April 30, 2021

Value Investor INSIGHT

The Leading Authority on Value Investing

Closing the Gap

Having come to the U.S. from his native Belgium to earn a Master's degree in Aeronautics from M.I.T., Arnaud Ajdler didn't catch the investing bug until a colleague in his first post-graduate-school job, as a management consultant, introduced him to Warren Buffett and the world of value investing. "It was instantly interesting, and I also liked the purity of investing," he says. "If you're right you get rewarded, if you're wrong there are consequences."

Adeptly weighing risks and rewards, Ajdler since founding Engine Capital in 2013 has delivered net annualized returns of 15.4%, vs. 12.7% for the Russell 2000. Often taking an activist stance, he sees upside today in such areas as government services, restaurants and K-12 education. See page 2

Arnaud Ajdler
Engine Capital

Built to Last

John Walthausen cites an engineering professor he had in the 1970s as a key influence on how he invests today. "Two things he emphasized are highly relevant," he says. "One, if you want to build something to last, you have to learn everything you can about what might cause it to fail. Two, don't rely solely on it, but when making decisions always consider your intuition, which should reflect the sum total of all you've learned over the years."

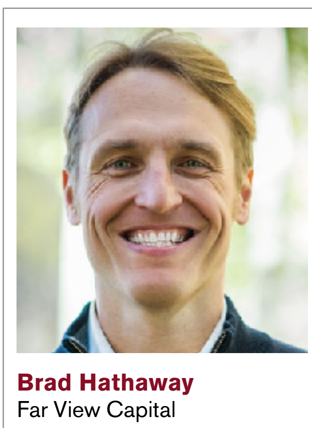
Walthausen appears to have learned his lessons well. His firm's flagship Walthausen Small Cap Value Fund has since 2008 earned a net annualized 11.7%, vs. 8.8% for the Russell 2000 Value Index. Among areas of high interest today: for-profit education, steel and women's apparel. See page 8

John Walthausen
Walthausen & Co.

Shifting Fortunes

In preparing an investor letter marking the five-year anniversary of his firm, Brad Hathaway spent some time reading through company write-ups he'd done when he started Far View Capital in 2011. "I was surprised how bad I thought they were," he says, "but in a business as competitive as this I realized that's probably a good thing. I want to be embarrassed in the future about the work I'm doing now – hopefully that means I'm getting better at it."

He's so far keeping up just fine. His fund since inception has earned a net annualized 15.7%, vs. 10.0% for the MSCI All Country World Index. Targeting what he calls "weirder, quirkier" ideas, he sees opportunity today in such areas as e-commerce, aerospace and wine. See page 14



Brad Hathaway
Far View Capital

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Concentrix, Dell Technologies, EchoStar, EPR Properties, FTAC Hera, Gores Guggenheim, Longview, PAI

Investor Insight: Arnaud Ajdler

Arnaud Ajdler and Brad Favreau of Engine Capital describe why they don't start out screening for cheap stocks, how they try to foster constructive conversations with the management and boards of companies they've targeted for activism, and why they're seeing mispriced value in CACI International, MTY Food Group and Houghton Mifflin Harcourt.

You describe your strategy as focused on "special situations." What does that mean in Engine Capital's case?

Arnaud Ajdler: It's critical to our process for us to understand why something is undervalued in the first place. That's why we don't start out just looking for stocks trading at low multiples, where you may find a lot of cheap stocks but they're not necessarily undervalued. If you understand why something might be mispriced, you then have a roadmap for how the value gap will close and can assess whether it will happen on its own or whether you need to be your own catalyst and become activist.

One category of idea for us is when there's non-economic selling. These can be classic Joel Greenblatt types of ideas around spinoffs and restructurings, but it can also be when a company is removed from an index and passive funds have to sell regardless of the price. Or it could take the form of an announced merger that falls apart and all the arbitrageurs have to sell their positions.

As a good example of the impact of non-economic selling, in mid-2019 the medical-instruments company Harvard Bioscience [HBIO] was removed from the Russell 2000 index after a bad earnings release pulled the market value below the index threshold. The board around the same time fired the CEO and the stock fell even further – all told it went from around $4.50 per share to less than $1.75. At that point we were very interested because we thought the business was fundamentally sound and believed there was a good chance the stock – which was trading at a very attractive free-cash-flow yield of 14% – was mispriced because 20% of the shareholder base had to sell because the company was no longer in the index. This ended up working out well for us. [Note: Harvard Bioscience shares recently traded at $6.70.]

Another category where we find mispricing is in companies with multiple divisions where the market doesn't appropriately value each piece on a sum-of-the-parts basis. Or maybe the shares are undervalued because the balance sheet is not optimized, say because there's too much cash and shareholders are worried the company is going to use it on ill-conceived M&A, when in fact there's an opportunity to add debt and significantly lower the cost of capital. These types of ideas can become activist situations when we conclude, as we often do, that they won't be resolved on their own and we need to push maybe for the sale of a division or for the company to return more cash to shareholders.

ON IDEA GENERATION:

We don't start out looking for low multiples – you may find cheap stocks but they're not necessarily undervalued.

Two years ago we first established a position in Dell Technologies [DELL], which owns 81% of publicly traded VMware [VMW]. At the time Dell stock was trading at around $53, while its stake in VMware was worth close to $78 per share. The market was valuing Dell's core business – that sells personal computers, servers and storage and generates $7 billion in annual EBITDA – at negative $25 per share. Our thesis was that this mispricing was unsustainable and eventually Dell would spin off its VMware stake after September 2021 when it could do so in a tax-free manner. We and others made it clear to the company how value-accretive the spin would be, and earlier this month Dell announced it was doing just that.

Dell's stock responded quite positively to the news. At today's price of $100, are you calling it a day and moving on?

AA: Actually, no. While the uncertainty of whether the spin will happen has mostly been removed, it still has to happen and the company hasn't clearly articulated the details on it or its future capital-allocation policies. Dell generates substantial free cash flow and we suspect it will return most of the cash from the spinoff to shareholders. Some investors are waiting for clarity on all this. We think that post-spin, Dell's core business can earn $7.2 billion in earnings before interest and taxes in the fiscal year that ends January 2023. Making assumptions on the debt post-spin and applying a 10x forward EBIT multiple – which is comparable to or less than the multiples at which companies with similar growth profiles such as Hewlett Packard Enterprise, Cisco and IBM trade – Dell's share price would be around $140, a 40% return in less than a year. Despite the spin announcement, we still think the core business is severely mispriced.

We see you recently established a new position in PAE Incorporated [PAE], which merged last year with a special-purpose acquisition company sponsored by private-equity firm The Gores Group. Are SPACs a newly fertile area for special-situations investing?

AA: We are typically not big fans of SPACs, but we have been following PAE for a while and there are three main reasons we think it's mispriced. The company provides operational systems and outsourced services, primarily to the U.S. government in areas such as counter-threat advisory services, training, systems testing, logistics and maintenance. One issue is that its results were hurt in 2020 by missteps with some growth initiatives in its National

Security Services business unit. A second reason is that private-equity firm Platinum Equity, the previous owner, retained a significant stake and as a result, private equity and insiders still own a high percentage of the shares, limiting the float and analyst coverage. Finally, just last month the CEO, John Heller, abruptly resigned without a particularly clear explanation.

Our due diligence indicates that none of those issues is a long-term problem and that the business at a recent share price of $8.70 is worth quite a bit more than less than 8x adjusted EV/EBITDA on this year's estimates. Again, our investment process is focused on determining why a stock is undervalued, and then trying to figure out whether or not the mispricing is justified. In this case we don't believe it is.

You haven't yet described what we'd call the more classic activist idea where you zero in on an industry laggard and make the case for how it can improve. Is that part of your playbook as well?

AA: Very much so. In these cases we typically don't believe the improvement will happen on its own, so we identify all the levers we think should be pulled – operational and strategic as well as with respect to capital allocation, capital structure and governance – and then approach management and the board privately with our recommendations. We like to lay out a thoughtful case both for fixing the company in the public market and for pursuing a sale, an approach we find leads to more constructive conversations. It's easier for the board and management to engage with a shareholder who offers tangible and constructive ideas for improving the business and the valuation as opposed to one who is only pushing for a sale.

Brad Favreau: A good illustration of our "fix it or sell it" approach was our investment a number of years ago in CST Brands. The company had been spun out of the fuel refiner Valero Energy, which saw it primarily as a distribution network for its refined product. As a result, CST wasn't very well run, particularly on the convenience-store side, where other big industry players had made significant strides in merchandising and profitability. Due to operational shortfalls and poor capital allocation, the stock also traded at a depressed valuation.

We approached the management team and board with a detailed analysis of how clearly the company was underperforming peers and with a plan to fix the business by focusing on improving the economics of their convenience stores and by optimizing their capital-allocation policies. If they were unable or unwilling to follow that plan, we argued they could also sell the business and that there would likely be considerable buyout interest from the bigger industry players. Having multiple ways to win coincident with a low valuation is usually a powerful combination. In this case CST ended up being sold in 2016 to Alimentation Couche-Tard, the Canadian parent company of convenience-store giant Circle K.

ON ACTIVISM:

We like to lay out a thoughtful case both for fixing the company in the public market and for pursuing a sale.

Are you finding plenty of ideas to pursue in today's market?

AA: We actually have less cash on hand than usual, which is somewhat surprising given overall valuation levels. We think the market is fairly polarized, with some areas expensive and bordering on insanity, while others are far more reasonable. We're finding a lot to do in more mundane businesses that generate a lot of free cash flow, but because they may not grow as fast can at times trade at very attractive multiples.

Is CACI International [CACI] a good example of that?

BF: CACI is one of the largest government-services companies in the U.S., supporting national security or large-scale modernization initiatives with its technological expertise, outsourcing services and, in some cases, its own technology. For example, it designs and implements enterprise IT solutions for approximately 50 federal agencies and helps government entities migrate databases and systems to the cloud. Over the years CACI has put an emphasis on developing technology that incorporates its own intellectual property, so the company generally generates higher margins than peers.

Part of the appeal here is that the government-services industry overall trades today at a discount to the S&P 500, when historically it has traded at a premium. We do think that reflects the gap we're seeing in how the market is treating high-growth companies and low-growth ones, even when the latter are of high quality.

More specifically, what attracted our attention to CACI was the stock getting hit in January and February when investors got concerned the company might issue stock to make a bid for Perspecta [PRSP], which had already announced that it would be acquired by Veritas Capital for $7.1 billion. (We were shareholders of Perspecta at the time of the announcement). Management compounded the issue in a quarterly earnings call around the same time, giving unclear and contradictory answers to questions about a potential bid.

We became comfortable fairly quickly that CACI didn't intend to pursue Perspecta, and used the decline in the share price to establish a position and immediately start to engage with the board. Our first message was that the company had significant capacity to buy back shares and should do so to take advantage of the lower stock price. We also made a number of suggestions around improving reporting transparency, taking a more balanced capital-allocation approach – not so focused on M&A – and adjusting management compensation to deemphasize growth at any cost. Already the company has announced a $500 million accelerated share-repurchase program and in its latest

quarterly call described positive changes to its capital-allocation strategy. CACI also announced that starting next year it will report and issue guidance using adjusted EPS instead of GAAP EPS, which is significant because it matches industry practice in a space where there is a fair amount of M&A-related amortization that negatively impacts GAAP earnings.

