Dear (future) partner,

The Sequoia Fund Investors Day 2017 transcript is a great read. You can get a very good idea of my investment approach just by reading theirs. So what is my investment approach? Well, I just try to find a handful of unique, exceptional and, at times, uncomfortable investing opportunities and then hold on to these companies as long as they remain good companies.

First of all, I am a "cloner". I study successful value investors and if I can understand and agree with the investment thesis, I buy it whether it is a classic Buffett company, spinoff, or whatsoever. Secondly, I look for companies that have their "value creation engine" up and running (companies like Mastercard or Verisign) and if such a company trades at a price that makes sense, I buy it. I work patiently and very hard every day to identify these unique and terrific businesses trading below their intrinsic value and I enjoy every minute of it.

So let's have a look at a pretty uncomfortable situation in my portfolio and how to assess that. And then I will elaborate a little bit more on this value creation engine in "Take the Buffett road". Enjoy!

How uncomfortable are we today?

A year ago I bought stock in Veritiv, a Seth Klarman holding. Probably because of the merger transaction that was implemented immediately after the International Paper spin-off, the misunderstanding and under-appreciation of the company's potential by the market was high by then and still remains high today. There are significant opportunities for growth, synergies, and cost savings due to a large size of the combined business.

On 2 August 2017, Veritiv reported a second-quarter loss of $9.1 million, after reporting a profit in the same period a year earlier. Veritiv shares had a rough ride last year, from $42 all the way up to $62, and all the way down to $28. Is Seth Klarman wrong and should I sell the stock?

I don't think so. During the latest quarterly update, CEO Mary Laschinger stated that the decrease of the consolidated adjusted EBITDA was primarily due to the combination of continuing industry pressures in the print and publishing segment, investment in their growth segments, and slightly higher operating expenses. Nevertheless, she expects a 2017 adjusted EBITDA of $190 to $200 million. (Wall Street loves EBITDA and I just don't. Not treating the depreciation of goods and amortization as "a real cost" is wrong. So I try to avoid EBITDA and try to focus on real cash flows). By the end of the trading day, on 2 August 2017, Veritiv traded at 3.2 times operational cash flow and at tangible book value. That is quite a margin of safety! So why not buy more?

Veritiv previously shared that they knew 2017 would be a challenging year due to the complexity and scale of the integration. Veritiv remains on track with their multiyear integration work and synergy capture plan and despite that, the environment in print and publishing has been more difficult than anticipated. I strongly believe that the growth in packaging and facility solutions more than offsets the decline in print and publishing. I see substantial long-term upside potential for this Fortune 500 stock. Even if things turn out to be worse and let's say that the revenues go down by 50%, it's still a $4B revenue company. With a more than moderate price to sales multiple of 1, you could argue that this company has the potential, if management succeeds, to end up with a market cap of $4B. As per today, 12 August 2017, the market cap is $450M. Veritiv is a small cap generating big cap revenues.

Charlie Munger reminded us that one of the most important aspects of risk management is the right temperament. Many people can articulate a good investment approach in theory. It is far more difficult to remain rational and execute it under conditions of uncertainty and real-world pressures. What's happening to Veritiv today is such an apt example.

Patience is one of the most critical attributes for a long-term investor because you can be right and the market may tell you that you're wrong. There can be times where it looks like an investment might not work out, but in the end it does. However, you must sometimes be willing to endure a period of time (sometimes many

years) that is uncomfortably long to reap the benefits of the investment. Peter Lynch has often said that many of his stocks biggest gains come in their 4th or 5th year. American Express was flat from 1985 to 1992 before becoming a multi-bagger. There's this balancing act between too ashamed to admit you are wrong or in denial about being wrong and being stoic. In this case, I choose the latter one. The basic assumption and belief is that management will be able to get the company "up and running" and that Veritiv will be around and doing well many years from now. Neglect the short term volatility. Volatility is the price you pay (if you are right) for long-term outperformance.

I am perfectly ready to be proven wrong. Everybody makes mistakes now and then. My position is hedged at $30 until 19 January 2018. So I have plenty of time to wait and see what's going to happen to the stock and then make up my mind. It looks like a low risk, high uncertainty opportunity: "Heads, I win; tails, I don't lose much".

