see tremendous upside for it as it becomes a legitimate #3 in the business behind Marvel and DC. CTM's name changed to IDW Media and the stock was upgraded in January to the OTC Best Market from the pink sheets.

The common thread in this IDT story is businesses that are either widely out of favor or mostly unknown, run by entrepreneurs like Howard Jonas and Ted Adams – the founder of CTM, now IDW – who have a unique ability to nurture, grow and monetize the assets under their care.

How about one more example of what attracts your attention: timeshare developer Diamond Resorts?

AW: We follow insider buying and what caught my attention in Diamond was a substantial buy a few years ago by Richard Daley, the former mayor of Chicago. What's a guy who may not have that much money doing investing this much in this company? I looked at the board, which was impressive. I saw that insiders owned 50% of the shares. I also knew that investors generally disliked timeshare businesses, which had a history of overextending themselves at exactly the wrong time.

Diamond was created in mid-2007 by Stephen Cloobeck, who had previously developed and managed timeshare resorts on his own and with the help of high-profile partners like Starwood Capital. He had sold the majority of his holdings to Marriott and was looking for the "next big thing," which he found in buying a deeply troubled timeshare company called Sunterra, renaming it Diamond Resorts, and using that as a platform over the next couple years to buy distressed properties for far less than their replacement costs.

The company went public in July 2013 at $14 and we started buying in the first quarter of 2014 in the $16-17 range. It traded at something like a 30% free-cash-flow yield – pro-forma for an imminent refinancing – which we attributed to negativity toward the timeshare business, the lack of brand profile in an industry where brands were perceived to matter, and a misunderstanding of the balance sheet, which was actually minimally levered at the corporate level. We thought management could deliver on its strategy to upgrade property quality, emphasize management fees and delever the balance sheet, in an industry that was poised to improve overall. But nobody seemed to care – that's often the case when we first get involved. [*Note*: Diamond Resorts was acquired last September by private-equity firm Apollo for $30.25 per share.]

Are there industries you tend to avoid?

AW: We avoid financials, energy or anything commodity-based, and healthcare and biotech. With financials, I learned the hard way in 2008 the dangers of their balance sheet opacity and natural levels of leverage. With businesses tied to commodities, I've concluded I don't want to invest in situations where I can get the micro story dead on but not get paid at all because a commodity price goes against me.

With healthcare maybe it's tied to my personal background and the fact I grew up in Washington, D.C., but I'm not comfortable with businesses where the government is actively trying to see that they make less money. [*Note*: Wyden's father is the senior U.S. Senator for Oregon, Ron Wyden.] I've also found that for smaller companies in this field outcomes are too often binary. I run a very concentrated portfolio and I can't make a big bet when the potential downside is catastrophe.

ON HEALTHCARE:

I'm not comfortable with businesses where the government actively tries to see that it makes less money.

You mentioned earlier the importance of management. How do you inform your opinions there?

AW: I'd like to believe I have the requisite technical skills and value investing background necessary to do this job well, but one way I can differentiate myself is through my interpersonal skills. Again, maybe it's my background, but I've learned the importance of closely observing people, of finding the right sources who have real insight into a situation, and of building alliances. I think of myself as much as a private detective or beat reporter as I do an investor. That's particularly important in developing a profile of top management. You just have to be persistent and relentless and never be afraid to pick up the phone and try to find the next person who might tell you something valuable.

You also can't underestimate the importance of understanding the incentives of management and aligning yourself with people whose bread is getting buttered with yours. This is critical in the small-cap space, where people make such a difference. Incentives drive all behavior – if they're eating buttered bread while you're going hungry, that's a recipe for disaster.

Most investors focused on small caps tend not to concentrate their portfolios as much as you do. Describe the rationale beyond your approach.

AW: I think about risk in terms of the quality of the business, the price I'm paying and, of course, the possibility and potential magnitude of permanent capital loss. If I've done my due diligence correctly, I'm willing to bet heavily on stocks that make the cut and have the potential over time to return multiples of what I'm paying. There aren't a lot of these at any given time, so I'll stock up when I find them. It's not unusual for us to have 75% of the portfolio in our top five positions.

To give an example of what I won't make a 10-15% position, we invested at the beginning of 2012 in Headwaters [HW], a building-products company that we thought we were buying at the bottom of the housing cycle in the U.S. It had acquired a number of high-quality building-products assets from 2003 to 2007 at too-high prices, leaving it levered at 5x net debt to EBITDA. There were refinancing options and we were pretty comfortable that housing starts couldn't go much lower, but at that leverage ratio the stock was vulnerable if industry conditions got worse rather than better. I could devote 5% of the portfolio to that, but not a lot more. [*Note*: Headwaters, whose stock at the beginning of 2012 traded below $3, has agreed to be acquired by Australia's Boral Ltd. for $24.25 per share in cash.]

