January 31, 2020

Value Investor INSIGHT

The Leading Authority on Value Investing

Living Up to the Name

"Law of capitalism #1 is that excess returns get competed away," says Keith Ashworth-Lord, who does his best to invest only in companies breaking that law.

It's pretty gutsy to take on the management of a "Buffettology" branded investment fund, as Keith Ashworth-Lord did in launching the CFP SDL UK Buffettology Fund nearly nine years ago. It's a tough name to live up to and there would certainly be no shortage of observers ready to take note if things didn't go well.

Naysayers, as it turns out, have had to hold their tongues. Since March 2011 Ashworth-Lord's £1.5 billion (assets) fund has trounced the market, earning a net annualized 16.0%, vs. 7.9% for the IA UK All Companies sector. Targeting mostly small to mid-sized firms that he "would prefer to hold forever," he's seeing upside opportunity today in such diverse areas as language translation, educational support, credit scores, fantasy games and pest control. See page 2

INVESTOR INSIGHT

Keith Ashworth-Lord
Sanford DeLand Asset Management

Investment Focus: Seeks companies with sustainable competitive moats in businesses "that should be in much their present form in 10 to 20 years' time."

Network Effect

Will investing in giant U.S. companies prove as fruitful over the next ten years as it has the last ten? David Shapiro and Evan Vanderveer offer a viable alternative.

INVESTOR INSIGHT

Vanshap Capital
David Shapiro [*l*], and Evan Vanderveer [*r*]

Investment Focus: Seek in capital-constrained markets off-the-radar companies that have far higher-quality businesses than are reflected in current share prices.

Count Evan Vanderveer and David Shapiro of Vanshap Capital among value-focused investors whose thinking on business quality has evolved. "We're as focused on inexpensive stock prices as ever, but we concluded we needed to put more emphasis on business and management quality," says Vanderveer. "The good news is that in the markets in which we invest, we don't think we have to compromise on one for the other."

So far so good. The duo's core investment strategy has earned a net annualized 7.9% since April 2012, vs. 2.7% for the MSCI Emerging Markets ex-China Index. Seeking out mispriced small companies in neglected markets, they're finding upside today in such areas as homebuilders, toll roads, shipping, mid-priced hotels and banks. See page 10

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Investor Insight: Keith Ashworth-Lord

Keith Ashworth-Lord of the U.K.'s Sanford DeLand Asset Management describes what investing like Warren Buffett means to him, what he expects from Brexit over time, why he avoids "chopping and changing" his portfolio, what he thinks Buffett's next great trade might be, and why he's high on RM Plc, Rollins, RWS Holdings and Games Workshop.

It's safe to say our readership has its fair share of learned and accomplished "Buffettologists" in their own right. Describe how you've translated your learning from Mr. Buffett into an investment strategy.

Keith Ashworth-Lord: The core idea that when you buy a stock you're buying an economic interest in a real company rather than chips at the gaming casino struck me as eminently sensible and smart. What it says is switch off the extraneous factors like predicting where the markets or economy or interest rates are going and spend all your time on the company's business, the industry it serves and the competitive market in which it operates. If you get those things and how they translate into cash generation right over time, you'll do perfectly well as an investor.

We have a pretty regimented way of going about it all. Right at the top we're looking for companies with economic moats that have consistently earned an excess return on capital without that excess return being competed away down to the cost of capital. Law of capitalism #1 is that excess returns get competed away over time. Companies that avoid that – and of course, critically, that you believe will continue to avoid that – have something very special. Much of our research is around the strength of the walls, barriers and drawbridges businesses have that keep the competition away.

We generally think profitability of capital is even more important than profitability of sales. We believe across the board that the cost of equity capital is around 10%, so we want returns on average equity to be in the late-teens or higher. We also want those to be cash returns because it's free cash flow that can actually be reinvested in the business, used for bolt-on acquisitions or handed back to shareholders through dividends and share buybacks. We look at moving five-year periods and are typically not interested unless the business is converting at least 80% of its book earnings into free cash flow. That often leads us to asset-light businesses, where generating returns depends less on physical assets.

We pay a lot of attention to operating-margin development. From garnering economies of scale and increasing bargaining power, businesses should at the very least see their margins steadily improving over time as they grow. Operating margins that are flat-lining or declining suggest to us that the economic power of the franchise is waning, which we most definitely want to avoid.

The last thing I'd highlight is our emphasis on businesses that are predictable with a higher than normal degree of certainty. By that I don't mean you can predict earnings down to decimal-place precision, but more that the characteristics of the business are going to be substantially the same in ten or even 20 years' time. One classic example from the portfolio would be Diageo [London: DGE], which has a premier global roster of hard-liquor brands. In general, teetotalism isn't likely to break out globally. There's also a direct correlation between GDP per capita and hard-liquor consumption, so you can imagine developing and emerging markets firing additional demand over time. This is not a business we'd expect to be fundamentally disrupted for the foreseeable future.

How important are growth prospects?

KAL: Ideally we're looking for companies and industries that have solid growth prospects, so we can benefit both from overall market growth as well as market-share gains. But we're not overly fussed about explosive growth – in fact we worry about it because it's very hard to manage. Businesses that can steadily compound

Keith Ashworth-Lord

Begging to Differ

While he'd already had a long career as an investment analyst, Keith Ashworth-Lord hadn't yet managed a portfolio for anyone else when he got a call in December 2009 from his friends David Clark and Mary Buffett, who co-authored the book *Buffettology*. They were looking to launch a Buffettology-branded investment fund in Europe and thought Ashworth-Lord was the perfect person to run it. Once they'd agreed on the geographic scope – Ashworth-Lord preferred to focus only on his home U.K. – "it took me about a nanosecond to say yes," he says.

He set up Sanford DeLand Asset Management in Manchester to manage the fund and he highly values the independence owning his own firm provides. "There's a real risk in working for a large investment house that if you get things wrong for three to six months you show up on Monday with a black sack on your desk and you're asked to clear out and leave the premises. That makes people prone to hug the indexes – like Warren says, no single lemming ever got bad press – and portfolios end up looking like the market. I'm accountable to my clients, of course, but I have freedom to own a portfolio that's very different than the market. That's obviously the only way you can ever beat it."

revenues at, say, 5%, 6% or 7% make wonderful investments over a long time horizon.

I should mention here that when it comes to capital allocation I always ask myself if the people running the business are acting like owners of the business or like expensively paid management consultants. I want owners, and our first choice on capital allocation is reinvestment into new projects generating high-marginal-return organic growth, which is the simplest form of growth to manage. Our next best use of capital would be bolt-on acquisitions that maybe add new expertise, new products or new technologies. We find that's often a perfectly rational use of shareholders' capital.

We're quite leery of "transformational" acquisitions. There's a horrible temptation for a professional manager with excess cash to go out and splash it, buying something big to make his or her name. I'd prefer they hand it back whenever it's truly cash they can't put to better use. We'll talk later about Games Workshop [London: GAW], but it's a beautiful example of a company that is reinvesting considerably in new growth but also is generating far more cash than it needs. They declare dividends as and when they think they have surplus capital, which last year resulted in five dividends being paid out. That to me is so rational – we love to see that.

Are you usually counting on a market break of some kind to create share prices at which you're willing to buy?

KAL: We will at times invest in companies going through some sort of transition or turnaround where the market is still pricing in defeat when we believe the odds favor victory. But yes, very often we'll pick up ideas that are on our watchlist during the depths of some sort of market funk. That happened noticeably in 2016 after Brexit first passed. It happened again in the last quarter of 2018, when shares we'd passed on just a short time earlier were suddenly selling for 20-25% less.

As an example, during that period we added Experian [London: EXPN] to the portfolio for the first time. It's one of the top three global credit-checking agencies, with strong market positions in the U.K. and the U.S. and an intelligent and successful strategy for further geographic expansion. It's a business with secular tailwinds, pricing power and high barriers to entry that we think translates into high and sustainable returns on capital. The stock didn't fall as much as some did when the market went into its funk, but it did enough for us to establish a position at what we considered a fair price. I should add that it didn't stay down for long. [*Note*: Experian's stock in October 2018 fell 11% in three weeks from its 52-week high. Since bottoming at that point, the shares at a recent £27 have increased more than 50%.]

A company that's been in the portfolio much longer is Rotork [London: ROR], which makes the actuators that basically open and close valves in such things as oil and gas refineries, power-generation facilities and water and wastewater plants. The key thing about it is that it's the best in the world at what it does, consistently at the forefront of innovation in its market. By the time the patent on an old product runs out they've got a new product out with a new moat around it. Its kits have been on virtually every refinery that's been built over the last 30-odd years, so the installed base is quite large and there's a substantial aftermarket business.

In this case there is an element of cyclicality, when new-build capex can turn down for a year or two before it comes back, but if you look carefully at the business over time the market tends to think it's more correlated to things like oil prices than it really is. Generally when the market gets really down on it we get the chance to buy more. A relatively stable company economically that has a volatile share price is a great opportunity for an investor.

ON BREXIT:

Mediocre businesses like to blame Brexit for their ills, while the great businesses are just getting on with it.

When you were first approached to launch your current fund it was envisioned as one investing across Europe. Why did you want to focus more narrowly on the U.K.?