What makes you positive about the business going forward?

BF: We think there are a number of tailwinds. CACI is a scale player with a broad portfolio of well-placed contracts in areas like intelligence and cybersecurity that are driving growth in funded bookings, which eventually translate into revenue growth. This is important in today's environment where investors are concerned about future growth rates in the industry in light of a change in administration. We don't believe those concerns are well-founded in CACI's case and expect continued strength in bookings, which were up 14% in the first half of the current fiscal year through December.

The company can drive profitability in excess of revenue growth. I mentioned that CACI puts emphasis on selling "technology" as well as "expertise," which drives materially higher margins than peers earn. As the revenue mix continues to shift toward higher-margin businesses that are receiving incremental capital and management attention, we think that should lead to profit growth in excess of peers who don't have the same benefit.

There's also ample dry powder to continue inorganic growth and share repurchases. Net debt to EBITDA should be below 2.0x by the end of fiscal year 2022. The company is targeting net leverage between 3.0x to 3.5x, which makes sense given the breadth of its business base and the limited need for capital expenditures. Between this balance sheet capacity and the cash flow the business generates, management could deploy more than 40% of the current market capitalization on either inorganic growth or share repurchases over the next few years.

How are you valuing the shares at today's price of around $254?

BF: Assuming roughly 4% annual revenue growth and a modest margin uptick, we think the business by 2024 can earn approximately $525 million in free cash flow. Investors typically value companies in the industry on cash EPS, which would be over $22 per share if we assume around $750 million in excess cash flow is used to repurchase shares. If we apply what we consider a normalized multiple of 16x, the stock would trade at around $360.

Pro-forma for the recent share repurchases, CACI's current enterprise value is approximately $7.7 billion and the market cap is around $5.9 billion. That equates to a cash P/E multiple around 14x and a free-cash-flow yield of 9%. This is too cheap for a company with this broad and diverse a portfolio and ample growth tailwinds.

You invest often in Canada. What attracted your attention to Montreal-based MTY Food Group [Toronto: MTY]?

AA: The idea popped up because the CEO was buying a lot of shares personally dur-

INVESTMENT SNAPSHOT

CACI International
(NYSE: CACI)

Business: Provider of technology systems and services – in such areas as electronic warfare, aerial systems and cybersecurity – primarily to departments of the U.S. government.

Share Information (@4/29/21):

Price	**254.05**
52-Week Range	190.16 – 266.31
Dividend Yield	0.0%
Market Cap	$5.92 billion

Financials (TTM):

Revenue	$5.98 billion
Operating Profit Margin	9.4%
Net Profit Margin	6.9%

Valuation Metrics
(@4/29/21):

	CACI	S&P 500
P/E (TTM)	15.4	42.7
Forward P/E (Est.)	15.1	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Vanguard Group	9.7%
BlackRock	7.8%
Fidelity Mgmt & Research	5.0%
Atlanta Capital Mgmt	4.9%
Dimensional Fund Adv	3.7%

Short Interest (as of 4/15/21):

Shares Short/Float	7.1%

THE BOTTOM LINE

The company through strong growth in funded bookings, ample capacity for M&A, and a continued mix shift toward higher-margin businesses is likely to exceed the earnings and cash-flow expectations currently priced into its stock, says Brad Favreau. At a forward 16x multiple on his 2024 estimate of cash EPS, the shares would trade at around $360.

Sources: Company reports, other publicly available information

ing the pandemic. I also knew the company and some of its brands fairly well because I was on the board of Imvescor Restaurant Group, another Canadian restaurant franchisor that was bought by MTY a few years ago. More generally, we follow the Canadian market closely and have made many successful investments in Canada since Engine's inception.

The company is not well known but is one of North America's largest restaurant franchisors, with a diversified portfolio of 80 different concepts and around 7,200 locations. It's been built through a disciplined M&A strategy with a straightforward playbook: using equity trading at around 10-12x EBITDA, buying smaller franchisors at a lower multiple, taking advantage of synergies to cut costs, investing in incremental growth and then doing it over and over again. Since Stanley Ma, the current Chairman, took MTY public in 2002, the stock up until the pandemic had compounded at more than 40% per year.

The pandemic gave us an interesting entry point – our average share cost is around C$28 – into an excellent business that we thought would come through the pandemic in good shape and in a strong financial position to restart its growth engine. The economics of restaurant franchisors are highly favorable, with stable royalty streams generating high EBITDA margins, high returns on invested capital and excellent free cash flow. Unlike the restaurants themselves, they don't have to worry much about things like commodity inflation and labor costs.

The company has fared relatively well during the pandemic. It has been proactive in taking out costs at the corporate level and we expect the franchise network to exit the pandemic mostly unaffected. In Canada, where business has been more impacted because the franchisee mix there tends more toward sit-down restaurants, the government has mitigated a lot of the pain by offering significant subsidies to pay employees and rent. In the U.S. – which now accounts for more than half of the network's sales – the business in many ways improved during the pandemic. The bulk of the U.S. exposure comes from two concepts, Papa Murphy's pizza and Cold Stone Creamery ice-cream shops, both of which have put up strong comps. Overall, MTY has continued to generate significant free cash flow during the pandemic – close to pre-pandemic levels – and has continued to delever its balance sheet.

That means the company is now in a position to resume its accretive M&A, sooner than most would have expected. The deal flow at the moment is pretty dead because the more-attractive targets are hesitant to sell at depressed prices, but we believe as things normalize MTY will get back on a consolidation path that has a very long way to run.

The shares have recovered their lost ground in the pandemic. At a recent C$52.40, what upside do you see from here?

AA: Over the past 12 months the company earned just under C$5.70 per share in free cash flow, so the stock trades today at only 9.2x that number. Coming out of the pandemic we think free cash flow in the fiscal year ending in November 2022 will be around C$6 per share. Based on history

INVESTMENT SNAPSHOT

MTY Food Group
(Toronto: MTY)

Business: North American franchisor of a wide variety of quick-service and casual-dining restaurants; top U.S. chains include Papa Murphy's pizza and Cold Stone Creamery.

Share Information
(@4/29/21, Exchange Rate: $1 = C$1.23):

Price	**C$52.40**
52-Week Range	C$17.03 – C$58.87
Dividend Yield	0.0%
Market Cap	C$1.33 billion

Financials (TTM):

Revenue	C$479.3 million
Operating Profit Margin	17.0%
Net Profit Margin	(-8.9%)

Valuation Metrics
(@4/29/21):

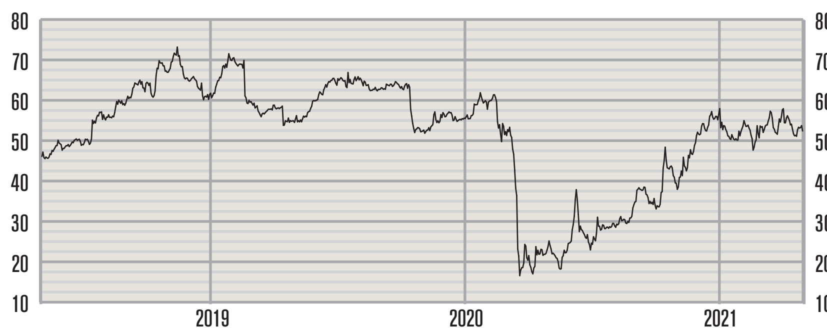
	MTY	S&P 500
P/E (TTM)	n/a	42.7
Forward P/E (Est.)	19.1	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	9.9%
Mawer Inv Mgmt	3.0%
Odin Forvaltning	2.3%
CI Investments	1.9%
Daiwa Asset Mgmt	1.6%

Short Interest (as of 4/15/21):

Shares Short/Float	n/a



THE BOTTOM LINE

The company has an advantaged business model and has fared quite well through the pandemic, says Arnaud Ajdler, leaving it better positioned to "restart its growth engine" than the market seems to expect. At what he considers a conservative 13x his C$6 per share estimate of free cash flow for the 2022 fiscal year, the share price would be C$78.

Sources: Company reports, other publicly available information

and peers, a 13x multiple on that would be conservative, resulting in a share price of C$78. At 15x, not at all unreasonable, the shares would trade at C$90.

We like when management is frustrated by the stock price, which is the case here. One catalyst on the upside might be a reinstatement of the dividend, which we expect them to announce in the second half of the current fiscal year. We also think there's a good possibility that the company pursues a dual stock listing in the U.S., which would likely raise its profile with investors and its valuation. As successful as MTY been over the years, it's still not widely followed by the U.S. investment community.

From restaurants to K-12 education, describe your interest in Houghton Mifflin Harcourt [HMHC].

BF: Following the recently announced sale of its trade-book division, the company is now a pure-play domestic provider of physical and digital instructional materials for students in kindergarten through the 12th grade. They break down the business further into core materials and extensions. Core materials are workbooks and learning programs, typically offered as anthologies for students who are "on-grade" in terms of learning expectations. Extensions is a catch-all category that includes intervention material targeted at students currently below grade, supplemental material for students at or above grade level, and a broad range of professional development materials utilized by teachers.

Two key strategies under Jack Lynch, who came to HMH as CEO in 2017, have been to leverage the company's large salesforce in the core market to cross-sell extension products, and to push the company more quickly and further into digital offerings for its materials. He has a strong and relevant background in building educational businesses through digital subscriptions, which is critical to HMH going forward. Its subscription-as-a-service revenues have been increasing at more than 100% per year and the usage on the company's digital platform is up over 300% year over year. While HMH is still largely perceived as a publisher of print education materials, it is already the largest ed-tech business in the U.S. In many ways we're betting that this transition remains on track with positive implications for profitability, free-cash-flow generation and share valuation.

Like many businesses, education has been hard hit by the pandemic. How has the company responded?

BF: Revenue has declined because many schools had to close during the pandemic and because education budgets were diverted to time-sensitive needs like supplying computers and iPads to students, enhancing distance-learning capabilities, and retrofitting facilities for safe on-premises learning. One company response has been to announce an aggressive strategic restructuring to accelerate its digital transformation and align its cost structure to that new environment. That should reduce total expenditures by up to $100 million per year, taking cash-flow breakeven in the education business to around $850 million in annual billings, which is well below what it produced in a dismal 2020.

INVESTMENT SNAPSHOT

Houghton Mifflin Harcourt
(Nasdaq: HMHC)

Business: Provider of instructional materials and other educational products targeting the U.S. K-12 market; recently announced the sale of its consumer book publishing division.