Why are you currently high on Imvescor Restaurant Group [IRG:CN]?

AW: Imvescor is a Canadian company that owns multiple restaurant brands and generates revenue in three ways: from royalties on sales at franchised restaurants, from selling products to franchisees, and from pure licensing, say on consumer packaged foods sold under restaurant or other brands the company owns. It's all asset light – maintenance capital spending is probably C$100,000 a year to generate roughly C$50 million in revenues – and returns on invested capital are very high. But when I found it, the stock was trading at 5x EV/EBITDA, roughly half the peer-group level.

Why the depressed multiple for a highly profitable business?

AW: The company under family leadership had overpaid to expand, put too much debt on the business and then distributed all the cash flow through an income-fund structure. When they had to recapitalize the company they brought in a new CEO who was just a financial engineer, looking to extract as much value from franchisees while cutting back on the quality of products supplied and on advertising and promotion.

As the business floundered, the board put the company up for sale, a process that ultimately went nowhere, but did result in the hiring of a very capable operator, Frank Hennessy, as CEO. He had a great track record in turning around Bento Sushi for a private-equity sponsor, and since coming in he's putting emphasis back where it should be on treating franchisees like customers. The more money they make, the more likely they are to reinvest in their existing business and to open new stores.

Among other initiatives, Imvescor is spending its own money – contributing C$4-5 million, 10% of the total cost – to help renovate up to 80% of its restaurant locations. That's helping repair the relationship with franchisees and is generating significant gains in comparable-store sales in the upgraded locations.

Does the company have any appetite for M&A-related growth?

AW: Imvescor's general and administrative costs as a percentage of revenues is much higher than that of larger peers. Management argues they need a minimum amount of G&A to run the business, which indicates there's a strong rationale for buying additional brands that could generate franchise and licensing revenue that falls almost directly to the bottom line. In February the company closed on a deal to buy Ben & Florentine, a terrific breakfast concept that has enormous, maybe even game-changing, upside potential. I think they'll continue to buy these types of assets and they have a balance sheet that supports their ability to do so.

How are you looking at upside from today's C$3.50 share price?

AW: I estimate the company can earn C$28 million in EBITDA in 2018, so on that level the shares trade at about 7.2x EV/EBITDA, with an unlevered balance sheet. MTY Food Group, a successful roll-up of Canadian franchise restaurants,

INVESTMENT SNAPSHOT

Imvescor Restaurant Group
(Toronto: IRG: CN)

Business: Operates mostly franchised restaurants throughout Canada under brand names including Pizza Delight, Mikes, Scores, Baton Rouge and Ben & Florentine.

Share Information
(@3/30/17, Exchange Rate: $1 = C$1.334):

Price	**C$3.48**
52-Week Range	C$2.33 – C$3.55
Dividend Yield	2.7%
Market Cap	C$210.8 million

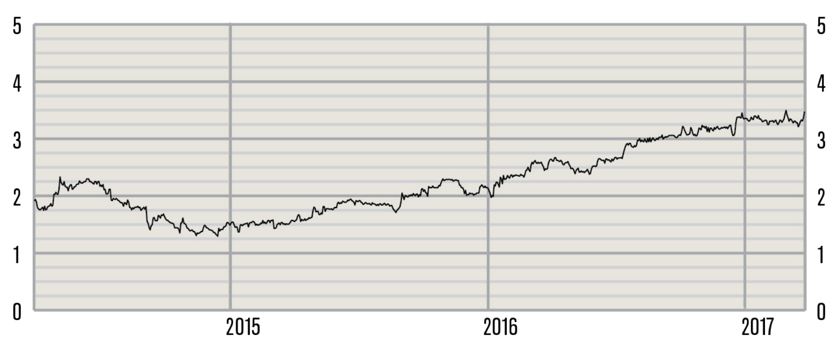
Financials (TTM):

Revenue	C$51.4 million
Operating Profit Margin	30.5%
Net Profit Margin	22.3%

Valuation Metrics
(@3/30/17):

	IRG	S&P 500
P/E (TTM)	17.2	24.5
Forward P/E (Est.)	13.4	18.3

IRG:CN PRICE HISTORY



THE BOTTOM LINE

Having gone astray under a financial-engineer CEO, the company has recommitted to partnering with franchisees to upgrade locations and promotional activity in order to drive comp-store sales, says Adam Wyden. At the EV/EBITDA multiple earned by its closest peer in Canada, the company's shares on his 2018 estimates would trade at C$5.70.

Sources: Company reports, other publicly available information

trades at 12.3x 2018 EBITDA. It's not unreasonable to assume Imvescor can trade at that level, which would put the stock on 2018 numbers at around C$5.70.