KAL: There's really nothing more to it than that the U.K. and Ireland were my home turf, where I knew the companies I wanted to invest in and those I didn't want to invest in. I wanted to start out with businesses and managements I knew well and was quite confident they wouldn't let me down.

Which is not to say our portfolio isn't international. With only two holdings that are not domiciled in the U.K. or Ireland – Berkshire Hathaway [BRK.A] and the pest-control company Rollins [ROL] – if you look collectively at where the companies earned their revenue as of December 31, it's 37% U.K., 25% North America, 14% rest of Europe, 6% Asia/Pacific and 4% other. The remainder was in cash. You would expect that type of breakdown given the companies we favor. If a company has a product or service that is fundamentally better than what else is in the market, you'd typically expect that good or service to be in demand the world over, not just in the domestic market. We're trying to find companies with something special like that.

How has Brexit impacted what you do?

KAL: It hasn't really. There have been times, as I mentioned, when the overall market went down out of concern for Brexit and we've tried to take advantage of that. But for most of our companies, they have international footprints and are basically prepared to respond to whatever hand they are dealt as a result of Brexit. I find in this country it's the mediocre businesses that like to blame Brexit for their ills, while the great businesses are just getting on with it.

Are you pro or con Brexit?

KAL: Personally, I'm very pro-Brexit. The economy in continental Europe is sclerotic and hindered broadly by regulatory overkill. Our mindset is much like yours in the U.S., as global traders operating in a global economy. Our trade with Europe has actually been falling while that with the rest of the world has been increasing. Freed from all the bureaucratic regulation and directives of Europe, I think it's a wonderful opportunity for this country.

Speaking of regulation, the U.K. has adopted the EU's MiFID II framework that says third-party equity research can no longer be bundled with other services and has to be paid for separately. Have you seen any impact from that?

KAL: You could see what was going to happen. Equity analysts were going to be shown the door and research was going to be cut back, predominantly in smaller companies that fewer people were interested in and where the trading commissions would be lower. The analyst coverage for many small companies has materially diminished, which is a positive for us. Fewer people paying attention makes valuation anomalies more likely. There is a negative to it, though. It feels like liquidity in smaller companies has been compromised by MiFID II.

Describe generally how you think about valuation.

KAL: We don't pay much attention to P/E ratios, all we're interested in is the long-term free-cash-flow generation. Trying to use conservative assumptions – which I know everyone says they do – we do full discounted-cash-flow models using a 10% discount rate for every company. The beauty of 10% is that if an equity investor does that per annum on average, he's going to be quite well off at the end of it. It also stops us from overvaluing things in low-interest-rate environments and undervaluing things when interest rates spike. I've been doing it this way for 25 years and it's always kept me on the straight and narrow.

Typically when I look at my portfolio I've got roughly one-third in stocks trading below our estimate of fair value, one-third trading around fair value, and one-third that's looking more fully valued. But it's quite rare that you'll see me trade. I put in 22 holdings when we started the fund in 2011 and 14 are still in the portfolio. Of the remaining eight, three have been taken over and five I've decided to sell. I do really believe the ideal holding period is forever. There are so few great businesses that when you have one, why would you want to get rid of it?

ON HOLDING "FOREVER":

There are so few great business out there that when you have one, why would you want to get rid of it?

Peter Lynch used to talk about "stalking the elusive ten-bagger." We actually have four of those in the portfolio today – Dart Group [London: DTG], which has been a 22-bagger, Games Workshop is an 18-bagger, and Liontrust Asset Management [London: LIO] and AB Dynamics [London: ABDP] are both 10-baggers. You don't get those if you're constantly chopping and changing your portfolio. We have yet to sell anything because it appeared to get too expensive.

That's particularly important because it's extremely difficult to know in advance what's going to hit big, and anyone who tells you otherwise is likely kidding themselves. We saw a lot of potential in Games Workshop, for example, but several things have happened that we didn't necessarily expect. We didn't expect that the COO who became CEO would be as talented on a variety of fronts as he's proven to be. We didn't expect the business to benefit from the devaluation of the pound – all the company's manufacturing is in the U.K. but 75% of revenues are abroad – to the extent it has. We didn't expect one of their new games, *Warhammer Age of Sigmar*, to be the blowout success it has been. I loved the company and its prospects, but I didn't see all this coming. Had I not truly signed up for the long term, there's a very good chance I would have missed a lot of the upside.

If we're reading it right, you appear to have sold and then bought back shares in sub-prime credit provider Provident Financial PLC [London: PFG]. What happened there?

KAL: This business has been around since 1880, engaged in door-to-door lending and collection to subprime customers. Agents were predominantly female, working part-time, and living in the same neighborhoods as their customers. The model worked very well, but then the company decided to change it. Go much more "professional." They started calling people customer relations managers instead of just agents. They wanted them to work full-time. They outfitted them with new technology which was supposed to replace the agents' good sense. I was already on my guard with all the management-school gobbledygook, but what killed it for me was seeing the early indications on what the new operating model cost, which came in at three times previously estimated levels. In this case I concluded something was out of control and sold my entire position in the high-teens in July and August 2017. Later that year the stock fell heavily and was below £7 when we bought back in the following Spring.

What made me go back in at the end of May 2018 was they brought back the guy who ran the main business for many years to sort it all out and he's been working to reverse the mistakes. I can't say it's worked yet the second time around. It's taking longer than I would have expected, but we do think they'll eventually get it right. [*Note*: Provident shares closed recently at around £4.70.]

Describe a sale after concluding you'd made a mistake.

KAL: In the middle of 2017 I took a position in Dignity [London: DTY], which is a funeral-services business I'd owned successfully before. I thought I knew a lot about funeral services and liked the steady demand, industry consolidation, general lack of pricing competition and low capex spending requirements. The stock had gotten cheap after a rocky quarter, which I just attributed to the natural pipeline cyclicality you see from time to time in the death business.

What I missed completely was the increasing prevalence of funeral price-comparison websites in the U.K. You were seeing a business where nobody talked about price now with a lot of information out there about comparison pricing. Within six months of our buying the shares, the company warned that in order to protect market share it was cutting the price of its no-frills funeral service option by around 25% and freezing the price of its full-service offering. That drove a stake through the heart of the business model and the stock responded accordingly. I will absolutely sell if I'm convinced a business has gotten materially worse and is not about to improve any time soon. That was the case here, giving us the worst result the fund has ever had.

Describe your broader investment case for language-translation company RWS Holdings [London: RWS].

KAL: The company started life as a patent and commercial translator and has built from that base a global franchise serving multinational clients such as Siemens, AstraZeneca and Mercedes-Benz. Say you're Siemens and you have a patent written in German but you want to file for that same technology around the world in whatever language necessary. Or you're Microsoft and you have highly technical documentation that needs to be translated broadly in the proper form and filed with the proper authorities globally. RWS handles all that for you.

What caught my attention early on was that they almost never seemed to lose a client. Then every year they'd add new clients and that's the way they'd organically grow. Much of it has to do with human capital. Their professional staff is typically dual-trained, both as linguists and in the scientific or technical specialization in which they work. No one else was doing that – they generally compete against patent attorneys, smaller mom-and-pop firms or freelancers. Big clients need to be sure this highly specialized work is done to the highest level and RWS has proven, at some scale, to do that consistently.

The company has a strong and unbroken sales, earnings and dividend record going back to its IPO in 2004. Early on that was mostly from organic growth, but they've also been quite successful in making bolt-on acquisitions that expand their geographic reach or extend their expertise. One took them into the life-sciences patent and translation business in a big way. Others built out their presence in the U.S. and brought in more computer and software clients. This all fosters cross-fertilization that makes sense. Global American companies they now serve hire them for business outside the U.S., for example. Or having hardware and software expertise in Europe helps them build out that type of business in the U.S.

INVESTMENT SNAPSHOT

RWS Holdings
(London: RWS)

Business: Global provider – primarily to corporate clients – of a broad range of language-translation, search and filing services related to the protection of intellectual property.

Share Information
(@1/30/20, Exchange Rate: $1 = £0.76):

Price	**£5.85**
52-Week Range	£4.46 – £6.74
Dividend Yield	1.4%
Market Cap	£1.61 billion

Financials (TTM):

Revenue	£355.7 million
Operating Profit Margin	17.4%
Net Profit Margin	12.7%

Valuation Metrics
(@1/30/20):

	RWS	S&P 500
P/E (TTM)	35.7	25.9
Forward P/E (Est.)	26.3	19.2

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

Company	% Owned
Liontrust Inv Partners	11.7%
Standard Life Inv	7.7%
Octopus Inv	5.0%
Hargreave Hale	5.0%
Investec Asset Mgmt	3.1%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

RWS PRICE HISTORY

THE BOTTOM LINE

The company has a "strong and unbroken" sales and earnings record going back to its 2004 IPO, says Keith Ashworth-Lord, who believes an expanding market and select acquisitions can drive attractive growth for years to come. Based on his DCF analysis, he believes shareholder returns from today's price can compound at least 10% per year.

Sources: Company reports, other publicly available information

Like many stocks in your portfolio, this one has been on a very good run over the past few years. How are you looking at upside today with the shares trading at around £5.85?