Share Information (@4/29/21):

Price	**9.16**
52-Week Range	1.03 – 9.16
Dividend Yield	0.0%
Market Cap	$1.11 billion

Financials (TTM):

Revenue	$1.03 billion
Operating Profit Margin	(-11.4%)
Net Profit Margin	(-46.5%)

Valuation Metrics
(@4/29/21):

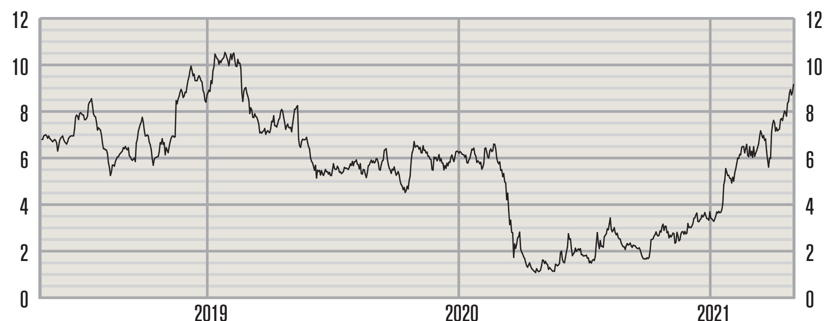
	HMHC	S&P 500
P/E (TTM)	n/a	42.7
Forward P/E (Est.)	n/a	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Wellington Mgmt	12.7%
Burgundy Asset Mgmt	8.4%
AllianceBernstein	6.8%
BlackRock	5.8%
Goldman Sachs	4.9%

Short Interest (as of 4/15/21):

Shares Short/Float	2.6%



THE BOTTOM LINE

The market is underestimating the company's earnings power as it continues its digital transition and restructures its cost base to reflect its ongoing strategy, says Brad Favreau. Assuming what he considers a conservative 7.5% free-cash-flow yield on his estimates two to three years out, the stock would trade at more than 50% above today's price.

Sources: Company reports, other publicly available information

As schools get back to normal, we see no reason why billings and revenues won't at least return to pre-pandemic levels. If some of the $130 billion in funding for schools in the latest stimulus program makes its way into curriculum materials – which we believe will be the case – that is likely to happen sooner rather than later.

How cheap do you consider the shares at the recent $9.20 price?

BF: Management updated its 2021 outlook and guided to billings and unlevered free cash flow of $930 million and $93 million, respectively, at the midpoints of the range. For context, pre-pandemic billings ranged from $1.1-1.4 billion, after adjusting for the to-be-sold books business. On that 2021 guidance, the stock trades at an unlevered free-cash-flow yield of around 8%. We think that's extremely attractive for a business that is transitioning to a subscription-based, digitally focused revenue model, at a time when billings and the top line are temporarily depressed.

Assuming the business normalizes and the company continues to successfully transition to digital, we expect annual billings over the next couple of years to reach at least $1.1 billion. With the streamlined cost structure, we estimate normalized unlevered free cash flow of around $140 million. At a still conservative 7.5% free-cash-flow yield, the stock on that would trade at around $14 per share.

We bought this well – our average cost is around $2.50 – but we still think there's plenty of upside with relatively limited downside. After the sale of the book business is complete, the company can significantly delever the balance sheet, providing additional operational and financial flexibility going forward.

Arnaud, you've been an activist investor now for almost 20 years. Do you think the game has changed in any fundamental ways over that time?

AA: One thing that has changed quite a bit is the interest in activism from large institutional investors and mutual fund companies. When I started out, getting a meeting with a traditional mutual fund portfolio manager was like pulling teeth. That's not at all the case today – often they're calling us wanting us to get involved and try to change things at one of their holdings.

With respect to companies, I'd say management and boards are generally more open to listening to our ideas and understand that shareholders can have a positive impact. On the other hand, there's also now a well-developed cohort of specialized bankers and lawyers offering their advice on how to "defend" companies from activist investors, which sometimes complicates discussions.

As for our own competitive set, there are probably more investors pursuing activist strategies than there were 20 years ago, but I wouldn't say there are too many people chasing too few good ideas. In rare instances we have been in names with other like-minded activists, but usually that's more a positive than a negative. VII

Robotti Value Live – Markel 2021

Monday, May 10: 10:00 AM – 2:00 PM ET | The Commonwealth Building at Richmond Raceway Complex

A series of live interviews pre-meeting, followed by post-meeting discussions with Markel executives

Speakers:
Chris Davis: Davis Advisors
Samantha McLemore: Patient Capital/ Miller Value Partners
Larry Pitkowsky: GoodHaven Capital Management
Isaac Schwartz: Robotti Global
Barbara Ann Bernard: Wincrest Capital
Curtis Jensen: Ossia Management, LLC
Peter Keefe: Avenir Corp
John Fox: Fenimore Asset Management
Andrew Walker: Rangeley Capital
Frank Hawrylak: Tweedy, Browne Company, LLC
Bob Robotti: Robotti & Company Advisors, LLC

And more to come!

Moderators:
Bob Robotti: Robotti & Company Advisors, LLC
Bill Brewster: The Business Brew Podcast
Andrew Walker: Yet Another Value Channel Podcast
Theo van der Meer: Robotti & Company Advisors, LLC

Registration Information:
Robotti Live: For more information, please reach out to spencer@robotti.com
Markel Annual Meeting: To register, please visit: shareholders-meeting.markel.com

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Investor Insight: John Walthausen

Walthausen & Co.'s John Walthausen, Gerard Heffernan and DeForest Hinman explain how they root out "neglected, dismissed or disliked" stocks with promise, which pandemic losers are more likely to surprise on the upside, how they battle value traps, and what they think the market is missing in Perdoceo Education, Cleveland-Cliffs and G-III Apparel.

Some investors aspire to own companies that exhibit consistent excellence. The profile of companies you tend to own appears somewhat different. Describe why.

John Walthausen: We're generally looking for stocks the market finds uninteresting, but where we see clear evidence that things are likely to get better. We're not value investors in the sense that there are static values that will eventually be uncovered. It's a dynamic world – industries change, companies change, markets change. Maybe there's something good going on at companies that are consistently dismissed by investors that will result in better-than-expected earnings that the market will recognize over time.

We're not investing in bad businesses. The return on equity of our portfolio companies at the end of March was 9.1% – versus, in a sign of the times, negative 1.7% for the Russell 2000 – so they have capital to invest in growth. They just maybe haven't managed that reinvestment of capital very well and they need to change.

Let me use a couple of examples. Vista Outdoor [VSTO] sells outdoor sports and recreation equipment, including shooting products, camping gear and a variety of action-sports accessories. It overexpanded through acquisition and excessively levered the balance sheet to do so, causing it to hit a wall a number of years ago when some key parts of the business slowed down. They brought in a new CEO, Chris Metz, who we met with soon after he joined Vista in 2017. We didn't invest at the time, but thought he was doing the right things in reorganizing the company, shifting product priorities, better managing inventory and working to reduce debt. The pandemic hitting last year gave us an opportunity to buy in March and May at what turned out to be particularly good entry points – consumers were shifting more to outdoor activities, which actually accelerated the turnaround that was underway. This one paid off more quickly than is typically the case and we exited when it hit our price targets in March of this year. [Note: Trading at less than $10 in February 2020, Vista shares fell below $5.50 in March 2020. The shares recently traded around $33.]

ON DISCOVERY:

We challenge ourselves to look into new names that may be highly complex or have a checkered history.

Another representative example would be Signet Jewelers [SIG], the owner of leading middle-market jewelry chains including Kay Jewelers, Zales and Jared. The company had struggled for years as it pursued a roll-up strategy and the market, including us, lost interest in it. Four years ago it also brought in a new CEO, Gina Drosos, and she initiated a number of rational changes, including decentralizing decision making to the individual brands, investing in the omnichannel sales effort, selling off a financing subsidiary, and reducing the number of mall stores dramatically. As was the case with Vista, we're in no rush to call a turnaround before everyone else, but rather want to see some clear evidence that things are improving. With Signet, that meant taking another close look at the company when the market tanked last March and then eventually taking a position in the fall of last year when we started to see tangible results post-pandemic from all the good changes the company had made. [Note: Signet shares, priced between $10 and $20 in the third quarter of last year, recently traded above $60.]

How do you identify the "neglected, dismissed or disliked" stocks that you're likely to find promising?

JW: One important part of our process is to maintain a scoring model that we update regularly on roughly 3,000 small-cap stocks in the U.S. It uses twelve different criteria, but they fall into three basic categories. When you're looking for stocks the market finds uninteresting, one is obviously valuation, based on metrics you can apply across industries like price to tangible book value and EV/EBITDA. The second category looks for hints that things are getting better, say from increased revenue growth, improving operating margins and insider buying. The third area is more focused on quality, looking at factors like leverage ratios and interest coverage.

Each stock is given a decile rating from 1 to 10 against all the other stocks in our universe, then we sum the twelve rankings to give a total grade. We like in doing it this way that a name can bomb out on a factor or two and still rank highly overall. We think that allows us to consider ideas that most people wouldn't find interesting but that may look much better a year or two hence. In general, we find this process challenges us to revisit names that we have dismissed and look into new names that may be highly complex or have a checkered history. As with any process like this there are a lot of false positives, but we regularly find ten to twenty names at the top of the ranking each month that deserve further investigation. If a few of those turn out to be worth buying, we're delighted.

Describe why you concluded "customer experience" outsourcer Concentrix [CNXC] was worth buying in this year's first quarter.

Gerard Heffernan: This was a rapidly growing division within Synnex Corp.

[SNX] that was spun off as an independent company in December of last year. Its core business is outsourced call centers, but what that means has evolved quite a lot over the past decade. The historical connotation is that a company would hire out its call-center activity as a way to provide a basically administrative function more cheaply. But with better technology and data analytics – particularly relevant in an online and omnichannel world – companies like Concentrix provide more dynamic communication points of contact that are really targeted at improving the customer experience and the lifetime value of the customer over time. Done well, it adds value beyond just saving money. That dynamic also has meaningfully expanded the company's addressable market.

If IPOs come to the market as a grand parade, spinouts are often more of a clandestine operation. Wall Street is slow to pay attention and you really have to dig into the details to understand the income statement and balance sheet both on a historic and prospective basis. If you conclude as we did here that the business has been set free to make it on its own, with an appropriate capital structure and a credible grow path, you can sometimes find interesting ideas before others are really paying attention.

Of course that's only true if the shares are also attractively priced. We were able to buy into Concentrix at around a 10x EV/EBITDA multiple on estimated forward earnings, at a time when comparable business-process outsourcing comps like Teleperformance [Paris: TEP] and TTEC Holdings [TTEC] traded at closer to 20x EV/EBITDA. The stock has moved up since we bought it [it recently traded at around $160], but it's still at a material discount to peers. If they continue to deliver on the promise we see, that disconnect should eventually go away.

Is today's market conducive to finding the types of ideas that interest you?

GH: Regardless of the market environment you can always find things that are out of favor. Specifically with respect to the pandemic, almost everybody a year ago had to go into survival mode. The best managers also saw that as an opportunity to address issues they might not have gotten to when things were humming along, but that will incrementally improve the performance of the company when the economy gets back on track. When the boat's in dock, that's when you paint it.