Playing a little bit with the possibilities, if the company acquired an additional C$20 million of annual EBITDA at a multiple of 5.5x, taking on C$110 million of debt, I think the stock could trade at closer to C$8 per share, an undemanding 12x EV/EBITDA multiple.

You seem to be exploring new territory in buying something like Fiat Chrysler [FCAU]. How did that come about?

AW: I've never been interested in the auto business, where manufacturers have a tough time earning their cost of capital. I'd read the sum-of-the-parts analyses on Fiat Chrysler, which I found interesting, but not convincing. What changed my mind was the announcement in the second half of 2015 that the company was spinning off Ferrari and that it was going ahead with a mandatory convertible bond issue to be back-stopped by the Agnelli family, which was investing an additional nearly $1 billion into the parent company.

John Elkann is Fiat's chairman and is also chairman of the Agnelli family's publicly traded holding company, Exor [EXO:IM]. He spearheaded Fiat's turnaround – including recruiting CEO Sergio Marchionne – and I believe he's in the early innings of establishing himself as one of the great capital allocators. That he was putting up new capital told me this is something I should look at more carefully.

When we first bought Fiat stock – at around today's share price – I could make the argument that Ferrari alone was worth more than the then market capitalization of the entire company. That meant you were getting Jeep, RAM, Chrysler, Dodge, Alfa Romeo, Maserati and other viable assets for free. As the company has executed its operating plan, our conviction on Fiat is even higher and we've also made Ferrari [RACE] a core position.

Describe why your conviction on the traditional business is higher.

AW: The profile of the business has changed. Dodge is effectively only a muscle-car brand. Chrysler is muscle cars plus minivans. Overall the company has deemphasized small-car production, leaving it with a higher-margin product mix. It has also largely completed a massive capital-spending program, which should translate into big increases in free cash flow in coming years.

There are cycles to think about, but I'd argue that works more in the company's favor than not. The Latin American market is rebounding. In Europe you have a change in mix and a market that is coming off the bottom. Even if the North American market contracts, the change in product mix there will mitigate the impact.

How are you valuing the shares at today's price of $11?

AW: I can come at it in a variety of ways to conclude the shares are extremely cheap. I believe the earnings power of the business is between $5 and $6 per share. These earnings estimates seem to be eye-popping to most, but in reality they come directly from the company's 2018 plan. The only adjustment we make is to adjust interest

INVESTMENT SNAPSHOT

Fiat Chrysler
(NYSE: FCAU)

Business: Designs, manufactures and sells cars, light commercial vehicles and automotive components worldwide. Brands include Chrysler, RAM, Fiat, Jeep and Maserati.

Share Information (@3/30/17):

Price	**10.98**
52-Week Range	5.45 – 11.63
Dividend Yield	0.0%
Market Cap	$16.67 billion

Financials (TTM):

Revenue	$119.26 billion
Operating Profit Margin	4.9%
Net Profit Margin	1.6%

Valuation Metrics
(@3/30/17):

	FCAU	S&P 500
P/E (TTM)	8.7	24.5
Forward P/E(Est.)	4.4	18.3

Largest Institutional Owners
(@12/31/16):

Company	% Owned
Baillie Gifford	6.6%
Harris Associates	4.4%
Tiger Global Mgmt	4.1%
Vanguard Group	1.8%
AQR Capital	1.6%

Short Interest (as of 3/15/17):

Shares Short/Float	2.8%

FCAU PRICE HISTORY

THE BOTTOM LINE

Having concluded a large capital-spending program while successfully executing on its operating plan to shift to a higher-margin product mix, the company has sharply increased its earnings power, says Adam Wyden. He believes it can deliver $5 to $6 in earnings per share, which at even a 5x multiple would result in a share price of $25 to $30.

Sources: Company reports, other publicly available information

expense to be more in line with Wall Street expectations. Assuming all the businesses are worth the same 5x multiple – which they are not – on that earnings power you'd get a share price of $25 to $30.

Take just two of the operating units, Maserati and Magneti Marelli, which produces automotive components. Maserati last quarter did €184 million of EBIT, for an annual run rate of about €750 million. Based on the valuations being discussed for a flotation of Aston Martin – over 10x EBIT – Maserati today would be worth €7.5 billion. Magneti Marelli does €8 billion in revenues. If it can get its margins in line with peers, it could be worth at least 1x revenue, or €8 billion. Add those two units together, plus the €5 billion in net cash the company expects to have by the end of 2018, you're at a market value of more than €20 billion. The entire market cap today [for the Milan-traded shares] is less than €16 billion. Even if Jeep, RAM, Dodge, Chrysler and Alfa Romeo were worthless – which they're certainly not – you would still have a margin of safety.