KAL: The underlying demand for what RWS does goes up every year and I believe through organic growth and continued select acquisitions the company can still grow quite nicely over the next five to ten years. Returns on equity are in the high-teens. Net debt to EBITDA is less than 1. It's true that the shares have done well, but we peg the current fair value – again, using a 10% discount rate – at close to today's price. So if all goes according to what we consider a conservative plan, we'd earn roughly 10% per year on the shares. This is one we wouldn't consider selling at fair value – it's too good a business not to just let it compound value for you.

Is this a business that technology like machine translation could disrupt?

KAL: That's always an accusation that's been leveled. The reality in our view is that machine translation has a very long way to go before it's able to do anything close to the job necessary for the types of applications clients need RWS to do. Even with the length of my time horizon, I don't see that as an issue here.

What made you venture from your side of the Atlantic to buy Rollins.

KAL: We were actually looking at a business here called Rentokil [London: RTO], which after a long period of di-worsifying was in the process of getting back to basics, which in its case meant pest control and washroom-hygiene services. As we looked at it, I said we should look more deeply at pest control in the U.S. market, because I can tell you as a homeowner in Florida that such a service is not a discretionary spend. We're not talking about the odd rat in the kitchen or a wasp's nest here or there, we're talking about the need for regular treatment for a variety of infesting or destructive insects, including termites in wood-frame houses. For commercial operators it's equally or even more important.

That brought us to Rollins, which is one of the top two pest-control businesses in North America, operating mainly under the trade name Orkin. It has been a steady compounder over decades, including right through the financial crisis in 2008 and 2009. Organic growth is 5% or so a year and they consistently make bolt-on acquisitions, allowing them to increase operating profit and earnings per share at around 11% per year over the past ten years. Great cash generation, great returns on equity, an owner-operator family that owns more than 50% of the shares, great capital allocation, low capital-spending and working-capital needs, and little risk of disintermediation – it fits all the boxes.

Is this still an industry consolidation play?

KAL: Very much so, in a business where scale works to the benefit of the biggest players. As selling, general and administrative costs get spread over a larger base, Rollins over the past ten years has increased its operating margin from 11.5% to better than 16%. It can also spend more on innovation. One initiative they cur-

INVESTMENT SNAPSHOT

Rollins
(NYSE: ROL)

Business: Provider of pest and termite control services to both residential and commercial customers in North America, Australia and Europe, primarily under the Orkin brand name.

Share Information (@1/30/20):

Price	**38.22**
52-Week Range	31.36 – 43.91
Dividend Yield	1.2%
Market Cap	$12.51 billion

Financials (TTM):

Revenue	$1.95 billion
Operating Profit Margin	16.1%
Net Profit Margin	10.4%

Valuation Metrics
(@1/30/20):

	ROL	S&P 500
P/E (TTM)	61.4	25.9
Forward P/E (Est.)	42.9	19.2

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

Company	% Owned
Vanguard Group	5.6%
T. Rowe Price	4.1%
Morgan Stanley Inv Mgmt	3.8%
BlackRock	2.4%
State Street	2.2%

Short Interest (as of 1/15/20):

Shares Short/Float	10.6%

THE BOTTOM LINE

The company "fits all the boxes," says Keith Ashworth-Lord: great cash generation and returns on equity, owner-operator family, smart capital allocation, low capex and low risk of disintermediation. With pricing power and benefits from further industry consolidation, he believes earnings – and shareholder returns – can compound at least 10-11% per year.

Sources: Company reports, other publicly available information

rently have is to work with the big home-builders to embed Orkin termite-control systems directly into the wood frames of houses. There's a little nipple they've designed – and patented – used to refill the pesticide as needed. That's a clever means of locking in customers in a way the mom-and-pop competitor just couldn't do.

Their long tenure in the business helps in other ways. Last year Rollins made a good-sized acquisition, buying Clark Pest Control, which was the eighth-largest pest-control company in the U.S. and the largest independent one in California. The senior Rollins, Randall, who is still the company's Chairman, said his family had been talking to Clark on and off about doing a deal starting 20 or 25 years ago. Rollins knows what it's getting and that type of history I think makes it more likely the acquisition goes well.

How are you valuing the shares, which don't look optically cheap, at today's price of around $38?

KAL: As I mentioned, we look at long-term free-cash-flow generation over current P/E multiples. We can't see this business being fundamentally different in 20 years, so it's not unreasonable to expect the company to compound earnings over a long period at 10-11% per year, plus the dividend. Using our 10% discount rate, we on a DCF basis think the shares today are right around fair value.

We bought into this last year and so far haven't had any performance out of it. With our time horizon, we've got plenty of time for that to change.

Describe the "in-transition" potential you see in RM Plc [London: RM].

KAL: This is a position we added to the portfolio in the latter half of last year. The company is a leading supplier of technology and resources to the education sector, operating through three divisions. The Resources business provides educational materials to "bring the curriculum to life" for teachers and students. The Education division supplies software, hardware, consulting and services to enable clients to better utilize technology to improve teaching and learning outcomes. The smallest unit, called RM Results, provides digital assessment and testing services and systems on a global basis.

I have known and followed RM on and off since the late 1990s. It was a major player in the U.K's "Building Schools for the Future" program, but operated more as a technology reseller than anything else. That tended to be low-margin, low-value-add business, and the company now for several years has been transforming its business to the current incarnation. Total annual revenues are down probably 40% from their peak, but operating margins have increased from a low of 2.5% in 2011 to better than 12% today. Earnings per share over the past five years have grown more than 15% annually. Returns on equity are above 30%.

Our view is that the business has turned and the new model is working. Intelligently applying technology to improve student learning outcomes is not going to go out of favor any time soon, nor are applications for digital assessment of both students and employees. The company is taking early steps in expanding its interna-

INVESTMENT SNAPSHOT

RM Plc
(London: RM)

Business: Designs, develops and provides curriculum, software and technology products and services for customer educational institutions primarily in the United Kingdom.

Share Information
(@1/30/20, Exchange Rate: $1 = £0.76):

Price	**£2.79**
52-Week Range	£2.20 – £3.10
Dividend Yield	2.7%
Market Cap	£234.1 million

Financials (TTM):

Revenue	£221.6 million
Operating Profit Margin	12.2%
Net Profit Margin	8.2%

Valuation Metrics
(@1/30/20):

	RM	S&P 500
P/E (TTM)	12.6	25.9
Forward P/E (Est.)	10.9	19.2

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

Company	% Owned
Schroder Inv Mgmt	17.2%
Aberforth Partners	15.0%
Sanford DeLand Asset Mgmt	12.2%
Hargreave Hale	5.6%
BlackRock	5.1%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

RM PRICE HISTORY

THE BOTTOM LINE

The market isn't fully recognizing the company's successful transition from low-margin technology reseller to a more value-added provider of educational products, software and services, says Keith Ashworth-Lord. His DCF value for the stock is nearly 20% above today's price, for a company he believes can grow EPS at a low-double-digit annual rate.

Sources: Company reports, other publicly available information

tional business – nearly 90% of revenues now come from the U.K. – and there's still some room to go in making the operations more efficient. Combining modest top-line growth and some margin expansion, we believe earnings per share can compound at a low-double-digit rate.

How are you looking at valuation with the shares currently trading at around £2.80?

KAL: Our DCF value today is around £3.30, so this is one where we still see an attractive discount to fair value even using our 10% discount rate. The dividend yield is also material, at 2.7%, and the dividend rate has been growing at a fairly nice clip. If earnings compound as we expect and the market takes notice, while it may not be a ten-bagger any time soon, we think it offers a very attractive potential return.

You mentioned it as one of your (at least) ten-baggers, but explain why you're still fully committed to Games Workshop.

KAL: This is really quite a fascinating business. The company makes fantasy miniatures that are used in war gaming. There are two basic game genres, one of which is more futuristic and exemplified by the game *Warhammer 40,000*, and the other more Tolkienesque, as in *Warhammer Age of Sigmar*. The miniatures are metallic and unpainted when you get them, so you also need to buy from GW the paint, scenery, vehicles, game manuals and most everything else needed to play.

Warren Buffett says the ideal product is something that costs a penny to make, sells for a dollar, and is preferably habit-forming. While the economics aren't quite that good here – gross margins are more like 67% and operating margins are over 30% – the customer base is absolutely rabid. Players, who are almost all male, come to this usually in their late teens and often play regularly well into their 30s. The products are sold through more than 500 company-owned stores, directly online, and through some 4,700 independent game shops. As I mentioned earlier, 75% of sales are outside of the U.K.

People have long said electronic games are going to be the death of this, but I'm sorry, they're not. In fact it's gone the other way. The people who play want to touch the miniatures, do the painting, set up the battlefield and interact with real people when playing. Over the past 15 years the company's compound annual growth rate of sales is 3.6%. Over the last ten years it's 7.4%. Over the last five years it's 15.7%. The current store base has been growing and is by no means saturated. Social media around the game community has taken off. Customer satisfaction scores are rising.

They're very careful with their intellectual property, but they do see licensing and other opportunities around entertainment and electronic media. Licensing revenues five years ago were £1.5 million per year. In just the first six months of the current fiscal year, that number was £10.5 million.

The company seems to be shooting the lights out. What makes things even better?

KAL: To take advantage of what they still see as considerable untapped demand, the company has been investing heavily in manufacturing and distribution. Capital

INVESTMENT SNAPSHOT

Games Workshop
(London: GAW)

Business: Design, manufacture and sale of model soldiers that are collected, painted and used to play in-person fantasy games, many of which fall under the Warhammer brand.