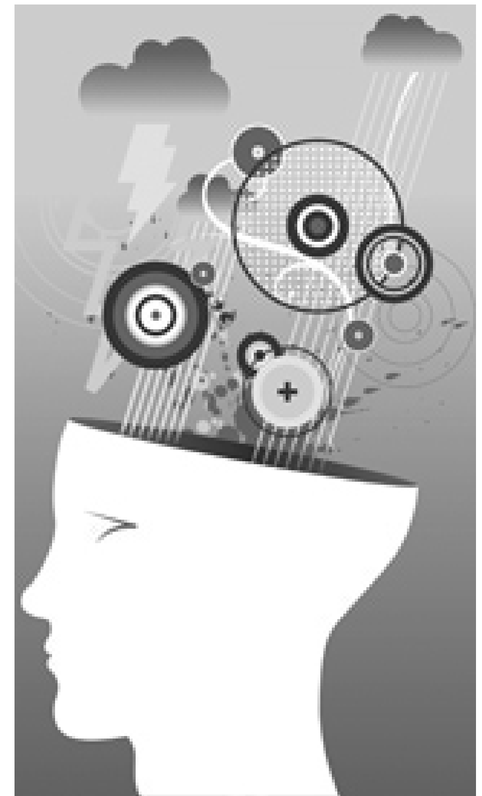
We're generally finding opportunity in businesses that may have done very poorly in the pandemic, but that we think can come back more strongly than people are expecting. It's natural to be conservative in these situations, but when that's overdone it can create opportunity.

JW: Last quarter we established a new position in EPR Properties [EPR], a real estate investment trust that owns movie theaters and other recreational facilities like secondary ski resorts and Topgolf entertainment venues. Roughly half of the business is cinemas, with AMC Entertainment as the top lessor. The movie business was obviously hit hard by shutdowns and the theaters leased by AMC were EPR's most vulnerable properties. The company reacted quickly. In return for deferrals, they negotiated a new master lease with AMC that covered the vast majority of the theaters but left aside some properties that were ripe to be redeveloped for other uses. This protected EPR from being cherry-picked if AMC went into bankruptcy.

Comfortable with the downside risk, we took the position and soon thereafter AMC did a major refinancing and the pace of vaccinations picked up. The stock has recovered somewhat, but we still believe that if the movie business comes back well, the company will significantly exceed the expectations built into today's $48 share price. Even if it doesn't come all the way back, we still think it can exceed the expectations built into the stock.

Describe your broader investment case for Perdoceo Education [Nasdaq: PRDO].

DeForest Hinman: Perdoceo is a for-profit education company – formerly known as Career Education – that offers online and



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on-site post-secondary degree programs in such areas as business, information technology and nursing. This has been a challenged space, stemming from Obama-administration reforms that cracked down on a number of industry practices that had resulted in poor student outcomes. Students in too many cases were taking on too much debt, never finishing degrees, and not finding jobs relevant to their training. There has been a long weeding out process of bad behavior and many companies in the business have gone away.

Perdoceo over the past six years has remade itself under CEO Todd Nelson. It has narrowed its product offerings to those providing the best student outcomes in terms of program completion and job placement. It's revamped pricing and payment terms to improve students' ability to pay. They generally chose the right way to do things even if it was painful for shareholders. As they shut down programs, for example, they continued to "teach out" the current students without adding new ones. Given the fixed costs involved, it was an inefficient way to run the business, but provided a better outcome for students than just cutting them loose.

Starting late last year the shares of companies in the industry came down over worries that the Biden administration would take another hard look at the industry's practices after four years with lighter oversight under Donald Trump. A couple key things made us less concerned in Perdoceo's case that that would be a problem. Our review of commentary from new Education Department Secretary Miguel Cardona and Undersecretary James Kvaal indicates they support a continuation of Obama-era regulations, but not a materially harder stance. Management argues that's perfectly fine, as they haven't relaxed the company's standards from the compliance required under the previous Democratic administration.

How has the business fared during the pandemic?

DH: Economic dislocation is usually good for the industry, as people losing jobs often invest in education to retrain and expand their career options. Enrollment numbers for Perdoceo have been good – the student census was up nearly 17% in 2020 – which we believe bodes well for future earnings and cash-flow growth. We also think the attention paid over the past year to online schooling will work in the favor of for-profit schools, who have a headstart in teaching online and should benefit as general acceptance of it increases.

How do you arrive at what you think the shares, now trading at $12, are more reasonably worth?

DH: We build out our model with key assumptions for student census, revenue per student and margins. We're expecting 4% to 4.5% top-line growth over the next two years, with operating margins staying where they've been at 20-21%. With those assumptions we think the company in 2022 can earn $180 million in EBITDA. The 10-year median EV/EBITDA multiple on the stock is a little over 8x, but if we use even 5x on our 2022 numbers, the shares would trade at $22.

We think the strength of the balance sheet provides upside optionality. The company currently has $400 million in net

INVESTMENT SNAPSHOT

Perdoceo Education
(Nasdaq: PRDO)

Business: Online and campus-based for-profit educational services, offering programs in such areas as business, nursing, information technology and healthcare management.

Share Information (@4/29/21):

Price	**12.04**
52-Week Range	10.62 – 17.77
Dividend Yield	0.0%
Market Cap	$843.9 million

Financials (TTM):

Revenue	$687.3 million
Operating Profit Margin	20.9%
Net Profit Margin	18.1%

Valuation Metrics
(@4/29/21):

	PRDO	S&P 500
P/E (TTM)	6.9	42.7
Forward P/E (Est.)	7.4	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
BlackRock	14.2%
Renaissance Technologies	7.7%
Vanguard Group	6.8%
Fidelity Mgmt & Research	5.7%
Dimensional Fund Adv	4.7%

Short Interest (as of 4/15/21):

Shares Short/Float	6.9%

PRDO PRICE HISTORY

THE BOTTOM LINE

After a long weeding out process of bad behavior and bad players in its industry, the company has a much brighter future than its current depressed valuation seems to imply, says DeForest Hinman. Applying a still-discounted 5x EV/EBITDA multiple to his 2022 estimates – the 10-year median multiple is just over 8x – the stock would trade at $22.

Sources: Company reports, other publicly available information

cash, and we'd expect management to use some of that for bolt-on acquisitions and to repurchase stock. We're starting to see some acquisition activity in the space after a relatively long absence, which signals to us that industry players are comfortable with how they'll be regulated under the new administration. Management should have options in allocating excess capital, and we're confident they'll do it in a way that creates shareholder value.

To another transformed company in a very different industry, explain your interest in integrated steel producer Cleveland-Cliffs [NYSE: CLF].

DH: The company has been changing often over the past ten years, which we think is one reason the market seems content to let things play out for a while before trying to make sense of it.

Cleveland-Cliffs' historical business was iron-ore mining and pelletizing to supply U.S. blast-furnace steel manufacturers. Ten years ago they decided they wanted to be a global mining company, changing the name to Cliffs Natural Resources and pouring money into various acquisitions and to build a gigantic greenfield iron-ore mine in Canada. That strategy was largely a disaster, so at the urging of an activist investor the board hired Lourenco Goncalves as CEO in 2014 and he essentially took it back to its origins in iron ore. That was a success in the sense that the business was saved from bankruptcy, but with the changing competitive landscape for U.S. steel – primarily impacted by competition from China and from steel made using electric-arc furnaces taking share – the company didn't think the status quo was viable long-term.

As a result, it made two large acquisitions – of AK Steel just prior to the pandemic and of ArcelorMittal USA last December – to become a vertically integrated manufacturer of steel in the U.S. using blast-furnace technology. We took on the challenge of analyzing how the company will come together both operationally and financially, and concluded that the market was severely underestimating its ability to increase earnings and free cash flow. We added the position in March.

What's driving your optimism about the business?

DH: There are a few things at least over the short to medium term. Despite concerns early on that the Biden administration would roll back a number of import tariffs put in place, we're fairly confident from the current dialogue around China that that will not be the case anytime soon for Chinese steel. That's of considerable benefit to domestic U.S. steel producers, both arc and blast. We're also seeing steel demand and pricing increase quite rapidly in the U.S as the economy recovers, confirmed by management meaningfully increasing earnings guidance for both the first and second quarters of this year. There has also been a strong increase in the price of scrap steel, raising input costs for electric-arc-furnace producers and now making the vertically integrated Cleveland-Cliffs the low-cost steel producer in the U.S.

How do you see all that translating into upside from today's $17.40 share price?

INVESTMENT SNAPSHOT

Cleveland-Cliffs
(NYSE: CLF)

Business: Largest North American producer of flat-rolled steel products and of iron-ore pellets used as an input to steel production; primary end market is the automotive industry.

Share Information (@4/29/21):

Price	**17.39**
52-Week Range	3.80 – 20.87
Dividend Yield	0.0%
Market Cap	$9.15 billion

Financials (TTM):

Revenue	$9.04 billion
Operating Profit Margin	6.4%
Net Profit Margin	(-0.3%)

Valuation Metrics
(@4/29/21):

	CLF	S&P 500
P/E (TTM)	n/a	42.7
Forward P/E (Est.)	5.4	23.6

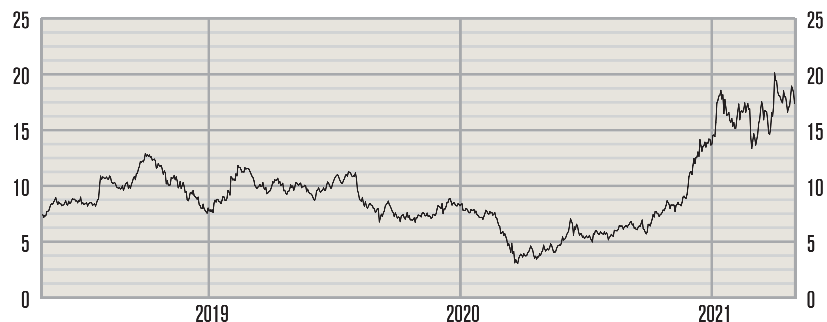
Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
BlackRock	11.3%
Vanguard Group	8.0%
Fidelity Mgmt & Research	3.9%
Fisher Asset Mgmt	3.4%
State Street	3.0%

Short Interest (as of 4/15/21):

Shares Short/Float	9.3%

CLF PRICE HISTORY



THE BOTTOM LINE

It's not unreasonable that the market would take a wait-and-see approach on the impact of the company's aggressive strategy shift over the past 18 months, says DeForest Hinman, but he thinks that reticence will prove to be a missed opportunity. On blow-out results expected this year, he believes the stock can double (or more) from today's price.

Sources: Company reports, other publicly available information

DH: In addition to working through some of the fairly complicated financial details on the combined company, a key input into any model is the assumed price for hot-rolled coil steel. Management in its latest guidance for the remainder of 2021 used $1,100 per short ton, which is quite conservative considering the current price is around $1,350.

Using an average price for hot-rolled coil of $1,250 per ton, we estimate the company this year can earn around $4 billion in EBITDA. It's now a steel manufacturer so we expect it to be valued comparably to its U.S. steel-manufacturing peers, which based on ten-year averages have traded at around 8x EV/EBITDA. If we use just 5x on our 2021 numbers, the shares would trade at around $34. At the ten-year peer-average multiple, the stock would be in the upper-$50s.