What's your case for Ferrari being a comparable bargain?

AW: The convertible-bond offering for Fiat Chrysler contained some segment financials for Ferrari, and reverse engineering the capital expenditures I was blown away by how little the capex requirements for it were. When you strip out the capital spending on the Formula One racing team, the automotive capex associated with incremental production is only around €100 million annually. By my estimate – which was confirmed by a former top executive at the company – the incremental margin on even a low-end Ferrari, costing around $300,000, is around 65%. Ferrari's maintenance capex per unit of revenue is actually lower than what luxury-goods manufacturer Hermes spends.

The company's gross margin last year of 49% reflects the effect of slack capacity. Having built another facility to increase production, the company has said that it doesn't require any additional fixed investment in order to scale. At the incremental margins I'm seeing, I expect to see dramatic margin improvement as slack capacity gets utilized.

What argues for the slack capacity being utilized?

AW: The number of high-net-worth individuals and their aggregate wealth have compounded at an average annual rate of 8.6% over three decades, while Ferrari has only increased production by 2.5% per year. That means while the wealth of the highly affluent grew by almost 10x, Ferrari production only doubled. The company can't and shouldn't try to bridge that gap overnight, but it signals to me that there's plenty of room to raise production. Too much economic value is now being lost by the company to the secondary market.

Do you value the shares, now at $74.50, like a car company or something else?

AW: I actually believe that a luxury-sector multiple is justified given Ferrari's capital intensity, incremental EBIT margins, operating leverage and the price inelasticity of its product.

Wall Street is modeling a 21% EBIT margin for the company in 2018, which we believe is way low. On production of

INVESTMENT SNAPSHOT

Ferrari
(NYSE: RACE)

Business: Founded in 1947, designs, manufactures and sells luxury performance sports cars under the Ferrari brand name; also owns and operates a Formula One racing team.

Share Information (@3/30/17):

Price	**74.45**
52-Week Range	38.71 – 74.99
Dividend Yield	0.9%
Market Cap	$14.07 billion

Financials (TTM):

Revenue	$3.34 billion
Operating Profit Margin	20.6%
Net Profit Margin	12.8%

Valuation Metrics
(@3/30/17):

	RACE	S&P 500
P/E (TTM)	33.1	24.5
Forward P/E(Est.)	27.5	18.3

Largest Institutional Owners
(@12/31/16):

Company	% Owned
Baillie Gifford	9.6%
T. Rowe Price	9.1%
AKO Capital	2.2%
Vanguard Group	1.6%
Norges Bank Inv Mgmt	1.3%

Short Interest (as of 3/15/17):

Shares Short/Float	n/a

RACE PRICE HISTORY

THE BOTTOM LINE

Arguing that it is "such a better business than people seem to think," Adam Wyden expects the company to show dramatic margin improvement as slack production capacity is utilized. On his 2018 estimates, if the company's shares traded at 75% of the EV/EBIT multiple of a luxury goods purveyor like Hermes, the stock would be worth at least $130.

Sources: Company reports, other publicly available information

9,000 units and assuming a 3.5% average unit price increase, our base case is for €1.4 billion in 2018 EBIT, a 35% margin. At that EBIT level the stock trades at an EV/EBIT multiple of less than 10x. Hermes on a comparable basis trades at more than 22x. For a one-of-a-kind asset like Ferrari, that discrepancy doesn't make sense to me. Just splitting the difference and using an EV/EBIT multiple of 16.5x, would result in a U.S.-listed share price today of more than $130.

Hitting my margin estimate may take longer than I expect, but offsetting that as a risk is the fact that I haven't included any value from outside the core automotive business. We believe ancillary revenues from licensing and particularly the white-labeling of Ferrari engines could generate €300 million to €500 million in EBIT over the next several years.

I tell people this is my See's Candies, with great pricing power, limited economic sensitivity and low incremental capital requirements. It's such a better business than people seem to think.

Turning to one of your favorite growth ideas, describe your interest in laundry-equipment company EnviroStar [EVI].

AW: At the University of Pennsylvania one of my fraternity brothers was A.J. Nahmad, the son of Albert Nahmad, whose company, Watsco [WSO], is a roll-up of HVAC-equipment distributors and has been one of the best-performing stocks on the New York Stock Exchange. It's a great business with high returns on invested capital that isn't going to get disintermediated by Amazon.

Henry Nahmad, Albert's nephew, worked in corporate development at Watsco and was looking for a similar type of industrial-distribution business to use as a platform to build upon. In March 2015 he took control of EnviroStar, where he's following the same playbook. The process is the same, the multiples paid are the same, many of the people are the same, but now instead of selling heating and cooling systems, the company sells and services commercial laundry machines.