Share Information
(@1/30/20, Exchange Rate: $1 = £0.76):

Price	**£66.55**
52-Week Range	£27.85 – £71.35
Dividend Yield	2.1%
Market Cap	£2.17 billion

Financials (TTM):

Revenue	£279.7 million
Operating Profit Margin	35.6%
Net Profit Margin	28.8%

Valuation Metrics
(@1/30/20):

	GAW	S&P 500
P/E (TTM)	27.2	25.9
Forward P/E (Est.)	n/a	19.2

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

Company	% Owned
Investec Asset Mgmt	9.4%
JPMorgan Asset Mgmt	8.6%
Schroder Inv Mgmt	5.6%
Standard Life Inv	5.4%
MFS International	4.9%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

GAW PRICE HISTORY

THE BOTTOM LINE

Keith Ashworth-Lord believes the company's upside is still high as it expands production and distribution to meet high demand. While he might not buy at today's price, he says he has no intention of selling the stock in a company "growing revenues at a mid-teens rate, with 30%-plus operating margins and returns on average equity close to 70%."

Sources: Company reports, other publicly available information

spending has doubled over the past two years to increase production capacity, expand the owned store base and invest in a new enterprise resource management [ERM] system. If demand growth stays as strong as it's been, the revenue growth potential is still quite high. As they look to increasingly shift revenues to their own stores and their own online channels, that should also have a materially positive impact on margins.

One unknown, of course, is whether they can keep coming up with blockbuster titles that people want to play. What's a bit different here is that the games tend to have a very long life. It's generally the same basic game, they just evolve it and add to it from time to time. That makes us a bit less concerned about a game actually going out of fashion.

The first GW shares you bought for your fund were at £3.75. Now trading closer to £68, would you buy the stock at this level?

KAL: To be honest, I'd want to see it come off a bit before buying any more. I would say though that as dramatic as the share-price rise has been, the vast majority of it has been driven by increasing earnings rather than the P/E expanding.

We have no intention of selling. With companies doing this well, it doesn't take long for the current price to look less expensive. For the fiscal year ending in May 2021 we think cash earnings could be 300 pence per share. So on that you're paying 22-23x earnings today for a company growing revenues at a mid-teens rate, with 30%-plus operating margins and returns on average equity close to 70%. Maybe that's not bargain-basement, but it's not bad either.

You mentioned earlier owning Berkshire Hathaway. How does it trade today relative to your estimate of fair value?

KAL: Before we started buying we sounded out our large investors because I thought I'd be accused of not only using the Buffettology name, but also just coat-tailing on the back of his company. I thought some people might not like that, but the opposite was the case. Most people were surprised we hadn't owned the shares earlier.

This I value by looking at the extent of the premium to book value. I first bought the stock in July 2018 when the shares were trading at what I considered an attractive 1.1-1.2x book. I felt good about the fact that Warren himself disclosed not long after that buying back some Berkshire shares at around the same level. My average price is something around $312,000 on the A shares. At today's price of around $340,000, I would say it's up with events near-term at that level.

One thing is exercising my mind about Berkshire. What if all the cash that's built up is partly there to do a massive share buyback if the stock tanks when Warren passes away. The share price might be resilient as the investment banks are all over it trying to break it up, but there's also a case to be made that the stock falls pretty sharply when Buffett and Munger are gone. What a wonderful deployment it would be to buy back equity if that happened. It could be his next great trade, from beyond the grave. VII

Investor Insight: Vanshap Capital

Vanshap Capital's David Shapiro and Evan Vanderveer explain why they exclusively target capital-constrained markets, how they try to differentiate their due-diligence process, what they learned from their most-painful investing mistake, and why they see significantly underpriced value in Hoteles City Express, Pinfra, TBC Bank and Glenveagh Properties.

With your top three country exposures being Greece, Georgia – the country, not the state – and Mexico, it's safe to say you're looking off the beaten path for investing opportunity. What brought you to that?

Evan Vanderveer: There are multiple aspects to it, but it's all about increasing our likelihood of finding pricing inefficiency. We target capital-constrained markets, where we say either "everyone has left" because of temporary economic stress, or "few have arrived" because the populations, economies and companies are too small. In the depressed markets, economic circumstances often lead to significant under-investment by both local and foreign investors, which can create opportunities that potentially pay off when capital eventually returns. In overlooked markets, neglect from a broader range of investors who just don't bother with them can also lead to a shortage of capital and bargains that similarly can pay off as the countries develop and attract more capital.

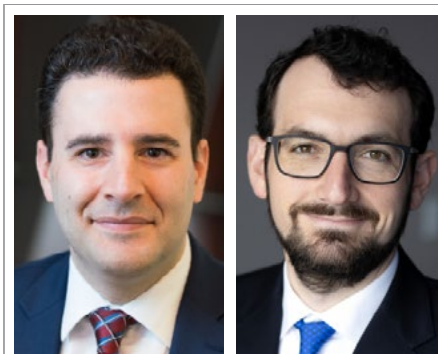
We also think our chances of finding mispriced stocks increases in smaller companies that are less followed and less liquid. Our sweet spot is $100 million to $1 billion in market cap, with the average somewhere around $500 million. We'd argue these types of companies are even more prone to mispricing as money increasingly flows into passive indexes and regulatory changes like MiFID II in Europe make it economically unfeasible for brokers to cover small stocks. We like as well in these companies that there's often high insider ownership, offering better alignment with our interests, but limiting the public float in a way that institutional capital stays away. We think all these things are good for us.

You're painting on a rather broad geographic canvas. How do you focus your attention?

David Shapiro: We're looking for where the best values might be, so one idea we took from the famous Canadian investor Peter Cundill is to plan research trips early in the year to countries with the worst-performing stock markets of the prior year. Chile, for example, is next on our list. A lot of work obviously goes into preparing those trips, from understanding the economic and political dynamics, to analyzing industries and competitive environments, to digging into specific companies and their financials. That helps us identify who we want to meet, where we want to go and what we need to learn from our on-the-ground due diligence.

Last year we went to Ireland after the market had been hit hard by concerns over how Brexit would impact it. In some of our advance screening we saw that two homebuilders, Glenveagh Properties [Dublin: GVR] and Cairn Homes [Dublin: C5H], had fairly recently raised equity in order to finance efforts to build their land positions and grow sales, but their stocks were struggling and trading below book value. Our work convinced us that the Irish housing market after an extended period of weakness was poised to improve pretty substantially and that Glenveagh in particular was well financed and positioned to take share in a consolidating and recovering market. We may not have looked at it in the first place if not for the market being so bad the year before.

EV: We naturally also focus a lot of our attention on countries where we've already spent extended periods of time and have developed a strong local network of company executives, analysts, consultants, politicians and investors. We've now been to Greece at least a dozen times, and in addition to constantly gathering new information on the companies we own, we're regularly learning about new people to meet and companies to research. It's a



David Shapiro, Evan Vanderveer

Going Global

As young investment analysts working at deep-value fund manager Aegis Financial, Evan Vanderveer and David Shapiro concluded their best opportunities were outside the U.S. rather than in it. "We believed strongly that the U.S. market had become more efficient, to the point where the real bargains we were finding here typically came with a lot of hair," says Shapiro. "We wanted to still pay cheap prices, but in better businesses with better management teams. We thought that was easier to do if we invested outside the U.S."

In 2012, with the backing of Tom Gayner and Markel Corp. [*VII*, April 29, 2016], they launched Vanshap Capital to do just that, focusing on small companies in international markets. In that quest, they as partners think they benefit from complementary skills. "I'm steeped in the numbers and the forensic-accounting aspect of investing," says Shapiro. "Evan, as comfortable as he is with numbers, is very good at the on-the-ground research and network building that's so important to what we do." Adds Vanderveer: "David is a natural skeptic, while I'm more of a natural optimist. That produces a dynamic we enjoy and we also think results in better investment decisions over time."

virtuous cycle that we think can give us an edge as investors. Things like a company's culture, or management's reputation and motivation, or which way regulatory or political winds are blowing – these types of things are particularly hard to get at without having people in the country to talk to who you can trust.

Once you're connected in a country, ideas come pretty organically. A few years ago when there was lot of turmoil in the Mexican market due to the Trump administration's questioning of NAFTA, we were speaking with the management of a hospitality-related FIBRA – the Mexican equivalent of a real estate investment trust – and we always at the end of such conversations ask if there are any other companies or executives in the country we should get to know. In this particular case the gentleman went on for about 15 minutes about how much he respected the hotel company Hoteles City Express [Mexico City: HCITY]. We never did buy into that particular FIBRA, but Hoteles City is now one of our core positions.

You concluded five years into your tenure at Vanshap that you weren't putting enough emphasis on management and business quality. Describe the evolution in your thinking on that.

EV: It kind of hit home for us when the manager of one of our then-current investments told us he was leaving the company for business school – as a student. This and other frustrating experiences led us to re-examine our original view that simply finding undervalued assets was typically enough. That was predicated on the theory that management would at a minimum not destroy value, or that the market would wake up or an acquirer would come along before management could do any damage. Given where we look for ideas and the extent to which we had expanded our network, we decided it wasn't at all necessary to settle for lower-quality businesses or below-average management talent. Maybe that realization was somewhat overdue, but it's been a significant upgrade.