Take the Buffett road

Value investors do not rely on the discounted cash flow (DCF) and capital asset pricing model (CAPM) approach that business schools teach in introductory corporate finance courses and that are at the core of methodologies like Economic Value Added (EVA), Market Value Added (MVA) and Shareholder Value Added (SVA).

Bruce Greenwald, the Robert Heilbrunn Professor of Finance and Asset Management and director of the Heilbrunn Center of Graham and Dodd Investing explains. "The DCF/CAPM methodology that business schools teach is a theoretical elegant formulation. But in practice, the margin of error makes it worthless for investing. These models depend not only on near-term cash flows, which can be projected reliably, but also on long-term cash flows and terminal values, which cannot. Terminal values rely on highly subjective assumptions of cost of capital and growth rates. Any error, however slight, in these variables can dramatically throw off valuations.

Furthermore, DCF models ignore balance sheets, throwing away some of the most tangible, reliable and therefor valuable information available. In contrast, the value investing approach starts with the balance sheet – first looking at the asset value, then earnings-power value, then competitive advantage and managerial ability and then growth – is in every way more accurate than the DCF method, and value investors tend to do much better than the market as a whole".

It's my understanding that Warren Buffett looks for companies that have very long term staying power and buys them at a price that any reasonable discount rate would give him a great return in the long run. His business partner Charles Munger once said, "Warren often talks about these discounted cash flows, but I've never seen him do one. If it isn't perfectly obvious that it's going to work out well if you do the discounted cash flow calculation, then he tends to go on to the next idea".

In general, I carefully try to avoid the great academic insights like the Capital Asset Pricing Model (CAPM), Black–Scholes, Beta and the weighted average cost of capital (WACC). WACC is used to measure the cost for a company to acquire capital (through a mixture of debt and equity). Once you have found this number, you theoretically have a nice discount in figuring out the present value of a company's cash flow. The problem is that any slight change in WACC will have vast implications on your investment decisions.

If you look at the formula for WACC, you will hopefully start to see some problems. For instance, the tax shield causes many problems, the first of which is that the more debt a company has, the better their cost of capital will be due to this tax shield. A company with a very high debt may sometimes have a very low WACC for this reason. It can definitely be argued that companies with less debt perform much better than their levered peers in the long-term and we are doing the exact opposite here by using WACC.

Then we have the beta problem. Warren Buffett came up with this example in "The Super Investors of Graham and Doddsville" speech: "The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the Post, Newsweek, plus several television stations in major markets. Those same properties are worth $2 billion now, so the person who would have paid $400 million would not have been crazy.

Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater and to people who think beta measures risk, the cheaper price would

have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million."

Return on Capital

In his 1987 letter to shareholders, Warren Buffett talks about the value of earnings: "Earnings by itself says nothing about economic performance. To evaluate that, we must know how much total capital - debt and equity - was needed to produce these earnings". This is known as return on capital (ROC).

There are many practices to calculate the ROC and you have to decide which methodology you want to use and why. For instance, you can calculate the rate of return from a financing perspective (e.g. by using long-term debt and equity as capital base), or you can calculate the rate of return from an operating perspective (e.g. by using the net working capital and the net fixed assets as capital base). People tend to think that the financing perspective is the most intuitive place to start because it builds up to the rate of return on capital from the standard return on equity. I definitely prefer to calculate the rate of return on capital from an operating perspective. The reason for that is that you will end up with terrible results if you calculate the rate of return of companies like Verisign and Autozone from a finance perspective. These are great companies, but these companies employ negative equity, which is indeed exceptional.

It's very hard to take just a few good investment decisions during your lifetime and that's all you need. It is probably even more difficult to hold on to a good investment during times of turbulence. So what is a good company? Warren Buffett once said that a good company is one that earns a high rate of return on tangible assets (the ROC from an operating perspective). Also, the best companies are the ones that earn a high rate of return on tangible assets and grow. If you take a closer look at Berkshire Hathaway holdings like Verisign, Precision Castparts or Mastercard, you will find that these are companies that earn a high rate of return on tangible assets (ROC) and demonstrate solid growth in the free cash flow per share (GROWTH). These are the characteristics I look for and I preferably want to buy these kinds of companies in the early stage of their competitive life cycle.