Is this such an attractive market in which to play?

AW: Laundry is water- and energy-intensive, so there's a move towards increasing energy efficiency and water reclamation, which typically requires updated equipment and regular servicing. We estimate the total addressable market at $5-6 billion, which is much smaller than the HVAC-equipment market, but the laundry market remains much more fragmented and we think has the potential to grow faster given the ability to expand the service side of the business.

There's also less competition for deals in laundry equipment and services. The guy doing $3-4 million in operating profit isn't thinking, "I'm going to build a $100-million platform out of this." If he's looking to sell, he doesn't want to sell to private equity because he's afraid they'll come in and fire all his people. And anyway, private equity isn't spending much time looking for assets with $3-4 million in annual EBIT.

You've emphasized the importance of incentives. How are you looking at the incentives here for Henry Nahmad?

INVESTMENT SNAPSHOT

EnviroStar
(NYSE: EVI)

Business: Distributes and services commercial and industrial laundry and dry-cleaning equipment and steam and hot-water boilers in the U.S., the Caribbean and Latin America.

Share Information (@3/30/17):

Price	**19.05**
52-Week Range	3.05 – 25.00
Dividend Yield	0.0%
Market Cap	$197.5 million

Financials (TTM):

Revenue	$64.0 million
Operating Profit Margin	8.2%
Net Profit Margin	4.5%

Valuation Metrics
(@3/30/17):

	EVI	S&P 500
P/E (TTM)	52.3	24.5
Forward P/E (Est.)	n/a	18.3

Largest Institutional Owners
(@12/31/16):

Company	% Owned
ADW Capital	6.1%
Zeff Holding	4.4%
Bard Associates	2.5%
North Star Inv Mgmt	1.3%
Renaissance Technologies	0.8%

Short Interest (as of 3/15/17):

Shares Short/Float	5.1%

EVI PRICE HISTORY

THE BOTTOM LINE

Following successful playbooks before it, the company can grow rapidly by buying and integrating sellers and servicers of commercial laundry equipment, says Adam Wyden. It is capable of compounding EBIT at 50-100% annually for the foreseeable future, he argues, and at the multiple that growth deserves is worth closer to $36 per share.

Sources: Company reports, other publicly available information

AW: I've met a bunch of his investors at the annual meeting and it's his mom and dad, it's his sister, and it's his friends from growing up. His stake isn't publicly disclosed, but I estimate it's probably two-and-a-half to three million shares. So you have a 38-year old guy who owns perhaps $60 million worth of stock, taking a modest salary and earning the rest of his compensation from very long-dated options. Unless the company is sold, the options only fully vest after a 28-year period. I think our incentives are very well aligned.

The stock, now around $19, is up sharply over the past 18 months. How are you looking at valuation?

AW: Assuming no additional deals, I think the company can earn $12.5 million in EBITDA this year, which puts the current EV/EBITDA multiple at around 16.5x. That's a similar multiple to Watsco's, which is a $5 billion company growing at only 3-5% per year. That means to me that I'm not really paying for EnviroStar's potential growth.

What could that growth be? I believe the company by following its established playbook can compound EBIT at 50-100% per year for the foreseeable future, without putting on a lot of incremental leverage. If that turns out to be right, it's not unreasonable that the stock could earn the 30-40x EV/EBITDA that a company like Fastenal earned in its early years. At 30x our 2017 estimated numbers, the stock would trade at $36.

Given your performance there probably haven't been many so far, but describe a mistake you've made recently and any lessons learned.

AW: We invested in 2013 in a company called USA Truck [USAK], which had a truckload-freight business that we thought was underearning and would improve, and a logistics business that was growing and generating high returns but wasn't receiving the credit we thought it deserved from the market. We believed in the operating team and plan in place, augmented by what seemed to be a competent and newly constituted board. The stock was cheap at around $10, which was close to book value per share.

Things started out fine, and by early 2015 the market started to get excited about the company's turnaround and the shares got to around $30. But it became increasingly evident that the truckload business was going to be harder to turn around and more cyclical than we expected. After the third CEO in three years put out great forward guidance that the company missed dismally in the second quarter of last year, we sold out of our position entirely.

ON AVOIDING HUBRIS:

If we start hitting the wall on performance and I feel I can't replicate the returns, we'll start returning capital.

As for lessons, I would say I'm unlikely to invest in trucking again, which is too close to a commodity business for comfort. I also don't think incentives here ended up at the management and board level to be as aligned with ours as they should have been. Most of the shares they owned were in outright grants, and everyone seemed a bit more interested in keeping their position than pursuing all avenues to create shareholder value. No one operating the business had enough of a vested ownership interest in it. [*Note*: USA Truck shares closed recently at $7.30.]