Is assessing management talent one of the big challenges in investing in capital-constrained markets?

EV: What generally separates the average manager from the exceptional one in our experience is creativity and skill around capital allocation. Where we're investing management teams often don't attend conferences, don't have conference calls and just aren't very widely known. The numbers obviously help, but it's just harder to get at the real outliers in terms of talent. Again, this is a key reason we put so much emphasis on having an on-the-ground network in the countries in which we invest. It's critical in understanding how companies really operate, their reputations and their histories.

ON BUILDING A NETWORK:

Things like a company's culture or reputation are hard to get at without having local people you trust to talk to.

To give an example, we've significantly increased our exposure to Georgia in the past year, specifically in TBC Bank Group [London: TBCG] and Georgia Capital [London: CGEO]. We like to invest in countries that are pro-business, pro-western, growing and liberalizing their markets. We also want to see relatively low private and public debt levels and a strong, independent central bank with a reasonable record of monetary-policy management. Georgia ticks all those boxes.

We'll talk later about TBC, but Georgia Capital is a holding company that was spun out of the Bank of Georgia and holds attractive assets, including stakes in the Bank of Georgia, Georgia Healthcare Group (the largest healthcare company in the country), and the monopoly water utility serving one-third of the country's population. We think the assets today are significantly undervalued and that the company's Chairman and CEO, Irakli Gilauri, is a talented capital allocator. He came from the Bank of Georgia, where he had been both CFO and CEO during a period when its stock was something like a 20-bagger through the 2000s. We wouldn't invest just because we've come to believe he's a great manager, but we think this is an idea that gives us the marriage of exceptional assets and exceptional management at a discounted valuation.

You have a core position in Navigator Holdings [NVGS], which ships liquefied petroleum gases. How does that fit your capital-constrained-market profile?

DS: We should say upfront that we're not big fans of the shipping business, where a fragmented market of operators and shipbuilders generally leads to intense competition, commoditized service offerings and poor pricing and investment discipline. We think Navigator is an exception because it has a market-leading position in the "handysize" semirefrigerated segment of the market for shipping petrochemical products, which is more specialized and concentrated, with more constrained supply and acceptable returns on capital over time. Navigator's return on invested capital has averaged approximately 10% over the past decade.

This is a case of investing more in a capital-constrained industry rather than geographic market. Despite being relatively more attractive, Navigator's segment of the market has been working through a classic down period triggered by overbuilding of handysize capacity, constrained supply of petrochemical-LPG export infrastructure, and some competition from bigger ships called VLGCs (Very Large Gas Carriers) trying to fill out their own excess capacity on the commoditized end of the market. Our case is that we're coming out on the other side of that capital cycle, some important long-delayed pipeline and infrastructure products are significantly increasing the supply of relevant LPG for transport, and that the resulting increase in day rates and utilization of its fleet will dramatically improve Navigator's results.

The stock today trades for around \$12.25, versus our average price of below \$9, but we think the company by next year can earn above \$2 per share, which will include profits from a new ethylene export terminal in which it owns a 50% stake. If we're right on earnings, the stock should trade at something closer to a 10x P/E, which would still provide attractive upside from here.

You've written, in reference to your research: "We stress observable factors such as the supply of capital and underlying competitive dynamics versus relying on long-term demand projections, addressable-market statistics, or trying to predict consumer preferences." Don't most investors rely "on long-term demand projections, addressable-market statistics, or trying to predict consumer preferences?"

DS: Yes, but we're saying there's more risk to that because of how hard it is to predict those types of things. We're not saying all that is unimportant, but we try to put more emphasis on understanding recurring capital cycles, industry dynamics and supply. We're also still strong believers in balance sheet and asset-based investing, paying attention to what we're paying for a business based on what we can accurately measure and observe.

The fewer competitors, the more capital that has left the market, the more supply that has been withdrawn, the higher the odds of a brighter future over the next three, five or seven years. Combined with undervalued assets, these are the situations we look for to make it more likely that the wind is at our back rather than in our face over a multi-year period. It's riskier in our mind to be betting more on demand soaking up the supply that's come into the market.

Describe your valuation discipline.

DS: We're generally trying to buy into businesses at mid-single-digit multiples of normalized earnings and frequently at a discount to book value. Putting what we consider a normalized valuation on normalized earnings over the next three to four years, we want to expect at least a 25% annualized return over that period. There's a range around the return expectation: If we're going into a Turkey or a Brazil, where the macroeconomic and political risk may be higher, we'll likely want to expect more like a 30% IRR. In places like Ireland or Australia, we might be satisfied with a 20% IRR.

ON CONCENTRATION:

As we've developed a greater appreciation for business quality, we've bumped up our expected full position size.

Given the size of the companies and the markets in which you invest, you run quite a concentrated portfolio. Describe your thinking on that.

DS: It's always made sense to us that your chances of outperforming increase with 10 to 15 positions in your highest-conviction ideas. As we've developed a greater appreciation for management and business quality, we've bumped up our expectation for a full position now to be 6-8% of the portfolio. We'll start lower than that, but only want to buy things we believe can eventually get to that size at purchase. If something works out and gets into the low- to mid-teens percentage of the portfolio, we're generally comfortable with that if we still think the upside is there.

One exception on position size would be if the name is particularly illiquid. We own a very small company in Australia called Swick Mining Services [Sydney: SWK], which has a strong underground core-drilling business and also developed a novel 3-D technology to scan drilled cores to provide non-destructive assay and geologic information to miners. We got in at a very low price on book value and estimated earnings, but it's been slow to pay off so far given the vagaries of the mining industry and the fact that the company announced a new capital raise that we think it doesn't need and will be dilutive. For something of this size and risk profile – the market cap is just over A\$50 million – we #1 need to see pretty amazing upside, and #2 won't likely make it a 7% position.

Walk through your broader investment thesis for Hoteles City Express.

EV: Hoteles owns and operates limited-service hotels in Mexico – sort of like a Holiday Inn Express in the U.S. – with close to 160 locations around the country. It's twice the size of its nearest competitor and has a long record of success under the CEO who founded the company in the early 2000s. We've spent a lot of time meeting with employees up and down the organization and have been quite impressed with the culture and how motivated and focused people are on operational excellence and customer satisfaction.

We don't think we're paying for it, but the growth runway for the company is long. Branded hotels are around 25% of the market and Hoteles should be at the forefront of taking share from independent mom-and-pop competitors who just don't have the access to capital, the consistency of quality, the loyalty programs and the marketing and operational expertise to compete. The market is not unlike where the U.S. was in the 1970s and 1980s, when branded chains like Marriott, Hilton and Holiday Inn really started to expand.

We think there are two key things weighing on the stock. One is concern over the administration of Andrés Manuel López Obrador [AMLO], who came into power at the end of 2018 and has been pursuing an agenda that hasn't always been considered pro-business and pro-economic growth. Related to that and the resulting increase in interest-rate levels in Mexico, the company last year also postponed the planned spinoff of a portion of its hotel assets into a FIBRA, which was widely perceived as a positive way to unlock shareholder value.

DS: The political situation in Mexico is very much like the situation we lived through in Greece. You had a populist administration come in that had very little idea of what it was doing. Not only was the ideology misguided, but the ministers put in place to execute it were inexperienced and/or incompetent. That's exactly like Greece in 2015.

As with Greece, though, the AMLO administration has started to moderate its extreme views and they're bringing in people with more relevant experience. While I wouldn't say the current administration is going to take Mexico to great economic heights, the worst fears are starting to subside. That gives us more confidence that overall economic growth can at least start moving up to a more appropriate level.

With respect to the FIBRA spinoff, we still expect it to get done. Interest rates are coming down and there's quite a bit of economic logic around splitting the business into a high-dividend REIT equivalent and a higher-margin, higher-multiple operating company. We don't know when it happens, but expect over our investment horizon that it will.

From today's share price of around 14.20 Mexican pesos, how are you looking at valuation?

DS: Because the company has been growing rapidly, at least one-third of the existing hotel properties are not yet earning proper returns. Given the high fixed-cost base of an individual hotel, the operating leverage for those immature properties is quite significant as most of the marginal revenue dollar falls to the bottom line. We don't believe the market is fully recognizing this.

Just from the existing portfolio maturing, we believe the properties on a normalized annual basis in the next three to four years can produce EBITDA on the order of 1.4 billion Mexican pesos. If we assume a roughly 10.5x blended EV/EBITDA multiple – 10x for the properties and maybe 12x for the management company – the shares would then be valued at around 27 pesos, giving us an IRR from today of about 21%.

And that's without taking into consideration future growth potential from a bigger overall market and gains in market share. It's not unreasonable to assume annual value growth of an additional 10% or so from that. We like that we don't have to assume that additional growth in order to find the stock attractive at the current price.

Staying in Mexico, describe why you're optimistic about the prospects of Promotora y Operadora de Infraestructura [Mexico City: PINFRAL]?

DS: This is one of the largest public-works concessionaires in Mexico, whose primary business involves operating, managing and maintaining nearly 30 toll roads in the country. When the government needs a road to be built it will often turn to companies like Pinfra to bid for the long-term contract. Winners are frequently guaranteed a real rate of return that generally runs between 11% on the low side and 14% on the high side.

