Intelligent Cloning

The Autumn 2018 edition

During the Graham & Dodd Luncheon Symposium, October 2, 2008, @ the Heilbrunn Center for Graham & Dodd investing (Columbia Business School), chaired by Seth Klarman, David Abrams, who actually worked for Seth Klarman's Baupost Group for 10 years, made it obviously clear:

"We just try to steal good ideas from other people.
A lot of my best ideas have been stolen."

And that's what you try to do: steal, copy or clone great investment ideas. The question obviously is, whether we can in any case still discover ideas that are "cloneable". I mean, we are right now amidst the longest positively trending market in history since World War II.

In this Autumn 2018 edition on Intelligent Cloning we will look back @ all the stocks covered thus far in my write-ups and rank them once again, to see if there is still some value out there. Furthermore, we will examine the portfolios of two fascinating value investors not covered thus far: Bob Robotti and Francisco García Paramés. Both of them showed up @ the London Latticework Conference 2018. It was a treat to be present at this motivating session.

Looking back

Just a quick reminder. The Joel Greenblatt Magic Formula approach shows that stocks that rank well on both Return on Invested Capital (ROIC) and cheapness do much better than the market over time. This approach makes a lot of sense to me, though I have to admit that I use a slightly different approach in calculating ROIC and cheapness (margin of safety).

Intelligent Cloning means copying great investors while avoiding their "too risky" investments. And to identify the "cloneables" I use 5 criteria, very straight forward: a "balanced" balance sheet; consistency in the per-share figures; substantial free cash flow; consistently high return on capital and a margin of safety. Without further ado, here are 3 compelling ideas from the past that meet the criteria:

Sinclair Broadcast Group Inc. (Seth Klarman, Leon Cooperman, Ruane Cunniff) is a 2.9B USD market cap company, trading @ 6.1 times cash flow (where cash flow equals the 3 year average operational cash flow). The company is one of the largest and most diversified television broadcasting companies in the United States.

Sinclair owns and operates, programs or provides sales services to more television stations than anyone and has affiliations with all the major networks. In addition, Sinclair is the leading local news provider in the country, as well as a producer of sports content. Sinclair owns a multicast network, four radio stations and a cable network. Sinclair's broadcast content is delivered via multiple-platforms, including over-the-air, multi-channel video program distributors, and digital platforms. Sinclair, either directly or through its venture subsidiaries, makes equity investments in strategic companies.

Spectrum Brands Holdings (Leon Cooperman, Bruce Berkowitz, Jeremy Grantham) is a 3.7B USD market cap company, trading @ 5.5 times cash flow. The company completed its previously announced merger with HRG Group, Inc. on Friday, July 13, 2018. Following the closing, Spectrum Brands continued as the successor to HRG Group under the name Spectrum Brands Holdings, Inc.

Spectrum Brands Holdings is a global and diversified consumer products company and a leading supplier of consumer batteries, residential locksets, residential builders' hardware, plumbing, shaving and grooming products, personal care products, small household appliances, specialty pet supplies, lawn and garden and home pest control products, personal insect repellents, and auto care products. Helping to meet the needs of consumers worldwide, the company offers a broad portfolio of market-leading, well-known and widely trusted brands. Spectrum Brands' products are sold in approximately 160 countries.

Fiat Chrysler Automobiles (Mohnish Pabrai, Guy Spier, Bill Miller, Bill Nygren, Steven Cohen) is a 23.4B EUR market cap company, trading @ 2.3 times cash flow. The company designs, engineers, manufactures and sells vehicles and related parts and services, components and production systems worldwide through 159 manufacturing facilities, 87 R&D centers, and dealers and distributors in more than 140 countries.

Its stable of brands includes Abarth, Alfa Romeo, Chrysler, Dodge, Fiat, Fiat Professional, Jeep, Lancia, Ram, Maserati and Mopar, the parts and service brand. The Group's businesses also include Comau (production systems), Magneti Marelli (components) and Teksid (iron and castings).

Cloning Robotti & Paramés

Francisco Garcia Paramés seeks to invest in easy-to-understand companies and is "willing to wait as long as necessary for the market to finally recognize true value." Value investing to him means in-depth analysis, picking quality companies at attractive prices, and being patient for them to rise in value. Very patient.

The current portfolio of investments is, I believe, a treasure of "cloning opportunities" and the companies I would like to highlight are Dixons Carphone and Aryzta.

Dixons Carphone is a 1.8B GBP market cap company, trading @ 5.0 times cash flow. The company is Europe's leading specialist electrical and telecommunications retailer and services company. The company has built an unrivalled offer for the connected world.

As mobile, electrical and connectivity increasingly integrate, Dixons now has a unique position in the UK&I and Nordic markets to grow the business; through a relentless execution within core multi-channel retail; via the expansion of its existing consumer services Team Knowhow division; and by developing existing and entering new agreements with other businesses through Connected World Services.

Aryzta AG is a 975M CHF market cap company, trading @ 2.4 times cash flow. Aryzta is a Switzerland-based company engaged in food business. It is primarily focused on specialty baking.