Another big potential positive here is that dramatic increases in EBITDA should translate into even more dramatic increases in free cash flow, given that the company has very large tax-loss carryforwards that will minimize cash tax outlays for some time. They can use that cash to quickly reduce leverage on the balance sheet, so that 12 months from now any concerns about debt should largely be gone. That could provide another reason for investors who currently aren't interested to take closer notice.

Why do you consider G-III Apparel [Nasdaq: GIII] an attractive recovery-from-the-pandemic play?

GH: We originally purchased shares in the company in 2019, in large part because we agreed with management's professed strategy to exit its lagging retail division – including Wilsons Leather and G.H. Bass retail stores – to focus on its strong wholesale apparel and accessories business selling licensed products under the Calvin Klein, DKNY, Donna Karan, Tommy Hilfiger and Karl Lagerfeld brands. Two quarters in, it became clear the company wasn't fully committed to getting out of retail, so with a key part of our investment thesis broken, we sold.

Then the pandemic hits and, as we've seen in a number of companies, foot-dragging on tortured strategic decisions goes out the window. G-III last summer finally announced it was pulling the plug on the majority of its retail business, closing the Wilsons and Bass stores permanently as of last year's fourth quarter. That got us interested again, but in this case we weren't quick to reestablish the position until we had more confidence in the recovery in consumer spending on clothes and accessories as the pandemic came under control. We took a new position in the stock just earlier this month.

Our basic thesis from here is relatively straightforward. We expect the company to produce strong near-term sales growth as vaccination numbers increase, as stores reopen, and as consumers increasingly want to refresh their closets with dressier clothes and shoes. As business starts to pick up – and there are excellent early signs on that front – G-III and its retail partners won't have to discount as much and can more consistently sell at full margin. Profitability for G-III will be further enhanced by the removal of the retail business, which we don't think the market is fully appreciating.

INVESTMENT SNAPSHOT

G-III Apparel
(Nasdaq: GIII)

Business: Sources and markets apparel and accessories under owned, private-label and licensed brands, including DKNY, Donna Karan, Calvin Klein and Tommy Hilfiger.

Share Information (@4/29/21):

Price	**33.60**
52-Week Range	7.76 – 34.71
Dividend Yield	0.0%
Market Cap	$1.60 billion

Financials (TTM):

Revenue	$2.06 billion
Operating Profit Margin	5.0%
Net Profit Margin	1.1%

Valuation Metrics
(@4/29/21):

	GIII	S&P 500
P/E (TTM)	67.8	42.7
Forward P/E (Est.)	14.1	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
BlackRock	13.3%
Vanguard Group	8.6%
Cramer Rosenthal McGlynn	8.0%
Dimensional Fund Adv	7.2%
Fidelity Mgmt & Research	6.8%

Short Interest (as of 4/15/21):

Shares Short/Float	11.4%

THE BOTTOM LINE

Spurred by the pandemic to clean up neglected strategic and operational issues, the company is poised to come back particularly strongly as consumer spending recovers, says Gerard Heffernan. At what he considers a fair P/E multiple for what is now a wholesale business, the stock on his $3.25 fiscal 2023 EPS estimate would trade at $49.

Sources: Company reports, other publicly available information

The stock, now around $33.50, is back from its precipitous fall a year ago. What potential do you see in it from here?

GH: Where I think we differ from other investors is in the extent of the operating-margin improvement we expect as sales rebound. In fiscal 2023 – which is really analogous to calendar 2022 because G-III's year-end is in January – we estimate on roughly $2.5 billion in revenues that operating margins will increase to 9%, up from 7.5% or so for the wholesale business prior to Covid. On our resulting $3.25 EPS estimate, we think a 15x multiple is reasonable for a pure-play wholesale business like this, which would translate into a share price of close to $49.

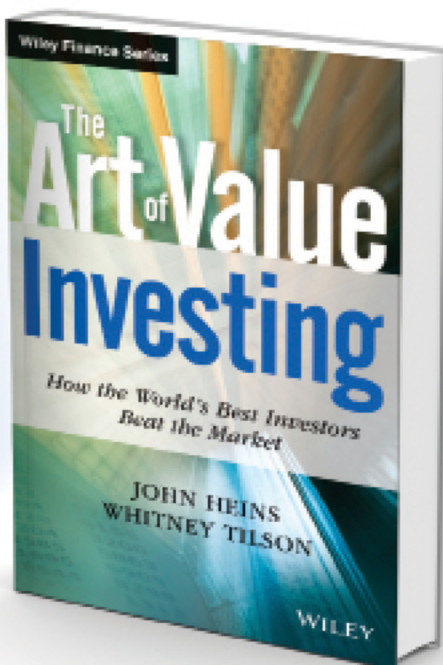
You've mentioned that your approach to selling has evolved over time. Explain that.

JW: I've always thought selling was one of the hardest parts – if not the hardest part – of the business. We like to think we're always rational, weighing the pros and cons, but once you buy something the act of selling it can be complicated by emotions having little to do with facts. If the stock goes up, you worry about getting money off the table before it goes down again. If the stock goes down, you resist admitting you're wrong and want to buy more because you know you're right.

We've tried to improve our process in either case. We're now very cautious about buying more of a stock that has fallen, acknowledging that the market may understand something about the company that we don't or that we haven't fully considered. Until we understand what that may be and fully consider it, we should be in no hurry to double down.

On the upside we try to fight the temptation to anchor on our original upside targets. Since we're specifically looking for companies where things are evolving in our favor, we need to apply any new, relevant information to our outlook for the business and the valuation. That shouldn't mean we're undisciplined about taking money off the table, but it does mean we want to diligently entertain the possibility that things can get better than we originally thought.

GH: This may seem elementary, but one refinement in our process has been to require that every analyst identify and commit to writing down exactly what they're expecting to happen for the company to produce the results the model is forecasting. As new information comes in, you can then easily see where on the key thesis points we're proving to be right or wrong. If we're wrong on a key thesis point, we should get out and not let pride or competitiveness make us stick with a position. We can always come back to the idea another day. That's how we fight the value trap, which is one of the most important battles for a value investor to win. VII



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James Montier, *GMO*

Investor Insight: Brad Hathaway

Brad Hathaway of Far View Capital Management describes the situations in which he believes he's more likely to gain an investment edge, why his on-deck circle of ideas to pursue is more crowded than ever, the buying discipline he decided to relax, and why he thinks the shares of EDreams Odigeo, Naked Wines, CDON and Park Aerospace are mispriced.

Good investors have to know how to zero in relatively quickly on ideas with a higher likelihood of paying off in their hands. How generally do you do that?

Brad Hathaway: There's a lot of arrogance involved in investing. When you're buying a stock, you're effectively saying that the specific person you're buying from and the market overall are wrong. Most of the time that's not true. So I'm very cognizant to focus on games where I think I can have some kind of advantage. I need to understand what other investors are concerned about and be capable of proving out a differentiated view on those primary concerns. If I can't see myself getting there, I try to be quick to say no. Sam Zell likes to say, "I'm the fastest no in the West," which I think is an important skill for any investor. Part of my process involves looking at as many potential ideas as I can and through the process of elimination hoping to get down to a few at a time that set up right for me.

We have a global fund that can go anywhere and invest in any size company. That's somewhat constrained by the fact that I typically avoid smaller emerging markets where there may be a premium on knowledge of government policy or on having special access to companies and others with local expertise. We also tend to invest only in global businesses impacted by global trends. An idea requiring understanding Korean fashion trends would quickly get killed in my idea-generation process because I don't believe I have the ability to diligence it.

There are a number of categories of ideas that might get our attention. We're attracted to securities with non-economic forced sellers, which could include spinoffs, a company being removed from an index, or when a big investor is liquidating. These situations often are less picked-over outside the U.S. than in it. Years ago I invested in a spinoff of the big Norwegian energy-services firm Subsea 7, called Veripos, which provides precision signaling to help ship navigation and to keep offshore oil rigs in place. The prospectus hit the market 48 hours before the stock was due to trade publicly, so I was doing due diligence in reverse, calling customers and competitors before I'd even seen the income statement. There was a huge information vacuum in addition to the typical forced selling from a spinoff, giving us what we thought was a great entry point into the stock.

> **ON SAYING NO:**
>
> **I need to prove out a differentiated view on what is concerning others. If I can't, I try to be quick to say no.**

Other potential ideas are typically more business-focused. We start by asking what are the main issues that a company's investors are uncomfortable with. These concerns could involve a negative one-time event that hurts results, or that the company's industry is heavily out-of-favor. People might be misvaluing a combined entity because they're too focused on one segment and ignoring another segment that could be a hidden gem. There can be a fundamental misunderstanding of the company's earnings power or competitive position. Sometimes, because truly great businesses are rare, people may be assuming a business is merely good when it's actually great.

Our idea-generation process is quite organic, but one thing I consistently do is a wide variety of keyword searches through Bloomberg and Google. There are a few hundred phrases and variations on phrases that I've identified as potentially interesting, from basics like "spinoff" or "post-bankruptcy," to mentions of "inflection point" or "hidden gem." We'll talk later in more detail about CDON [Stockholm: CDON], but I first came across it last year when it hit my keyword search for the Swedish equivalent of "spinoff" as it was being spun off by the e-commerce company Qliro Group. CDON started in 1999 literally selling CDs online, and it had a somewhat checkered history as a public company. But the business had evolved considerably and was further transitioning to become a scaled e-commerce marketplace for the Nordic region. We think there's a significant misunderstanding in the market today of the business and its potential.

Once something passes your initial screening, where do you tend to focus your research next?

BH: I believe there are only a small number of things that really matter in any given investment thesis, and that's where I'm going to drill down. In addition to all the typical due diligence with SEC filings, earnings transcripts and other publicly available information, I pride myself on doing a lot of calls to get at things like competitive dynamics, the size of the addressable market, the quality of the company's technology, the strengths of its management team, the potential for its new products – whatever the critical questions for my thesis are. I use expert-network services and also source experts independently on my own. I'll call industry journalists who have written about a company and ask if they can introduce me to people who know an industry very well. I'll cold-call people who speak at industry conferences. Can you find yourself going down blind alleys? Yes, but I find the time I devote to all this is usually well spent.

As my investment horizon gets longer, the more management matters. What will impact the company in the future may not show up in the financials or even in the business today. Amazon Web Services didn't exist until it was launched as a small side business of Amazon in 2006, but it's been a remarkable creator of value for the company. You have to be comfortable that management has the right strategic vision and the competence to navigate a future they're going to see more clearly than you can. I put a lot of emphasis also on their ability to attract the best people to the company. "A" players only want to work with "A" players, so I spend a lot of time trying to understand the culture and quality of the employee base.

I'd also highlight the importance of management integrity. Some of my worst mistakes have been in trusting that management's interests were properly aligned with mine and then being proven wrong. We had an unsuccessful investment in recent years in Ezcorp [EZPW], the pawnshop company, in part because the controlling shareholder turned out to be more creative in securing an egregious compensation package for himself than he was in driving shareholder value. There's a saying that when you get in the mud and wrestle with a pig you'll both get dirty, but the pig is going to enjoy it.

You've written about relaxing somewhat the quantitative buy/sell discipline you employed for the first several years after starting your firm. Explain that.