The investment business has a way of bringing managers with outsized returns back to earth. How do you keep that from happening?

AW: I'm just putting one foot in front of the other, trying to stay within the boundaries of what I'm good at. I think the fund can get bigger and still make good returns, as some of our positions can support a lot more capital. But we'll think long and hard about taking new money once we get to $250-300 million in assets.

What I tell people is that I'm right with them every step of the way. I'm the largest investor in the fund and I expect that to probably remain the case. If we start hitting the wall on performance and I feel I can't replicate the returns, we'll start returning capital. VII

Heartburn?

Value investors might naturally gravitate to a company like Chipotle, a wonderful success story interrupted by an unfortunate spate of troubling news. When Kian Ghazi took a closer look, he was left with a bad taste.

Kian Ghazi of special-situations research firm Hawkshaw LLC likes to look for investment ideas in which there's clear "tension," by which he means there are logical hypotheses both for why a company's stock is a potential short and for why it's a potential long. General consensus, the thinking goes, will rarely result in mispricing.

Tension he found late last year while digging into Chipotle Mexican Grill, the fast-casual restaurant chain that had gone from hero to goat in the market's and customers' eyes after a string of highly publicized foodborne-illness incidents at its U.S. restaurants in the second half of 2015. Even though its once high-flying stock price had fallen from mid-2015 highs of nearly $760 to well below $400, short interest in the stock was still stubbornly high. At the same time, well-known investors – most prominently Bill Ackman's Pershing Square Capital – had established large long positions. Tension appeared sufficiently intact.

Ghazi's initial inclination was that the stock was likely a buy rather than a sell: "You had a company that was a leader in its space, that was still generating good returns on capital, that had been hit by the type of challenge that in similar situations historically tended to fade away, with a stock that was cheap if you believed the company could resume its growth and come anywhere close to its historical operating metrics," he says.

As he proceeded with his research he came across some early warning signs. Roughly a year after the crisis peaked, fourth quarter 2016 sales per restaurant – despite heavy advertising and promotional spending – was still running 20% below prior levels, and the speed of recovery in such sales was materially slower than had been the case in previous food-safety outbreaks at Jack in the Box, Taco Bell and KFC China. In addition, Chipotle's brand-trust and food-quality scores based on survey information from Technomic's Consumer Brand Metrics database remained well below historical levels and showed little evidence of recovering. Finally, Google searches using the word "Chipotle" that were unrelated to food safety – searches that likely indicate a desire to order online or to find a location to eat – fell sharply after July 2015 and not only hadn't recovered, they continued to decline.

The picture didn't get brighter as he started speaking with unpaid, independently sourced industry executives who, for example, previously worked at the company or who currently led private competitors. From those conversations he came to learn that consumers' lunch patterns tend to be habitual and that it would likely be much harder for Chipotle to recover lapsed customers who had formed new habits with the expanding base of

INVESTMENT SNAPSHOT

Chipotle Mexican Grill
(NYSE: CMG)

Business: Owner and operator of more than 2,200 fast-casual Mexican-food restaurants located primarily in the U.S., focused on selling what it bills as "food with integrity."

Share Information (@3/30/17):

Price	**443.92**
52-Week Range	352.96 – 473.75
Dividend Yield	0.0%
Market Cap	$14.05 billion

Financials (TTM):

Revenue	$3.90 billion
Operating Profit Margin	1.5%
Net Profit Margin	0.6%

Valuation Metrics
(@3/30/17):

	CMG	S&P 500
P/E (TTM)	576.5	24.5
Forward P/E (Est.)	37.7	18.3

Largest Institutional Owners
(@12/31/16):

Company	% Owned
Fidelity Mgmt & Research	11.4%
Pershing Square Capital	10.0%
Vanguard Group	9.2%
Sands Capital	5.8%
BlackRock	4.5%

Short Interest (as of 3/15/17):

Shares Short/Float	16.5%

CMG PRICE HISTORY

THE BOTTOM LINE

Kian Ghazi believes that the company will not bounce back from its food-safety issues to the extent the market seems to believe, due to increased fast-casual-restaurant competition permanently absorbing a material number of its lapsed customers. His target share-price range, assuming normalized earnings of $10 to $13 per share, is $220 to $338.

Sources: Company reports, other publicly available information

fast-casual competitors. That competition was greater in markets along the coasts than in middle America, which was consistent with the fact that Chipotle was suffering greater sales declines on the coasts than elsewhere. Four of the five executives of privately held fast-casual competitors with whom he spoke suggested that their same-store sales were under pressure in those same markets, which they attributed to increased competition that was unlikely to abate.