You might question if you want to include net working capital in the capital base. Net working capital was included by Joel Greenblatt because a company has to fund its receivables and inventory, but does not have to lay out money for its payables, as these are effectively an interest-free loan. If you believe that the cash generated on the net working capital is important for a long-term investor, you should include it.

There are choices to be made in the numerator of the ROC equation as well. You can use the classic definition of NOPAT (Net Operating Profit after Taxes), or you might want to use the pretax operating earnings (which is what Joel Greenblatt uses as described in his classic "The Little Book that Beats the Markets"). You might also have a preference for the CFROI Valuation Framework (introduced by Bart Madden and Bob Hendricks in the 70s and which is now owned and used by Credit Suisse) which uses cash flow as the numerator. So, there are actually a lot of choices to be made and I do not believe that there is such a thing as the one and only correct ROC. I guess it depends on your beliefs and convictions.

For the sake of simplicity, I use the following definition of ROC. As the numerator, I use a cash flow version which is defined by the operational cash flow minus the maintenance capex. It is assumed that depreciation and amortization expenses are roughly equal to maintenance capital spending. As the denominator, I just look at the tangible fixed assets as stated on the balance sheet. So, I will exclude intangibles and goodwill. I agree with Aswath Damodaran (Professor of Finance at the Stern School of Business at New York University, where he teaches corporate finance and equity valuation) that "good-will" is probably the most destructing accounting item ever created in history.

The question arises if there is an appropriate benchmark for ROC. Once again, Warren Buffett guides us through the accounting swamp. In his 1987 letter to shareholders, he refers to the Fortune 1988 Investor's Guide, where Fortune reported that among the 500 largest industrial companies and 500 largest service companies, only six had averaged a return on equity of over 30% during the previous decade.

Only 25 of the 1,000 companies met two tests of economic excellence— an average return on equity of over 20% in the ten years, 1977 through 1986, and no year worse than 15%. These business superstars were also stock market superstars. During the decade, 24 of the 25 outperformed the S&P 500. Buffett uses return on equity, because really good businesses usually don't

need to borrow. But if a company has debt, you should include debt into the capital base for calculating the ROC. Even better, always use tangible fixed assets as capital base.

Charles Munger also emphasizes the importance of a high ROC in "The Art of Stock Picking": "If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."

Growth

There are many ways to calculate GROWTH. You can look at the revenue growth, the EBIT growth, the net income growth, the operational cash flow growth, the EBITDA growth, the free cash flow growth, the dividend growth, the book value growth and the tangible book value growth. And then, for all these items, you can decide to look at the "per share growth". So that already makes 18 different growth rates. Then, for all these 18 items you can look at 1-year growth, or 3-year growth, 5-year growth, 10-year growth etc.

Although I'm not a big fan of management consultancy firms, I have to admit that McKinsey made some interesting observations on balancing ROC and GROWTH: "When a company's ROC is already high, GROWTH typically generates additional value. But when it comes to GROWTH, companies are very likely to experience substantial declines. Of companies that grew by more than 20 percent in 1994, for example, 56 percent were growing at real rates of less than 5 percent ten years later".

Many analysts often project companies like these to grow at double-digit rates for many years to come and they are wrong. While some quickly growing companies certainly maintain high growth for a decade or more, the average high growth company simply does not. Only 13 percent of the high-growth companies maintained 20 percent real growth ten years on, and acquisitions probably drove most of it.

The Value Creation Engine

What I prefer to look for are companies that have their value creation engine up and running and are trading at a price that makes sense. So what is the "Value Creation Engine"? Well, it's ROC times GROWTH. But be careful. I am talking about a very conservative estimate of the long-term growth. As conservative as good old Ronald Reagan.

Margin of Safety

You want to buy these companies when they are trading way below their intrinsic value (margin of safety). And that's easier said than done. There are many ways to value a company. You can look at replacement costs, book value, present value of future cash flows, price to earnings multiple, price to cash flow multiple, price to sales multiple, sum of the parts, private market value, the PEG ratio, the Bruce Greenwald Earnings Power Value, the Peter Lynch Fair Value, the Ben Graham Number, the Joel Greenblatt Earnings Yield, etc. Some of them do not apply to all companies though. So you have a range of outcomes and if a stock trades below the lowest of that range, it's perhaps quite interesting.