BH: When I started out I put in place numerical guidelines to help me decide when to buy and sell. I generally want to find long-term multi-baggers, and after estimating the potential upside and downside values of a given stock I'd look to buy new positions that offered at least a 5x reward/risk ratio. I'd start selling when that ratio approached 1.5x.

For several years, that drove the timing and magnitude of our purchases and sales. It was especially helpful through periods of high volatility, pushing me to be more cautious during periods of greed and more aggressive during periods of fear. What I found over time, however, was that the buying discipline in particular was causing too many errors of omission. I'd pass on investments where I had a high degree of qualitative certainty, but where the price didn't quite match my quantitative rules.

One good example was in early 2018 when I concluded MIPS AB, a Swedish manufacturer of sport-helmet components that help reduce concussions, had superior technology and was well positioned to capitalize on increasing customer demand for its products in highly underpenetrated markets. I also thought its true profitability was being hidden by the cost of a patent lawsuit it had initiated against Bauer, a Canadian helmet company. Based on my estimates at the time, MIPS' reward/risk ratio was roughly 4.5x at a share price near 50 Swedish kronor. I decided to wait for the share price to pull back until it met my purchase criteria.

ON BUYING RIGHT:

If the potential is $100, whether your thesis is correct is much more important than whether you pay $45 or $50.

That never happened, and over the next two years my thesis played out as I'd envisioned. The company won the Bauer dispute and significantly increased its penetration in a number of end markets. Revenues and earnings increased sharply and the stock revalued. At the time I wrote about it in an investor letter, the shares traded at around SEK 500. Now they're not far from SEK 700. I'm not at all saying the price you pay doesn't matter, but I am saying that small changes in valuation are much less important than the soundness of your investment thesis. If you believe a security has a potential long-term value of $100, whether your thesis is correct is going to be much more important than whether you pay $45 rather than $50 to buy it.

You maintain an "on-deck circle" of ideas to pursue at any given time. Is that circle more or less crowded than usual?

BH: Right now my on-deck circle is as full as it's ever been. The length of that list is generally a function of two things. One is how many ideas appear interesting after a quick initial screening. The other is how long it takes me to kill ideas once they're on that list. Either I've lowered my standards on ideas to pursue or there are still of lot of interesting things out there, especially in the weirder and quirkier niches where I like to play. It's possible I've lowered my standards, but the bifurcation in the market between hot, momentum-driven sectors and things that are less sexy or off the beaten path is still pretty pronounced. We're finding the opportunity set pretty good at the moment.

Let's talk about that. Describe your investment case for European online travel agency EDreams Odigeo [Madrid: EDR].

BH: If you look at most of the global post-Covid travel-reopening plays, their stocks have typically come back very well and trade at relatively significant multiples of their pre-Covid EBITDA. EDreams hasn't had that type of full recovery, which we think is a function of two things. First of all, the company has had a tortured capital markets history, including a busted IPO in 2014, management (since replaced) that chronically overpromised and underdelivered, and recurring problems with regulators. So there are still legacy issues with market perception.

The second issue is that the analysts who follow the company don't appear to fully understand the business model. EDreams is Europe's leading OTA with just over 30% market share, and it's #3 worldwide after Expedia and China's Ctrip.com. For this business it's logical to expect that when leisure travel recovers, the financial results should snap back very quickly. That's what analysts are expecting for most OTAs, with consensus estimates for 2022 EBITDA that are generally back to pre-Covid levels. For EDreams'

fiscal year ending in March 2023, consensus EBITDA is only 70% of the pre-Covid number.

We'd actually argue that improvements in EDreams business over the last couple of years should result in EBITDA that is much higher than pre-Covid levels. The company through the pandemic has significantly expanded its Prime membership subscription program, where people pay an annual €60 fee to get access to discounted fares and priority customer service. Even in a terrible year for travel like last year, Prime subs grew 35% to over 750,000, and we think the target of two million by 2023 is achievable as they continue to roll out new membership benefits and expand to new markets. This type of program adds a ton of value. It lowers customer-acquisition costs because subscribers are much more likely to go directly to the EDreams site to book a trip. Prime subscribers also book more frequently, increasing the customer lifetime value. The company's flight-booking market share has increased during the pandemic as smaller European competitors have been forced to pull back.

There are other positives going on. The company has been diversifying its revenue mix so that now more than 50% of total sales come from non-flight bookings, which tend to earn higher margins. It has also significantly improved its mobile app, which should further lower customer-acquisition costs as shoppers come through the app directly to EDreams without comparison shopping first. Taking all of this into account and assuming leisure travel does bounce fully back, we expect fiscal 2024 EBITDA to be €175 to €200 million, vs. the pre-Covid level of around €130 million.

How do you expect that to translate into upside for the shares from today's price of around €4.85?

BH: If EBITDA increases to €175 million, that would translate into about 70 euro cents in free cash flow per share. At the 4% free-cash-flow yield at which successful peers trade, that would result in a €17.50 share price. That would put the EV/EBITDA multiple at around 12.5x, at the low end of where other global OTAs are trading on two years' out estimates.

The biggest risks?

BH: Europe is coming out of Covid more slowly than the U.S. appears to be – if that continues, the recovery could be delayed beyond what we're expecting. The company also has a fairly high level of net debt, close to €500 million, which shouldn't at all be a problem if cash-flow generation is close to what we think it should be. If the recovery is much slower and flatter than we expect, the debt level could cause some concern.

I'd also mention as a risk if the flight-booking business becomes more competitive, say if Google pursues the market more aggressively or if airlines increasingly sell directly. We don't have a strong opinion on what Google might do, but we think the threat of airlines going direct is less of a concern in Europe, where the airline market is less consolidated and customers want the choice offered by OTAs.

INVESTMENT SNAPSHOT

EDreams Odigeo
(Madrid: EDR)

Business: Based in Luxembourg, Europe's largest online travel agency (OTA) offering flights, car rental, cruise, hotel and other travel services through a variety of online brands.

Share Information
(@4/29/21, Exchange Rate: $1 = €0.82):

Price	**€4.84**
52-Week Range	€1.66 – €5.36
Dividend Yield	0.0%
Market Cap	€529.3 million

Financials (TTM):

Revenue	€204.6 million
Operating Profit Margin	(-20.5%)
Net Profit Margin	(-68.2%)

Valuation Metrics
(@4/29/21):

	EDR	S&P 500
P/E (TTM)	n/a	42.7
Forward P/E (Est.)	n/a	23.6

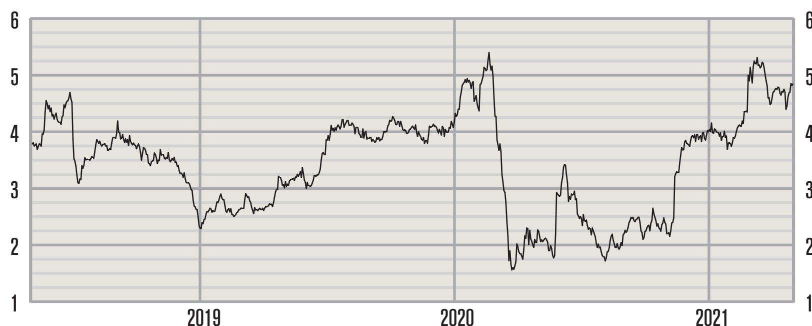
Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Bybrook Capital	10.4%
Sunderland Capital	5.5%
Henderson Global Inv	2.6%
Dimensional Fund Adv	1.7%
ETF Managers Group	1.5%

Short Interest (as of 4/15/21):

Shares Short/Float	n/a

EDR PRICE HISTORY



THE BOTTOM LINE

While strides made by the company through the pandemic position it to improve upon pre-Covid performance, says Brad Hathaway, the market seems to think it will struggle even to get back to where it once was. On his 2024 estimates, at the free-cash-flow yield at which successful peers trade he believes the stock can more than triple from today.

Sources: Company reports, other publicly available information

One upside option to add is that EDreams is 40%-owned by two private equity firms that are invested in it for about a decade. At some point they're going to want to realize value and we think EDreams would have considerable strategic value to other big global OTAs wanting to solidify their positions in Europe.

The pandemic had a positive impact on Naked Wines [London: WINE]. Describe why you expect the benefits to last.

BH: After the sale of its legacy Majestic Wine retail business to Fortress Investment Group in 2019, the company has become a pure-play operator of subscription-based wine clubs in the United States, United Kingdom and Australia. The basic model is that Naked identifies up-and-coming winemakers, sells subscriptions online to wine lovers who want access to the quality wines they produce, and uses the subscription proceeds to actually help fund the production and marketing of the wine. It's a great benefit to the winemakers who might find it very difficult and expensive to get a new wine business off the ground. Club members benefit from being able to buy high-quality wines for less than they'd typically pay in a retail store. Wine preference is obviously a personal thing, but Naked's wines have consistently earned better ratings than other wines at their price points in popular wine-review sites like Vivino.

As you say, the pandemic significantly increased customer awareness of online wine retail, and Naked has been one of the primary beneficiaries. Rather than just providing a temporary bump, however, we think the demand inflection over the past year will have a permanent, positive impact. Club subscribers have learned about a new way to buy wine where you get better quality for a cheaper price and it's much more convenient. In almost every retail category, once people shift and find a better e-commerce solution, they don't shift back. When they hear about Naked from their friends, they want to try it out. The shift to online for wine purchasing that might have taken five years for the company to build in a normal environment happened in less than five months as a result of Covid. We believe this will result in dramatically higher, long-term revenue growth than what could have been expected pre-pandemic.

Is there a risk the business model doesn't prove out?

BH: That's a good question for any developing e-commerce business like this, especially one where you have to spend a lot of money up front to build a subscription base. One positive on that front is that in 2018 Naked's U.K. business was growing at a double-digit annual rate and was already earning an 8% operating margin. This is also clearly a business where scale should drive significant benefits in sourcing, customer-acquisition costs and distribution. As the subscriber base grows, the company can attract even better winemakers. Word of mouth becomes even more important and they can incent current subscribers to help enlist new ones, which is the most attractive customer-acquisition channel. On the distribution side, in the

INVESTMENT SNAPSHOT

Naked Wines
(London: WINE)

Business: Wine retailer operating in the United States, United Kingdom and Australia, primarily selling independent-winery brands using an online, subscription-based model.

Share Information
(@4/29/21, Exchange Rate: $1 = £0.72):

Price	**£8.27**
52-Week Range	£3.12 – £9.14
Dividend Yield	0.0%
Market Cap	£601.4 million

Financials (TTM):

Revenue	£272.5 million
Operating Profit Margin	(1.7%)
Net Profit Margin	2.4%

Valuation Metrics
(@4/29/21):

	WINE	S&P 500
P/E (TTM)	n/a	42.7
Forward P/E (Est.)	n/a	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Ruane, Cunniff & Goldfarb	9.8%
JMX Capital	5.0%
Standard Life Inv	5.0%
Morgan Stanley	4.2%
Shareholder Value Mgmt	3.7%

Short Interest (as of 4/15/21):

Shares Short/Float	n/a

WINE PRICE HISTORY

THE BOTTOM LINE

Customer awareness around its online model for selling wine "that might have taken five years for the company to build in a normal environment happened in less than five months as a result of Covid," says Brad Hathaway. He expects permanent benefits from that and pegs the shares' discounted-cash-flow-derived fair value at £15 to £23 per share.