The beauty of the model is that if the traffic on the road ends up being lower than projected, then the term of the concession is extended to make up for that. If traffic ends up being higher, the concessionaire makes its money faster, but may

INVESTMENT SNAPSHOT

Hoteles City Express
(Mexico City: HCITY)

Business: Owns, operates and franchises branded limited-service and value-priced hotels that serve primarily business travelers throughout Mexico and other Latin American countries.

Share Information
(@1/30/20, Exchange Rate: $1 = 18.76 Mexican pesos):

Price	**MXN 14.17**
52-Week Range	MXN 12.95 – MXN 24.00
Dividend Yield	0.0%
Market Cap	MXN 5.26 billion

Financials (TTM):

Revenue	MXN 3.09 billion
Operating Profit Margin	18.1%
Net Profit Margin	6.5%

Valuation Metrics
(@1/30/20):

	HCITY	S&P 500
P/E (TTM)	26.0	25.9
Forward P/E (Est.)	n/a	19.2

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

Company	% Owned
Aberdeen Asset Managers	4.7%
Caisse de Depot et Placement (Quebec)	3.5%
Vanguard Group	3.2%
BBVA Bancomer	3.1%
Handelsbanken Fonder	2.7%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

THE BOTTOM LINE

David Shapiro believes that higher earnings resulting just from the maturing of the company's existing hotel portfolio can drive a near doubling of the stock price within three to four years. He expects ample upside beyond that as the company capitalizes on a growing overall market and its ability to take market share from less-capable competitors.

Sources: Company reports, other publicly available information

have the life of the concession shortened a bit as a result. A won concession is almost like an inflation-adjusted bond that guarantees a real rate of return.

In general, the long lives of the concession awards (around 30 years), the set maintenance patterns and the ability to pass through inflation on tolls leads to predictable, high-margin cash flows. Since the company was completely reorganized under CEO David Peñaloza Alanis – whose family controls more than 40% of the stock – revenue and EBITDA have grown 12% and 15% per year, respectively, over the last thirteen years.

Has the populist government weighed on the stock here as well?

DS: Government policy has clearly been a concern, especially after the administration early on cancelled a Mexico City airport project that relied on private funding and participation. The worry was that it would possibly also renege on other infrastructure-related projects like toll roads. Nothing has happened so far on that front and we believe the government actually realizes that in order to upgrade this type of infrastructure – which is an important need in Mexico – that it will require the active participation and funding of the private sector.

Another seeming overhang on the stock is a new competing toll road and rail line challenging the existing toll road Pinfra has running between Mexico City and Toluca. This will likely have a negative impact on that road's traffic, but we estimate the resulting revenue loss at maybe 10-15% on that specific asset. We believe even a very modest rate increase across most of the rest of the portfolio will wash that away pretty quickly.

The company has two share classes. Why do you own the non-voting L shares?

DS: The L share is a less-liquid preferred share. Holders of the L shares are explicitly entitled to all the same economic rights, including takeout rights, of the common. So these shares are functionally completely equivalent except for voting rights. When you have a CEO whose family controls over 40% of the stock, having voting rights doesn't really matter. You probably can't influence what he does anyway. If you're not comfortable with him, you shouldn't own the regular shares either.

So the reason we own the L shares is that we were able to acquire them at more than a 35% discount to the common. Given the functional equivalence, that makes no sense to us. The discount may never go away, but even at the current 33% it's materially above the long-term average of around 20%. It was as low as 10% when the shares first started trading.

How cheap do you consider the L shares at the recent price of close to 144 pesos?

DS: Just from already-approved projects coming online and toll increases on existing roads, we estimate Pinfra can increase EBITDA at a 7% or so annual rate over the next three years. If it traded at what we consider a reasonable 12x EV/EBITDA and the L-share discount went back to the historical 20% average, the L shares would be worth around 240 pesos. And they'll likely pay a mid-single-digit dividend yield along the way.

INVESTMENT SNAPSHOT

Promotora y Operadora de Infraestructura
(Mexico City: PINFRAL)

Business: Constructs, operates and maintains long-lived concession infrastructure projects – primarily consisting of toll roads but also including port terminals and bridges – in Mexico.

Share Information
(@1/30/20, Exchange Rate: $1 = 18.76 Mexican pesos):

Price	**MXN 143.79**
52-Week Range	MXN 104.00 – MXN 143.80
Dividend Yield	6.5%
Market Cap	MXN 96.00 billion

Financials (TTM):

Revenue	MXN 11.44 billion
Operating Profit Margin	55.7%
Net Profit Margin	45.1%

Valuation Metrics
(@1/30/20):

	PINFRAL	S&P 500
P/E (TTM)	11.9	25.9
Forward P/E (Est.)	n/a	19.2

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

Company	% Owned
GBM Admin de Activos	7.1%
Fidelity Mgmt & Research	2.9%
BBVA Bancomer	2.7%
SAM Asset Mgmt	2.3%
International Value Adv	2.1%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

PINFRAL PRICE HISTORY

THE BOTTOM LINE

The strength of the company's (literal) toll-road business model isn't currently reflected in its stock price, says David Shapiro. At what he'd consider a reasonable 12x EV/EBITDA multiple on his estimates three years out, the shares would be worth around 240 pesos – while also paying a mid-single-digit annual dividend yield along the way, he says.

Sources: Company reports, other publicly available information

One thing to add is that the company has the equivalent of 25% of the current L-share market cap in net cash on its balance sheet. If they deploy that into new projects to jump-start growth again, or if they can't and end up returning a large part of it as special dividends, that should provide us with pretty significant incremental upside or potentially accelerate the closure of the L-share discount.

Returning to Georgia, describe the upside you see in TBC Bank.

DS: TBC is the largest bank in Georgia with market shares of approximately 39% in loans and in deposits. It and the Bank of Georgia dominate the market, which has allowed TBC to generate above-average returns for decades while using relatively less leverage than a typical bank. It is sophisticated technologically, which has allowed it to parlay information on its customers' wants and needs into selective new businesses in areas like credit cards, payments and insurance.

An important part of the story, as Evan described earlier, is the attractiveness of Georgia, which has one of the most impressive track records in the world of free-market reform over the past 20 years. That said, the country is tiny and in a fairly tough neighborhood, with Russia and Turkey on its borders. There are only four public companies of any note and they all are listed in London. These are pretty much orphaned investments in an orphaned country.

The fundamentals of the business are quite strong. Georgia has one of the most-concentrated and high-barrier banking systems in the world. Western banks have tried and failed to gain traction there, leaving TBC and Bank of Georgia in control of their destinies. Net interest margins run at close to 500 basis points, 25-30% higher than for banks in most emerging markets. Average returns on equity over 20 years have been above 20%. Expense structures tend to be relatively low. At the same time, the overall economy is growing at 4-5% per year and the market is still extremely underpenetrated when it comes to financial products, including basics like home mortgages.

There would seem to be some frontier-market type issues here as well, such as the company's two former chairmen being under investigation for money laundering. How do you process that?

DS: I would first point out that TBC itself hasn't been implicated and that the two people in question haven't been involved in operations for a long time.

From what we've been able to determine, the investigation revolves around loans the bank made in 2008 to a large business whose CEO was a friend of the chairmen, which then lent back to the two of them money in seeming contravention of related-party lending rules. If true, it is likely that this was an improper related-party transaction. But it also likely wasn't money laundering, a more serious charge that was probably brought because the statute of limitations on that charge hadn't expired, and because the two former chairmen happen to be political rivals of the administration in power.

It's all now going through the court system and we obviously don't know what's

INVESTMENT SNAPSHOT

TBC Bank
(London: TBCG)

Business: Largest bank in the country of Georgia as measured by both deposits and loans, with primary product and service franchises in retail and small-business banking.

Share Information
(@1/30/20, Exchange Rate: $1 = £0.76):

Price	**£12.42**
52-Week Range	£11.24 – £17.32
Dividend Yield	4.5%
Market Cap	£685.0 million

Financials (2018):

Total Assets	£4.01 billion
Return on Equity	22.7%
Return on Assets	3.2%

Valuation Metrics
(@1/30/20):

	TBCG	S&P 500
P/E (TTM)	5.0	25.9
Forward P/E (Est.)	n/a	19.2

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

Company	% Owned
Schroder Inv Mgmt	6.7%
JPMorgan Asset Mgmt	6.2%
Dunross & Co	5.9%
SEB Inv Mgmt	2.6%
BNY Mellon Inv Mgmt	2.5%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

TBCG PRICE HISTORY

THE BOTTOM LINE

While the company has taken advantage of a favorable market and competitive environment to consistently generate 20% returns on equity, says David Shapiro, its stock trades only at book value. From that ROE, the dividend yield, and a re-rating to 1.4-1.5x book value, he believes the shares over the next three to four years can generate a 30% IRR.

Sources: Company reports, other publicly available information

going to happen. But we don't believe the bank will be in any trouble as a result. If the chairmen were forced to sell some of their shares – they own 18% of the company – that might be a short-term overhang. But it's not one that changes our opinion on the stock.

Not to be overly dramatic, but how do you think about the risk of a potential invasion from Russia, which last happened over a territorial dispute in 2008?

DS: I'd call it a severe but remote risk. When we talk to Georgians about risks, they're almost always economic and internal in nature, not having much to do with Russia. The fact is that Georgia as it exists today really provides nothing of strategic value to Russia. Do we have to consider something like this when investing in Georgia? Yes. But we believe the risk of it negatively impacting our investment in TBC is very low.