And you must take into account an estimate of the future interest rates. Warren Buffett talked about the importance of the future interest rates on business valuation in February 2017 on CNBC: "U.S. stock prices are on the cheap side. If rates were to spike, however, then the stock market would be more expensive. If interest rates were 7 or 8 percent, then these prices would look exceptionally high".

I would rephrase "on the cheap side" as "moderate expensive, but by no means in a bubble". Howard Marks recently wrote that we are living in a low-return, high-risk world. And that's the way it is.

Ranking the stocks

Joel Greenblatt came up with a solid approach for ranking the stocks. So you rank e.g. 10 candidates by ROC. The highest gets 1 point and the lowest 10 points. And then you rank them by margin of safety. The highest gets 1 point and the lowest 10. You add the numbers and choose the lowest number.

At times I rank the stocks by multiplying the value creation engine (which is ROC times GROWTH) with the margin of safety and then choose the highest number. If you want to play it safe, use the Joel Greenblatt ranking system. But if you want this extra nuance of high growth companies you might want to try the latter approach. But keep in mind, growth is a very dangerous parameter, both in ranking the stocks as in business valuations.

Reengineering the investment thesis

There is no such thing as an investment without a thorough investment analysis. It takes a lot of time to really understand a business and its environment. I always start with the balance sheet. This might sound old fashioned, but it's a very important step and many value investors nowadays take the balance sheet information too lightly. You want the balance sheet to be as solid as a rock. But that's easier said than done. For instance, how do you assess a balance sheet that has negative equity (like Verisign and Autozone)?

However, I think the most exciting part is the assessment of the long-term growth potential of the company. You have to be certain about the future cash flow streams of a company—very certain. That can be achieved by studying industry trends, the regulatory environment, disruptive technologies, the long-term competitive dynamics of an industry and the durability of the competitive advantages. Where will this company be 15 years from now and what does that mean in terms of market capitalization?

Warren Buffett once said: "If there is risk, we just don't go ahead". What helps are two checklists. The first is in the appendix of Philip Fisher's classic "Common Stocks and Uncommon Profits", entitled "Key Factors in Evaluating Promising firms", where he discusses functional factors, people factors and business characteristics. The second checklist is in appendix A of an article written by Michael J. Mauboussin and Dan Callahan, entitled "Measuring the Moat Assessing the Magnitude and Sustainability of Value Creation", where they discuss e.g. barriers to entry, rivalry, brands, disruption and disintegration, etc. It's also worthwhile studying articles on "The Reinvestment Moat" by Connor Leonard and the comments on that by John Huber. Reinvestment moats are companies that have all the advantages of a legacy moat and earn strong returns on capital plus opportunities to deploy incremental capital at similar high rates.

A high caliber leadership team

Finally, let me stress the importance of good management. This might be the most crucial one. Warren Buffett looks for a proven track record and a history of operational success, the utmost integrity, the ability to allocate capital wisely and people who care deeply about the business that they led. I couldn't agree more.

So here we are

The methodology described thus far, based upon return on capital, growth and a margin of safety, and then reengineering the investment thesis, is, I believe, a very sound framework for stock picking. My talk during The Zürich Project 2017, on "Intelligent Cloning," was well received. I argued that by studying the latest 13Fs of Berkshire Hathaway, Sequoia Fund, Chuck Akre, Lou Simpson and Thomas Russo, my number one stock pick by then was Verisign.

However, companies like Credit Acceptance Corp (which is a Seth Klarman and Sequoia Fund holding), Linamar and Dart Group (both are Meryl Witmer holdings) also showed up by applying this methodology. Isn't that interesting? And it even gets better if these great businesses buy back their own stock at appropriate prices.

I started this memo by referring to the Sequoia Fund Investors Day 2017 transcript and I might as well end with a quote from David Poppe. *"Performance doesn't happen on a schedule, and I don't care who we are or what we do, over the next one, two, three years, the result we get is unfortunately out of our hands for the most part. The market is going to do whatever the market is going to do".*

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
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