Bulls are hoping that the company's average unit revenues will approach their pre-crisis highs, but Ghazi thinks AURs will stall at 15% or so below peak levels. He assumes increased food-safety and promotional expenses will represent a permanent 350-basis-point or so drag on restaurant-level margins going forward. He also expects the company's historically high returns on invested capital to fall to the mid-20% range, in line with strong competitors like Panera. While he builds in modest price increases to help offset labor and other cost increases, he believes the company's pricing power isn't what it once was given the lingering hit to its reputation – a hit more difficult to overcome because the issues setting off the crisis directly challenged the company's "food with integrity" branding.

Add it all up and he believes the company on a normalized basis will earn $10

ON REPUTATION:

The hit may be more difficult to overcome because the issues challenged the firm's "food with integrity" branding.

to $13 per share. With lower margins and lower ROIC's, he expects normalized valuation levels also to fall more in line with companies like Panera, which has traded in a 22x-30x P/E range over the past five years. At the low end of that valuation range on $10 per share in earnings, the stock would trade at $220. At the midpoint of the range on $13 per share in earnings, it's a $338 stock. The share price today: $444.

Key threats to the bear case? While some bulls believe that Chipotle has untapped international growth potential, Ghazi is skeptical given that there are only 12 European stores today, seven years after the first was opened in London in 2010. His discussions with former Chipotle executives indicated that the European stores are uneconomic because of significantly higher operating costs. More problematic to his thesis would be tax reform that features lower corporate rates, a boon to the company given that its current tax rate is just under 40%. He is also closely watching the brand-trust and Google-search data for early signs that customer sentiment is becoming more positive, which could signal an improved recovery.

The nightmare scenario for Chipotle – impossible to handicap – would be if the food-safety issue reared its ugly head again anytime soon. Says Ghazi: "If it happens again, it will be very, very damaging for the company." VII

Blast Off?

Aerojet Rocketdyne certainly doesn't have the name recognition of its putative new competitors, but it may have a number of other things going for it at the moment that the market doesn't seem to fully appreciate. By Ori Eyal

Despite the shortfall of having a concentrated customer base, military contracting can be a great business. Once chosen after an arduous qualification process, suppliers often enjoy the benefits of multi-year contracts with high financial visibility, high switching costs and limited exposure to the general economic cycle.

Half Moon Capital's Eric DeLamarter sees those attributes in full force at Aerojet Rocketdyne, a leading manufacturer of jet propulsion systems. The company in 2013 acquired United Technologies' rocket-engine business, doubling its size and giving it an "effective monopoly" in providing medium and large rocket engines, he says. Its largest defense application is providing propulsion systems for interceptor missiles, which account for 50% of company revenues and a higher share of its profits.

Missile-defense systems have been a Department of Defense priority due to rising ballistic-rocket threats from Russia, China, North Korea and Iran. The budget for DoD's Missile Defense Agency has increased even through periods of sequestration imposed by Congress, helping drive consistent growth in Aerojet's revenue and backlog despite cuts in overall U.S. defense spending. Looking ahead, DeLamarter says the latest DoD budget shows appropriations for the company's main programs growing in the mid-teens annually over the next five years.

Despite this positive backdrop, he doesn't believe the market is giving the company its due. One reason is concern over competition from startups SpaceX, backed by Elon Musk, and Blue Origin, backed by Jeff Bezos. These companies compete only in the space market, which accounts for just one-quarter of Aerojet's revenues. DeLamarter also argues that their success isn't assured, or necessarily a big drag on Aerojet. "It's not a winner-take-all market," he says. "The market for space propulsion systems is expanding, with a number of programs requiring different engines. There's plenty of room for more than one beneficiary." He points out that Aerojet in the past two years has won two good-sized NASA contracts, validating its position in the industry.

Another contributor to the market's lack of interest, he says, has been the company's historical indifference to investor communications. One story to tell is a multifaceted cost-cutting program that has included refinancing high-cost debt, installing a new Enterprise Resource Planning system and executing on a Competitive Improvement Program targeting $145 million in annual cost savings by 2019.

What are the shares reasonably worth? DeLamarter estimates the company will this year generate $240 million in earnings before interest, taxes, depreciation, amortization and pension expenses, a common measure of profitability for defense contractors. Using a 12x EV/EBITDAP peer multiple and adding $150 million for non-core real-estate assets that are being sold, his price target for the shares is $36, a 67% premium to today's price. VII

INVESTMENT SNAPSHOT

Aerojet Rocketdyne
(NYSE: AJRD)

Business: Manufacturer of propulsion systems for defense and space applications, as well as armaments for weapon systems.