What kind of return could you imagine on the stock from today's price of £12.40?

DS: It's pretty rare even for an emerging market that a bank earning 20% ROEs trades at only book value, which is the case here. So barring an economic catastrophe we don't envision, from this share-price level we should at least earn the ROE as a shareholder. If over the next three to four years the stock made it to 1.4x to 1.5x book – where it's been before and which wouldn't be a demanding valuation for a bank of this quality – with the ROE and the dividend yield we're talking about an IRR of 30% or so.

There's a risk in a stock like this that the valuation doesn't ultimately reach full value. Given how inexpensive the shares are, that's okay because we don't need it to reach full value to be a great investment.

Flesh out further your thesis for Irish homebuilder Glenveagh Properties.

DS: We have some experience investing in homebuilders in the U.K., where the bigger homebuilders many years ago took advantage of their scale and access to capital in order to consolidate the market and basically improve the quality of their businesses. We think the same thing is happening now in Ireland and that Glenveagh and Cairn Homes are by far the biggest likely beneficiaries.

Glenveagh was formed only in mid-2017, through a combination of Bridgedale Homes, an established but small Irish homebuilder, and the land bank in the country held by Oaktree Capital. The new firm came public in October 2017, raising €550 million, and then raised in the second quarter of 2018 another €214 million to buy additional land for development. Its aspiration is to be the largest homebuilder in the country, becoming the go-to provider of primarily starter homes.

An important part of our thesis is that the Irish housing market after a devastating downturn is very much on the mend. In the aftermath of the financial crisis the supply of housing dramatically lagged the estimated 30,000 to 35,000 new homes necessary to meet demand from household formation and housing-stock obsolescence. But now on the demand side strong employment, wage growth and a decade's long correction in household le-

INVESTMENT SNAPSHOT

Glenveagh Properties
(Dublin: GVR)

Business: One of two large-scale publicly traded homebuilders in Ireland (the other is Cairn Homes); product focus is on lower-priced homes for first-time home buyers.

Share Information
(@1/30/20, Exchange Rate: $1 = €0.91):

Price	**€0.90**
52-Week Range	€0.59 –€0.93
Dividend Yield	0.0%
Market Cap	€784.2 million

Financials (TTM):

Revenue	€128.3 million
Operating Profit Margin	1.9%
Net Profit Margin	(-0.2%)

Valuation Metrics
(@1/30/20):

	GVR	S&P 500
P/E (TTM)	n/a	25.9
Forward P/E (Est.)	n/a	19.2

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

Company	% Owned
Rye Bay Capital	9.0%
GIC Private Ltd	8.9%
Fidelity Research & Mgmt	8.4%
Oaktree Capital	6.3%
Paradice Inv Mgmt	5.4%

Short Interest (as of 12/15/20):

Shares Short/Float	n/a

GVR PRICE HISTORY

THE BOTTOM LINE

The company's aggressive push for market leadership should pay off nicely now that the Irish housing market – after the devastation of the financial crisis – is very much on the mend, says David Shapiro. His base-case valuation going out to 2023, as the company reaches scale and stable production levels, pegs the share price then at around £1.70.

Sources: Company reports, other publicly available information

verage has finally led to a pick-up in housing transaction volumes, home values and rental rates.

Glenveagh has a flush land bank acquired at low prices, industry-low costs due to scale efficiencies, and a focus on lower-end homes that more easily qualify for bank financing and government-assistance programs. As demand continues to recover, we think it has a multi-year runway for profitable growth.

How do you see that translating into upside for the stock, now trading at 90 Euro cents per share?

DS: The company's margins today are low as it has had to invest in some fixed overhead to take advantage of the improving industry prospects. In our base-case valuation we go out to 2023, which is when we expect it to reach scale and stable production levels of 2,800 homes per year. At that point we estimate revenues of €950 million, EBIT margins of around 17% and earnings per share of around 16 Euro cents. If we put a 9x multiple on that EPS – in line with peer valuations in the U.K. at a comparable point in the industry cycle – and add net cash, the share price would be around €1.70.

In our bull case, we don't assume any increase in home-delivery volumes, but assume house-price inflation outstrips construction costs by 1% per annum and that the market uses a fuller 11x P/E multiple to value the shares. That would result in a year-end 2023 target price above €2.20 per share.

Is Brexit a pro or con here?

DS: We really don't know. Much of the trade between the U.K. and Ireland is related to food and agriculture, which would primarily impact rural areas of the country if trade declined. Those aren't markets driving much current housing demand anyway. Additionally, the vast majority of materials used to construct the company's homes come from within Ireland or, if they did come from the U.K., could pretty easily be sourced elsewhere in Europe. If companies shift financial and other services out of the U.K. for their European bases, that could be a positive for Dublin and its real estate market.

Describe something you've recently sold and why?

DS: We've sold our position in Direcional Engenharia [Sao Paolo: DIRR3], one of Brazil's largest low-income homebuilders. We had bought this when the Brazilian stock market was crashing a few years ago and liked the relatively capital-light business model, aided by bank guarantees backing most of the company's home sales. Management was very strong on operations, cost control and capital discipline, consistent with their owning 45% or so of the shares.

ON ONE BIG MISTAKE:

It was a company with way too much exposure to a single supplier that held all the power in the relationship.

Sentiment in Brazil has recovered quite a bit and the thesis overall has worked out. On higher earnings, the stock has rerated and now trades at around 13x forward earnings estimates and 1.9x book value. For a homebuilder in Brazil, that's pushing our valuation norms, so we sold accordingly.

You've described your investment in British Automotive Holding [Warsaw: BAH] as one of your biggest mistakes. What did you get wrong there?

EV: British Automotive was the exclusive Jaguar Land Rover importer for Poland and also owned and operated the largest dealership network for it in the country. There were a number of initial attractions. The domestic luxury car market in Poland was growing at a low-teens annual rate, we thought JLR's market share had the potential to grow materially, management was well pedigreed and very focused on shareholder return, and the stock was optically very cheap, trading at 7x earnings and with a 12% dividend yield.

We were not unaware of the risk that JLR could pull the business back inside and start its own national sales organization in Poland, but we didn't see that as an imminent threat. The business was doing well in Poland, and JLR had more than 30 importer partners around the world and had developed a reputation as an excellent partner under Tata Motors' ownership. Unfortunately, we misjudged that. Apparently due to new and very aggressive sales-volume targets, the company was pushing to go it alone in multiple markets and JLR cut the contract with British Automotive not long after we invested.

DS: In terms of lessons, we basically violated one of Porter's five forces by buying into a company with way too much exposure to a single supplier that held almost all the power in the relationship. As Evan said, we were well aware of the risk, but misjudged the probabilities. This is an important type of risk in investing in small companies – in this case we just didn't manage it correctly.

Is one added appeal to your strategy – in addition to pointing you toward what you think is more likely to be market inefficiency – that it's a fun way to see the world?

EV: That is a huge attraction. We try to make four to six big international trips a year and we do find the people we meet, the cultures we're exposed to, and the puzzles we have to solve to be fascinating. We joke sometimes that we could maybe focus a bit more on geographies where the food is always good and the sun is always shining, but the view we get is far different than you'd get as a tourist. We don't think there's a better way to try to understand a culture and the inner workings of what's going on in a country. I'm 33 and David is 40, so we expect to keep at it for a long time to come. VII

Clear Skies Ahead

Stocks can often be priced as if there's nary a cloud on the horizon when in fact a storm may be brewing. Yen Liow of Aravt Global thinks the opposite may better describe the case today for commercial jet-engine manufacturer Safran.

Only about 200 companies worldwide meet the quality standards – for competitive position, business-model sustainability, growth potential, management acumen and balance-sheet strength – that Yen Liow of Aravt Global has defined for potential investments. Add "attractive valuation" to the mix and the number shrinks quite a bit further.

So it means something when Liow offers up aerospace company Safran as one of his favorite current ideas. The French company's primary business – generating some 60% of operating profits – is in commercial jet engines, where its joint venture with General Electric dominates the market supplying narrow-body aircraft. That market is essentially a duopoly, with Safran holding a roughly 75% share of the current narrow-body order book, with United Technologies' Pratt & Whitney accounting for most of the rest.

Liow ticks off Safran's virtues: Its industry has strong secular growth prospects, driven by a long-term 5-6% annual increase in global air traffic. Its business benefits from long-lived, high-margin aftermarket revenues, which account for almost all of the company's profits. The threat of new competition is low, the result of entrenched customer relationships and difficult-to-replicate scale and technological expertise. Management has proven skilled, both operationally in ramping up the next-generation LEAP engine, and in capital allocation by exiting unrelated businesses to focus entirely on aerospace. "We call the companies we want to own 'horses,'" says Liow, "and this is an excellent example of one."

Clouding the picture at least somewhat is the debacle surrounding Boeing's 737 MAX. The LEAP engine is the sole option for the plane, and while Safran has ramped up its production of engines for the competing Airbus A320 NEO, the MAX grounding is reducing the company's cash flow by some €300 million per quarter. Confident that the MAX will again be cleared to fly, Liow considers MAX-related cash flow deferred, not lost.

Another uncertainty he thinks may be concerning the market is the fact that more than half of the LEAP engines being sold have fixed-price maintenance contracts attached. If these contracts prove to be priced as well as his research suggests they have been, he believes the LEAP aftermarket should be more profitable than it has been for the predecessor CFM56 engine. If not, he says, "That would be a problem."