Sources: Company reports, other publicly available information

U.S. the company has added fulfillment centers so that it can now ship to most parts of the country within 48 hours, at half of what it would cost an independent vineyard. We think all of that will eventually drive a highly profitable business.

I should also mention that the growth runway here is long. In the U.S., which is the biggest opportunity, Naked's addressable market for wines above $10 per bottle in states to which they ship is approximately $20 billion. We believe direct-to-consumer penetration will go much higher and that Naked can at least maintain, if not grow, its current leading 20% market share in that channel. They have nearly $100 million in cash from the Majestic Wine sale, so can put their foot on the gas to go after that big addressable market.

The shares currently trade at £8.25. How do you value an idea like this?

BH: As a subscription business, we think a discounted-cash-flow approach can be useful as long as you use a range of inputs and accept a range of outcomes. Flexing a variety of inputs related to things like investment spending, the economics of bringing on new subscribers, subscriber retention, pricing, margins and discount rates, we arrive at current fair value estimates of £15 to £23 per share. To highlight a couple key items, we see revenue growing at a 20%-plus annual rate over the mid-term, customer retention gradually improving over the long term, and repeat contribution margins expanding to above 30%.

One thing we expect to help close the valuation gap is for Naked's stock to be relisted in the U.S., which is now its most important market and also where its CEO, CFO and new Chairman – Darryl Rawlings, the founder of Trupanion – are located. Coverage on the company today comes mostly from U.K. retail analysts who previously followed it as a mostly on-premise retailer. A U.S. listing would allow for more coverage by specialist direct-to-consumer analysts and expose the company to a wider shareholder base that is likely to more fully value its prospects as a DTC subscription business.

Let's come back to CDON. Why do you think the market is misunderstanding its business and potential?

BH: Some of it, again, is legacy perception that is slow to change. The company had a poor public-markets experience the last time it was independent, with a history of writedowns, restructurings and unexpected capital raises. The ongoing transition in its business model is also quite fundamental, so it's not entirely surprising the market is taking more of a wait-and-see approach.

CDON three years ago under new CEO Kristoffer Väliharju started transitioning from selling its own products online to becoming a full 3rd-party e-commerce marketplace for the Nordic region, patterned after companies like Bol.com in the Netherlands and Allegro in Poland. That is a not-insignificant undertaking and has required a significant revamp and upgrade in the site's technology and functionality. In October they finished the turnover to

INVESTMENT SNAPSHOT

CDON
(Stockholm: CDON)

Business: Operates an e-commerce marketplace selling primarily third-party merchandise in Nordic countries; spun off from then-parent company Qliro Group in November 2020.

Share Information
(@4/29/21, Exchange Rate: $1 = SEK 8.37):

Price	**SEK 530.00**
52-Week Range	SEK 99.00 – SEK 975.00
Dividend Yield	0.0%
Market Cap	SEK 3.27 billion

Financials (TTM):

Revenue	SEK 742.1 million
Operating Profit Margin	(0.6%)
Net Profit Margin	(0.7%)

Valuation Metrics
(@4/29/21):

	CDON	S&P 500
P/E (TTM)	n/a	42.7
Forward P/E (Est.)	n/a	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Mandatum Life	9.8%
Far View Capital	3.4%
East Capital Fin Serv	0.8%
Lansforsakringar Fond	0.7%
eQ Asset Mgmt	0.7%

Short Interest (as of 4/15/21):

Shares Short/Float	n/a

THE BOTTOM LINE

While the market seems content to wait for more evidence, Brad Hathway believes the the company's transformation to become the leading e-commerce marketplace for the Nordic region will pay off handsomely. Making key assumptions about market penetration, market share and profitability, he believes the shares have multi-bagger potential.

Sources: Company reports, other publicly available information

an internally built technology stack that is much more scalable. They've rolled out things like much better reviews, price monitoring and comparison tools, a new ad platform, and a new program for technology partners to integrate to the website. There are a lot of moving parts, all necessary to create a winning e-commerce marketplace.

We like the marketplace business model, which doesn't require buying and holding inventory and generates revenue from transaction fees, advertising fees, subscription fees and financing commissions. Operating leverage should be high if they can generate sufficient volume against mainly fixed technology expenses. There's also an attractive growth flywheel: As merchants join the marketplace they increase the supply of goods for consumers, making CDON a more attractive shopping destination. As CDON attracts more shoppers, more merchants want to sign on to sell their goods.

How would you characterize the relevant competitive market today in Nordic e-commerce?

BH: CDON is the largest 3rd-party marketplace in the region, but it still has a very small share of total Nordic e-commerce revenue. In many countries marketplaces like this can account for more than 50% of overall e-commerce sales, but in the Nordics that percentage is less than 5%. That allows plenty of room for growth as marketplaces become more penetrated, on top of the still-high growth in e-commerce in general. On their most recent earnings call, management noted that if CDON achieved market share similar to Bol.com, the gross merchandise value [GMV] on its marketplace – the industry-standard way of saying gross sales – would be around 55 billion Swedish kronor, vs. just SEK 2.5 billion today.

Many investors are worried about Amazon's entry in the Swedish market with the launch of Amazon.se in 2020. The launch hasn't gone smoothly – early on the site showed the Argentine flag rather than Sweden's and prices showed amounts to the nearest Ere, the Swedish equivalent of the penny that hasn't been used for more than a decade – but our general take is that the potential for e-commerce and marketplace growth in the region is more than sufficient for multiple players to prosper. If Amazon's entry into the market drives increased awareness from merchants about the value of marketplaces, that's likely a positive for CDON.

ON THESIS "INVERSION":

It challenges our conviction early and later on makes it mentally easier to pull the plug if the risks play out.

You're betting quite heavily here on what will be versus what currently is. How are you valuing what the shares, trading recently at 530 Swedish kronor, are potentially worth?

BH: The financials are currently rather scary as the business model shifts from booking total revenues on 1st-party sales to booking commissions on 3rd-party sales. But that will work itself out as 3rd-party sales that generate 95% gross margins – vs. around 10% for 1st-party sales – become the lion's share of the total. There's also considerable profitability upside as they add high-margin subscription and advertising revenue to the mix, as other e-commerce marketplaces have successfully done.

Here's one way we think about valuation: Current annual Nordic e-commerce sales are about 250 billion Swedish kronor. We think it's reasonable to assume that the gross merchandise value on CDON's marketplace can reach 4% to 6% of the total market by 2025. So if e-commerce sales don't grow from today – which won't be the case – GMV through CDON would be SEK 10-15 billion. Mature marketplaces like Allegro earn EBITDA as a percentage of GMV of around 5%, which in CDON's case would translate into SEK 500 to 750 million in EBITDA. With revenues growing 30%-plus per year and considering the attractive qualitative aspects of e-commerce marketplaces, we could imagine a 25x multiple on that, which would result in a share price of SEK 2,100 to SEK 3,100.

The key risk here is certainly around execution. We're confident the potential is there, but delivering a winning e-commerce marketplace requires doing a great number of things very well and CDON still has a lot of work to do. If the customer and merchant experience turns out not to be first-rate, the business is unlikely to grow as fast or as well as we expect.

Turning to a U.S. idea, what do you think the market is missing in Park Aerospace [NYSE: PKE]?

BH: This a high-quality business with no analyst coverage that has been hit hard by the pandemic but that we think comes back better than the market expects.

The company supplies carbon-based components for aircraft, mostly used in and around engines. The Airbus A320 is its largest program, accounting for roughly 30% of total revenues, but it has a fairly diverse customer base including engine and aircraft original equipment manufacturers like GE, Bombardier and the Commercial Aircraft Corporation of China. As one of only two American suppliers, it also sells into U.S. military programs like Boeing's V-22 Osprey combat aircraft and Kratos Defense's Valkyrie drone.

Given the expertise and qualifications required, the company often operates on sole-source contracts that are extremely long-lived and where customers are very reluctant to change out suppliers. Its material and components are of high value, but for the scope of the programs involved are very low relative cost. With those positive dynamics, Park's EBITDA margins in normal times are above 25% and returns on invested capital are in the mid-20% range.

When Airbus cuts production on the A320 as they did in 2020, the supply

INVESTMENT SNAPSHOT

Park Aerospace
(NYSE: PKE)

Business: Develops and manufactures advanced composite materials used to produce primary and secondary structures found in commercial and military aircraft and drones.

Share Information (@4/29/21):

Price	**13.45**
52-Week Range	10.51 – 15.57
Dividend Yield	3.0%
Market Cap	$275.8 million

Financials (TTM):

Revenue	$47.3 million
Operating Profit Margin	14.9%
Net Profit Margin	13.1%

Valuation Metrics
(@4/29/21):

	PKE	S&P 500
P/E (TTM)	40.9	42.7
Forward P/E (Est.)	n/a	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
BlackRock	13.7%
Renaissance Technologies	7.6%
Vanguard Group	6.6%
Invesco Capital Mgmt	5.5%
Dimensional Fund Adv	5.1%

Short Interest (as of 4/15/21):

Shares Short/Float	2.2%

PKE PRICE HISTORY

THE BOTTOM LINE

This high-quality business has no analyst coverage and has been hit hard by the pandemic, but Brad Hathaway believes its earnings power has improved and will exceed expectations when its end-markets normalize. At an 18 EV/EBITDA multiple on his base-case estimates for the year ending in March 2025, the share price would be around $28.

Sources: Company reports, other publicly available information

chain cuts back on inventory as well, so a company like Park that is at the beginning of the chain can be hurt disproportionately by a downturn like the one we've had from Covid. Because the business was in many ways firing on all cylinders prior to the pandemic, management in January 2020 forecast at the midpoint of its range over $26 million in EBITDA by the fiscal year ending March 2024. For the year just ended that number will likely be more like $8 million.

But we expect the business to fully recover and, given some new military-project wins and add-on business for the COMAC C919 in China, that the prior EBITDA forecast will prove to be conservative. The company is also in a good position if the A320 gains market share due to Boeing's issues with the 737 MAX.

Park's shares haven't been as volatile as many have over the past year. How cheap do you consider the stock at today's price of around $13.50?

BH: If we take the midpoint of management's guidance and push it back a year, the company within four years would be earning at least $26 million in EBITDA. We think given the competitive advantages and long-term growth potential of the business that it's reasonable to assume a high multiple – if we use 18x EV/EBITDA the share price then would be around $28. As I mentioned, we also think there's quite a bit of potential upside to that EBITDA estimate.

Another source of upside: The company has $100 million in net cash on the balance sheet – about $6 per share. There are a lot of distressed aerospace assets out there and we think a home-run scenario would be if they put some of that cash to work in accretive M&A. We don't know if that will happen, but it could generate a lot of incremental value.

Describe something you've sold recently and why.