Share Information (@3/30/17):

Price	**21.50**
52-Week Range	15.52 – 22.99
Dividend Yield	0.0%
Market Cap	$1.49 billion

Financials (TTM):

Revenue	$1.76 billion
Operating Profit Margin	5.5%
Net Profit Margin	1.0%

Valuation Metrics
(@3/30/17):

	AJRD	S&P 500
P/E (TTM)	80.2	24.5
Forward P/E (Est.)	20.3	18.3

Largest Institutional Owners
(@12/31/16):

Company	% Owned
Fidelity Mgmt & Research	12.8%
BlackRock	11.3%
NewSouth Capital	7.7%

Short Interest (as of 3/15/17):

Shares Short/Float	4.3%

THE BOTTOM LINE

The market isn't adequately valuing the company's dominant market position in high-demand defense program areas, says Eric DeLamarter. At a peer multiple on his 2017 earnings estimates, plus the value of for-sale real estate assets, his share-price target is $36.

Sources: Company reports, other publicly available information

Off the Beaten Path

Alaska's economy is currently sluggish and even in better times isn't exactly a bastion of vibrant competitive intensity. Could both of those characteristics bode well for General Communication Inc.'s prospects? By Ori Eyal

Small-cap investors pride themselves on finding off-the-beaten-path ideas that through the market's neglect or disinterest appear misunderstood and mispriced. That describes well what Nitin Sacheti, portfolio manager of Papyrus Capital Management, sees in General Communication Inc., Alaska's only cable-services provider. "You could say this is off the beaten path both literally and figuratively," he says.

The remoteness and size of GCI's addressable market is both a curse and a blessing for the company. Alaska's economy has stalled at the moment due to lower oil prices and stagnant population growth, but the lack of competitive interest in the market has allowed the company to establish a dominant position. It offers cable services to 98% of the state's population and its infrastructure for high-speed broadband access leaves that of primary fixed-line competitor Alaska Communications in the dust. The incumbent telephone utility, ACS offers only one plan for $80 per month, with speeds dependent on how far away customers are from its facilities. As a result, some 50% of its customers receive speeds of only 10 megabits per second. GCI offers 50-mbps broadband service at $60 per month, and 100-mbps service for $85.

On the wireless side, AT&T is the only major competitor but it lacks competitive coverage in rural areas and prices its packages at a roughly 20% premium to GCI. GCI is the only company in the state able to bundle cable, data, landline and wireless services, significantly reducing customer churn.

Papyrus Capital's Sacheti believes the company has made the right financial moves in response to the sluggish Alaskan economic environment. It sold tower assets in mid-2016 for $90 million at an attractive cap rate and reinvested the proceeds into its fiber/microwave network that stretches from Anchorage to Kotzebue. It cut capital spending by one-third and implemented a cost-cutting plan to increase operating margins by 500 basis points, to the mid-30s. Finally, it bought back 7% of its shares last year and plans to use the majority of free cash flow at least in the near term to continue buying back stock. All that should increase earnings power as the Alaskan economy improves, says Sacheti, fueled both by already-recovering oil prices and a large North Slope oil discovery announced earlier this month by Spain's Repsol and U.S.-based Armstrong Energy. That find alone could boost the state's oil production by some 20%.

Assuming 1% or less annual revenue growth, he believes GCI can earn $3.33 per share in free cash flow in 2019, on which he believes a 10x multiple would be reasonable given the strength of the company's market position. That yields a price target for the stock of $33, more than 50% above the current price. In a buyout by a Lower-48 competitor – which he isn't counting on – the premium would likely be even higher. VII

INVESTMENT SNAPSHOT

General Communication
(Nasdaq: GNCMA)

Business: Provider of wireless and broadband services to residential and enterprise customers primarily in the state of Alaska.

Share Information (@3/30/17):

Price	**21.52**
52-Week Range	12.26 – 22.34
Dividend Yield	0.0%
Market Cap	$768.4 million

Financials (TTM):

Revenue	$933.8 million
Operating Profit Margin	8.5%
Net Profit Margin	(-0.4%)

Valuation Metrics
(@3/30/17):

	GNCMA	S&P 500
P/E (TTM)	n/a	24.5
Forward P/E (Est.)	67.2	18.3

Largest Institutional Owners
(@12/31/16):

Company	% Owned
BlackRock	12.2%
Vanguard	9.2%
Dimensional Fund Adv	7.0%

Short Interest (as of 3/15/17):

Shares Short/Float	4.6%

GNCMA PRICE HISTORY

THE BOTTOM LINE

Given its dominant market position and adept cost control through a sluggish period, the company should prosper as the oil-rich Alaskan economy improves, says Nitin Sacheti. At 10x his 2019 estimate of per-share free cash flow, the stock would trade at $33.

Sources: Company reports, other publicly available information

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