Despite an extended run in recent years, he believes Safran's shares at a recent €147.50 still don't reflect its underlying value. The stock trades at 21x his 2020 earnings estimate, below its historical average, at a time when he expects the combination of overall industry growth, aftermarket pricing power, reduced capital spending, operating leverage, share buybacks and dividends to drive a high-teens to low-20% annual shareholder return. "The risk/reward skew we see here is pretty unique in today's market," he says. VII

INVESTMENT SNAPSHOT

Safran
(Paris: SAF)

Business: Based in France, manufacturing, sales, maintenance and repair of aircraft engines, electronics, equipment and interiors.

Share Information
(@1/30/20, Exchange Rate: $1 = €0.91):

Price	**€147.60**
52-Week Range	€112.05 – €150.85
Dividend Yield	1.2%
Market Cap	€61.71 billion

Financials (TTM):

Revenue	€24.11 billion
Operating Profit Margin	12.9%
Net Profit Margin	9.0%

Valuation Metrics
(@1/30/20):

	SAF	S&P 500
P/E (TTM)	29.4	25.9
Forward P/E (Est.)	21.3	19.2

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

Company	% Owned
Capital Research & Mgmt	7.6%
TCI Fund Mgmt	4.1%
Vanguard Group	2.4%

Short Interest (as of 1/15/20):

Shares Short/Float	n/a

SAF PRICE HISTORY

THE BOTTOM LINE

Yen Liow believes concerns related to Boeing's 737 MAX and to the economics of new fixed-price maintenance contracts are overdone, masking the company's bright overall prospects that he expects will "drive a high-teens to low-20% annual shareholder return."

Sources: Company reports, other publicly available information

Zig or Zagg?

Growth investors are prone to shoot first and ask questions later when it comes to the stocks of companies whose heady-growth days show signs of waning. That's when value investors like Jim Roumell often step in to have a look.

Here's a common value-investing narrative: A company succeeds with a unique, advantaged product or service and reinvests along the way in expanding its franchise. But then the traditional business shows signs of flagging and the market slams the stock. If the core business is no longer as important as the market seems to think – or even better, it isn't as challenged as feared – that can provide bargain-hunting investors with an opportunity.

That neatly describes what Jim Roumell of Roumell Asset Management sees today in Zagg, Inc. The Utah-based company makes InvisibleShield smartphone screen protectors, by far the U.S. leader with a 45%-plus market share. It also through acquisition has added other phone accessories such as mophie battery cases, Gear4 protective cases and Halo portable power products. Roumell estimates that screen protectors, which accounted for two-thirds of the company's revenue in 2015, will account for close to 40% this year.

There are things to worry about with screen protectors. Phone replacement cycles are getting longer. Original-equipment screens continue to get stronger and more resistant to damage. Cheaper alternatives to the premium InvisibleShield brand proliferate. Roumell counters those potential negatives with a number of positives. Zagg is a valued supplier to phone sellers like Verizon, AT&T and Best Buy, offering unmatched reliability and speed-to-market around phone launches, as well as products on which retailers earn high margins. Screens have gotten stronger for years, but the percentage of new phones sold with protective screens has increased from around 15% five years ago to 25% today, in no small part due to the ever-increasing price of new phones. Though the timing isn't clear, he says, the coming replacement cycle should get a strong boost from the rollout of 5G-enabled phones.

Roumell also expects the company's new products to make up for slowing screen-protector sales. Its strong retail ties have driven added distribution, to the particular benefit of the Halo and Gear4 brands, each of which earn above-company-average gross margins and he believes grew revenues by at least 50% in 2019.

Even with flattish screen-protector sales growth over last year, he estimates Zagg can earn $80 million in EBITDA on $610 million in revenue in 2020. Assuming a "more-than-reasonable" 7x multiple and subtracting $60 million in estimated net debt, the resulting market cap would translate into a $16.50 share price, double today's level. If the 5G replacement cycle kicks in as he expects in 2021, the stock upside should be significantly higher.

The company last August hired Bank of America to help it review strategic alternatives, presumably in response to private-equity interest in the cash-cow screen-protector business. While Roumell considers a deal possible, he's made it clear to Zagg management that unless they get a blowout offer, they're better off on their own. As he puts it, "Why let somebody else capture most of the upside?" VII

INVESTMENT SNAPSHOT

Zagg Inc.
(Nasdaq: ZAGG)

Business: Design, production and sale of smartphone accessories such as screen protectors, protective cases and external power.

Share Information (@1/30/20):

Price	**8.17**
52-Week Range	5.26 – 12.43
Dividend Yield	0.0%
Market Cap	$237.7 million

Financials (TTM):

Revenue	$498.5 million
Operating Profit Margin	2.2%
Net Profit Margin	0.6%

Valuation Metrics
(@1/30/20):

	ZAGG	S&P 500
P/E (TTM)	72.3	25.9
Forward P/E (Est.)	8.1	19.2

Largest Institutional Owners
(@9/30/19):

Company	% Owned
Fidelity Mgmt & Research	7.7%
RBC Global Asset Mgmt	7.7%
Arex Capital	7.5%

Short Interest (as of 1/15/20):

Shares Short/Float	19.5%

ZAGG PRICE HISTORY

THE BOTTOM LINE

The market is both overestimating the challenges facing the company's core business and underestimating the potential of its new ones, says Jim Roumell. At 7x EV/EBITDA on his 2020 estimates, the shares would trade at around $16.50, double their current level.

Sources: Company reports, other publicly available information

Be a Learn-It-All

You never know where you'll find an interesting interview relevant to investing. (Except, of course, in every single issue of *Value Investor Insight*!) One excellent example: a recent Q&A in the alumni magazine of Washington, D.C. private school Sidwell Friends with Mason Morfit, a Sidwell graduate and now CEO and Chief Investment Officer of preeminent activist investing firm ValueAct Capital.

In the interview Morfit describes investing in Microsoft around the management transition from Steve Ballmer to Satya Nadella, the "paradigms" ValueAct often questions when engaging with a company, and the mindset he believes investment analysts will need to succeed in the future. Here are some selected excerpts:

Challenging Paradigms

> We invest in companies where we're arriving as an outsider to the party, as a minority participant without a lot of power, and we have to gain trust about effecting cultural changes. It requires a personal touch that's consensus-oriented and gentle but also firmly convicted.
>
> Companies, countries and organizations coalesce around certain paradigms, worldviews and missions. Sometimes they are permanent and evergreen, but often they are helpful and constructive for a period of time but then they become hindrances. Companies go through lifecycles. Often when my firm engages with a company, what is holding it back is their old paradigms. Microsoft's prioritization of Windows over all else would be one good example.
>
> Another paradigm would be "if you're not growing, you're dying." A lot of times I'll come into companies that have had this ethos of aggressive growth at all costs that has led them to do a lot of diversifying, and they're spread way too thin. It isn't working, it's distracting everybody, and it can come crashing down.
>
> More often than not, these paradigms companies are beholden to are inhibiting their progress. They have to let go. We come from the outside and say: "It's okay. It's time to move on from this and reorganize yourself around something different.

Change at Microsoft

> The issues facing Microsoft were profound. Many felt underlying technology shifts had left the company in the dust, but those shifts were actually opportunities to change, including abandoning some of the company's long-held cultural beliefs.
>
> To get an organization of almost 100,000 people to let go of those paradigms is difficult. It's not something you can mandate heavy-handedly. It is something you can be a part of if you come in willing to engage and willing to have your mind changed. Satya was very open-minded about embracing things. He says that the "learn-it-all" always outperforms the "know-it-all." I replay that over and over in my mind. Nobody likes a know-it-all, and the know-it-all usually doesn't get very far because nobody wants to see the know-it-all win. But if you reorient yourself as a learn-it-all, you create mutually beneficial situations where you grow and the counterparty grows as well.
>
> Usually when we come into a company and present some outsider views, those views are threatening to the company's status quo. We generally present these things quietly and respectfully, behind the scenes to the chairman or the CEO, and they either disappear or they get re-filtered and show up gradually. But when I arrived at Microsoft and presented a document of my thoughts from the outside, the first thing they did was put it on the internal intranet for the entire board of directors and senior leadership to see. That was remarkable. I had never seen a company just say: "Let's put this on the table. Let's talk about it."
>
> Satya and Microsoft inverted the paradigm from "We will win at all costs, we will dominate, we will crush, and we will destroy," into "We will work together." He created a coalition of players in the software ecosystem that used to be at war, and together they thought about the industry as one of cooperation and coexistence rather than Hobbesian competition.

Knowing vs. Learning

> For students and professionals of the future, the most important quality is the ability to learn and ramp up on any discipline on the fly. We tell our analysts things like this all the time: "You know nothing about radio frequencies and how walkie-talkies work, but we're looking to make an investment in a company that does those things for police officers and firefighters. Learn it. Go!"
>
> The culture we're trying to build at ValueAct is learn-it-all – with the courage to go anywhere and do anything. And with a mission that goes beyond making money. Obviously we have to do that or we wouldn't have any clients. But with a willingness to ask questions, we can leave each company better off than we found it, treat people respectfully, and have good intentions. If you do that, it's remarkable where the world takes you.

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