BH: We had a not altogether satisfying experience with EchoStar [SATS], a position we closed out earlier this year. In the end we concluded the competitive threat to the company's satellite-broadband business was greater than we thought. I was focused originally on the unattractive economics of the competing technologies – from venture-backed low-earth-orbit satellite companies like Elon Musk's SpaceX, for example – without giving sufficient weight to the fact that much of that competition wasn't actually that concerned about economics for the foreseeable future.

A positive note on this is that one important element of our process is always to "invert" our buy thesis and specifically write down the primary reasons we might be wrong. Not only does that challenge our conviction appropriately prior to our taking a position, but I think it also makes it mentally easier to pull the plug when we see the identified risks start to play out. In Echostar's case, the second bullet point in our pre-mortem was something like "various competitive threats shrink total addressable broadband market." When those threats became more obvious to us, I'd like to believe we moved on more quickly than we might have otherwise. Limiting losses is as worthy a goal as maximizing gains. VII

Exclusive Property

Unlike many businesses where you can more or less assume a return to normal as the pandemic crisis fades, real estate investors still have to ponder a number of ongoing questions. Baron Funds' David Kirshenbaum offers some guidance.

While all industries have been turned upside down by the pandemic, the real estate business broadly defined has to be high on the list in terms of disruption. Some industry sectors like housing, data centers and cell towers have prospered, while others like office buildings, retail properties and lodging have been slammed. Complicating the situation for investors: Unlike most businesses where you can assume a return to "normal" when the crisis fully recedes, with real estate it's often harder to decipher what normal will look like. To what extent will office workers return to the office? What happens to business travel? Does the housing boom have legs?

If, as Warren Buffett counsels, "Uncertainty is the friend of the buyer of long-term values," then real estate would appear to be an interesting place to look for ideas. To inform that endeavor, we called on Baron Funds' David Kirshenbaum, an assistant portfolio manager on the real estate team that manages $1.7 billion in assets for the firm, mostly in the Baron Real Estate Fund. "There are a number of themes we find interesting and are investing behind today," he says.

One such theme includes what he considers pandemic recovery beneficiaries, businesses hit hard last year and where the market is slow to price in a rebound. An example is real estate investment trust Douglas Emmett [DEI], which owns and manages commercial-office and multi-family residential properties located primarily in west Los Angeles, the San Fernando Valley north of L.A., and Honolulu. What sets it apart, says Kirshenbaum, is the uniqueness of its asset portfolio, weighted toward properties that zoning restrictions would no longer allow to be built today, and that are in high-demand sections of L.A. like Santa Monica, Westwood and Century City where Emmett commands market shares on average of approximately 40%. "We think pound-for-pound this is the highest-quality portfolio of office and multi-family assets that exists in the public markets today," he says.

While there are legitimate question marks for many office landlords concerning tenant demand post-Covid, Kirshenbaum expects the long-term impact on Emmett to be minimal. Its tenant base relies on smaller, high-end professional-services firms that already don't rent a lot of space and whose principals live near their offices. Competitive supply in most of its sub-markets is constrained. The company also has a healthy pipeline of development and redevelopment projects that can make up for lingering pockets of weakness.

Emmett's shares trade today around $33.75, well off pre-pandemic prices in the mid-$40s. At the current price, the market is valuing the irreplaceable office portfolio at close to $500 per square

INVESTMENT SNAPSHOT

Douglas Emmett
(NYSE: DEI)

Business: Real estate investment trust that acquires, develops and manages higher-end office and multifamily properties located primarily in the Los Angeles area and Honolulu.

Share Information (@4/29/21):

Price	**33.74**
52-Week Range	22.88 – 34.95
Dividend Yield	3.3%
Market Cap	$6.76 billion

Financials (TTM):

Revenue	$888.0 million
Operating Profit Margin	17.8%
Net Profit Margin	5.7%

Valuation Metrics
(@4/29/21):

	DEI	S&P 500
P/E (TTM)	117.4	42.7
Forward P/E (Est.)	63.3	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Vanguard Group	13.3%
BlackRock	9.0%
Fidelity Mgmt & Research	6.6%
Wellington Mgmt	4.8%
State Street	4.1%

Short Interest (as of 4/15/21):

Shares Short/Float	4.7%

DEI PRICE HISTORY

THE BOTTOM LINE

With "pound-for-pound the highest-quality portfolio of office and multi-family assets that exists in public markets today," David Kirshenbaum believes the company is uniquely positioned to rebound even in an altered post-pandemic real estate environment. As earnings return to previous levels, he sees at least 33% upside in its stock from today's level.

Sources: Company reports, other publicly available information

foot, which is a steep discount to the over $1,000 per square foot prices at which similar properties have traded hands in recent years. Kirshenbaum sees no reason that the company's cash flow within the next two to three years can't at least return to prior levels, and argues that new projects and pricing power in key markets should drive cash flow higher. If cash flow just matches prior levels, he'd expect the share price to return to at least $45. On top of that is a 3.3% annual dividend. He also sees further potential upside from management using its rock-solid balance sheet for bargain-hunting if the real estate M&A market comes back to life.

Kirshenbaum also sees opportunity in housing-related names poised to incrementally benefit from industry tailwinds. One favorite is Installed Building Products [IBP], a leading installer of insulation and other products like rain gutters, shower doors and garage doors. All are what new-home builders might consider "nuisance" products, requiring somewhat specialized expertise and professional installation that is easy and efficient to outsource. Insulation is the biggest business, where IBP is a leader with about a 25% market share.

The company should benefit from multiple drivers of growth, says Kirshenbaum. From a cyclical perspective, the U.S. housing market remains underbuilt, with a recent Freddie Mac study suggesting there are at least four million fewer single-family homes in the U.S. than demand warrants. Housing affordability remains high, with interest rates still near historic lows and household savings significantly up after a year of pandemic. From a secular perspective, the flight to the suburbs led by millennials seeking more space and wanting to work more from home should continue. "We expect a more elongated and steady period of housing-start growth than we have seen for many years," he says.

IBP has company-specific virtues as well. It is a "structural market-share gainer," he says, driven by disciplined execution and by leveraging its scale. It has considerable growth potential in its non-insulation product lines: Only half of the firm's 190 branches offer a full slate of complementary-product installations, and those that do generate 4x the revenue per home as do the insulation-only branches. Management has also proven adept in growing through acquisition, which Kirshenbaum believes can reliably add at least 5% to annual sales growth per year.

All in, he thinks IBP can grow EBITDA by more than 20% annually for the next several years, potential that he doesn't believe is reflected in today's $136 share price. If the company generates the $475 million in EBITDA he expects by 2023 and trades at what he'd consider a reasonable 12x EV/EBITDA multiple, the stock would trade at closer to $200. One sign of management's confidence in the company's prospects: They last quarter announced the company's first-ever dividend and committed to increasing its share-repurchase program. "That they're expanding capital return even as they plan to invest into rapid growth gives us a sense of how cash flow has inflected," Kirshenbaum says. "That demonstrates to us they're really excited about the next several years, not just the next several months." VII

INVESTMENT SNAPSHOT

Installed Building Products
(NYSE: IBP)

Business: Installer of insulation and other building products, including garage doors, rain gutters and closet shelving; primarily serves U.S. new-home construction market.

Share Information (@4/29/21):

Price	**136.01**
52-Week Range	44.41 – 136.39
Dividend Yield	0.9%
Market Cap	$3.92 billion

Financials (TTM):

Revenue	$1.65 billion
Operating Profit Margin	10.0%
Net Profit Margin	5.9%

Valuation Metrics
(@4/29/21):

	IBP	S&P 500
P/E (TTM)	40.5	42.7
Forward P/E (Est.)	24.1	23.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
BlackRock	11.6%
Vanguard Group	7.9%
Baron Funds	6.6%
Dimensional Fund Adv	3.1%
Wellington Mgmt	2.9%

Short Interest (as of 4/15/21):

Shares Short/Float	4.1%

THE BOTTOM LINE

Its advantaged competitive position and unique firm-specific growth drivers should allow the company to incrementally benefit from current positive cyclical and secular tailwinds in the U.S. housing market, says David Kirshenbaum. Assuming what he considers a reasonable 12x EV/EBITDA multiple on his 2023 estimates, its stock would trade at $200.

Sources: Company reports, other publicly available information

Back to Basics

Most readers of *Value Investor Insight* have likely watched the market for special-purpose acquisition companies [SPACs] with detached bemusement. The concept isn't at all new, but SPAC issuance over the past year has exploded and the market has at times provided one of the clearer signals of potential speculative excess. In February when SPAC Atlas Crest Investment Corp. [ACIC] announced a deal to buy "electric air-taxi" developer Archer, its stock – which came public in December at $10 – rose on the news to above $17. That was despite the fact that Archer didn't really have a product yet, just some solid financial backers and an "order" to buy from United Airlines if they were actually able to produce a viable electric air taxi. ACIC shares have since come back to earth and today trade at around $9.90.

We've covered SPACs before, turning to experts on the subject at Bulldog Investors [*VII*, May 31, 2018] who have actively invested in them since 2005. Rather than seeing SPACs as speculative fliers, Bulldog generally considers them low-risk plays, better than cash when cash actually paid something. SPACs upon issuance usually price at $10 per unit, with a unit typically consisting of a share of stock and some fraction of a warrant to buy the stock over the next five years. The cash raised in the IPO is held in trust, to be returned if the sponsors can't find a deal, often over a two-year period. If a deal is announced and the market likes it, the SPAC common shares and warrants often rise in price. If the market doesn't like it and the shares trade below the cash in the trust, holders can opt to get their money back for the cash amount in the trust. The warrants, which will have some value in the business combination, can be sold or held. "We never pay more than $10 per unit and will try to pay less, so our downside is limited and often positive," says Bulldog portfolio manager Rajeev Das. "If a good deal is announced, we can have nice upside."

With the SEC threatening stricter SPAC regulation and with less secondary financing available to complete deals, air has come out of the market in recent weeks. Bulldog's Das is doing what he always does, looking for offerings from good sponsors with proven records of closing successful deals. When their units trade for $10 or less – either at the IPO or in the aftermarket – he's potentially interested.

What is Das finding interesting today at the right price? He offers three current examples:

Gores Guggenheim [GGPIU] is co-sponsored by private-equity firm and serial SPAC issuer The Gores Group, which has already successfully closed a number of deals to take public a diverse set of companies including snack-food maker Hostess Brands, technology company Verra Mobility and government-services firm PAE [**see p. 2**].

FTAC Hera Acquisition [HERAU] is the latest SPAC from financier Betsy Cohen, who has also announced or closed a number of recent deals, most of which have been related to financial payments.

Longview Acquisition Corp. II [LGV.UN] is the second SPAC sponsored by Larry Robbins' Glenview Capital, a leading hedge fund with particular expertise in healthcare investing. Its first SPAC, now trading as medical-imaging company Butterfly Network [BFLY], currently trades at 40% above the IPO price.

"It's more about the team than anything else," says Das. That's often true, of course, but even more so in today's wild and woolly world of SPACs. VII

Value Investor Insight™ is published monthly at www.valueinvestorinsight.com (the "Site"), by Value Investor Media, Inc. Co-Founder, President and Editor-in-Chief: John Heins. Annual subscription price: $349.

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