The company's products include artisan breads, sweet baked goods and morning goods, as well as an array of other savoury items, such as pizza, tarts and pies. The company's customer channels consist of a mix of retail, convenience and independent retail Quick Serve Restaurants.

The company is now planning a share sale to raise as much as 800 million euros as the firm struggles to lower its debt after multiple profit warnings. Always do your own due diligence!

Robotti & Company focuses its research to identify companies which for various reasons are trading at significant discounts to intrinsic value. A particular area of focus is on cyclical businesses which at depressed times in their cycles can be dramatically discounted. Once identified, Robotti's investment team focuses on deep primary industry and company research to identify investments through the lens of a long-term business owner.

Also this portfolio is very unique and interesting for a professional cloner like me. **Spectrum Brands Holdings**, as discussed before, also popped up in the Robotti portfolio and the other company I would like to highlight is Ensco (which is actually also a Paramés holding).

Ensco PLC is a 3.7B USD market cap company, trading @ 3.7 times cash flow. The company provides offshore contract drilling services to national and international oil companies as well as independent operators. It operates its business in U.S. Gulf of Mexico, Mexico, Brazil, the Mediterranean, and the North Sea. Ensco owns one of the newest jackup and deep-water fleets in the contract drilling industry. The firm is based in London, but its rigs drill around the world for national and international oil companies, as well as independents.

Shenanigans

Have you read the awesome book on Financial Shenanigans by Howard Schilit? You should. Because of his track record in detecting the manipulation of financial results, Howard Schilit has been called the Sherlock Holmes of accounting. Whereas most forensic accountants come in after the fact for the investigation and litigation, Schilit is the rare exception who comes in to detect accounting manipulation before it is widely discovered.

Additionally, in case you welcome that stuff, you should start examining the Journal of Forensic and Investigative Accounting. They contend that that there are six well stablished fraud or earnings manipulation detection tools and ratios: The New Fraud Model (Dechow, Ge, Larson, and Sloan 2007); The Old Fraud Model (Beneish 1999); The Quality of Earnings (Schilit 2010); The Quality of Revenues (Schilit 2010); The Altman Bankruptcy Model (Altman 2005); The Sloan Accrual (Sloan 2012).

Exceptionally intriguing for sure, but allow me to give you some simple ideas that might turn out to be valuable as well. With the following 5 red flag questions you would have avoided business failures like Valeant, Enron, Toshiba, SunEdison, Royal Ahold and Royal Imtech. Actually, just the first 2 questions would do.

1. **Does the company generate free cash flow?** Ahold, Enron, SunEdison and Toshiba did not generate any substantial free cash flow at all over a 3 to 5 year period before collapsing. Huge red flag.
2. **What about debt?** Just try to use the total liabilities relative to EBIT and relative to operational cash flow. You would have found terrible results for Valeant, Enron, Imtech, SunEdison and Toshiba. Huge red flag.
3. **Is the company profitable?** Before crashing, Valeant was not (GAAP) profitable at all for 3 out of 5 years and SunEdison for 5 out of 5 years. That's a huge red flag.
4. **Does operational cash flow lag way behind net income?** With this simple "quality of earnings" test you would have identified Royal Imtech easily. Red flag.
5. **And what about financing future growth?** If the cash flow from investing substantially exceeds the cash flow from operations, that's not a good sign. Imtech, Valeant, Enron, SunEdison and Ahold used way too much debt to finance future growth. Huge red flag.

"It takes a very special type of ineptitude to fail on such a massive scale." – Quote Eric Wesoff on SunEdison.

In the end only Royal Ahold and Valeant were able to raise from the ashes. Valeant, nowadays known as Bausch Health, still does not make the grade of a safe investment. The debt is still way too high and the cumulative net income over the last 3 and 5 years is still negative. But Royal Ahold, nowadays known as Royal Ahold Delhaize, does make the grade of a safe investment and actually, it is trading at what I consider an attractive price for a very long term investor.

And what about Lehman Brothers and AIG? Leverage is the no. 1 reason why financial companies fail. In 2007 the leverage ratio (total assets relative to equity) of AIG was approximately 11, while the leverage ratio of more conservative insurance operation like Berkshire Hathaway was just 2. And in the banking sector Lehman Brothers hit the jackpot with a leverage ratio above 30, while e.g. J.P. Morgan levered up only 10 times then, and now.

I am not in the business of predicting bankruptcies, but over the last 4 years Tesla's operating income, net income, operational cash flow and free cash flow were negative. In 2017 Tesla generated a negative free cash flow of 4B USD and @ the end of the second quarter 2018 their net debt position (total debt minus cash & cash equivalents) was almost 11B USD!

That's it for this edition on Intelligent Cloning. As always, one must be prepared for the unexpected, including sudden, sharp downward swings in markets and the economy. Whatever adverse scenario you can contemplate, reality can be far worse.

In the Winter edition, we will revisit the Mohnish Pabrai Free Lunch Portfolio, have a look at the portfolios of Allan Mecham and Leucadia and disclose the latest additions to the Intelligent Cloning Portfolio.

"We just try to steal good ideas from other people."
David Abrams

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
6 October 2018

Everybody makes mistakes now and then. If you find any, let me know: peter@thevaluefirm.com. Always do your own research!