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Hidden Value Stocks
small caps with little or no coverage

From ValueWalk

INTERVIEW ONE: HYDEN CAPITAL

Fred Liu, CFA

founder and portfolio manager of Hayden Capital

Prior to founding Hayden, Fred was the industrials analyst on J.P. Morgan's Small Cap Equity fund, a five-star Morningstar ranked strategy that invested in securities under $2 billion in market cap. He then moved to New Street Research as a research analyst covering the cable and satellite industries.

Fred holds a B.S. in finance and international business from the Leonard N. Stern School of Business at New York University.

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INTERVIEW TWO: AVENIR CAPITAL

Avenir Capital is a global equities investment manager and is majority owned by its staff. Avenir was founded in 2011 to apply a private equity mindset to invest in a concentrated selection of publicly listed companies with a focus on risk minimisation and long-term compounding of capital.

Led by Adrian Warner, Managing Director and Chief Investment Officer, the Avenir Global Fund has produced a gross return of more than 17% per annum for its investors since inception.

Before founding Avenir Capital, Adrian was Managing Director and part-owner of Catalyst Investment Managers Pty Ltd, a mid-market Australian private equity firm following a stint at CVC Asia Pacific Ltd, one of the leading private equity groups in Asia.

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INTRODUCTION

Welcome to the December issue of Hidden Value Stocks. In this last issue of the year, we profile two funds that have different strategies, but both are looking to accomplish the same goal; finding value where others can't.

The first interview is with Hayden Capital's managing partner Fred Liu, CFA. Fred and his team are looking for stocks that are undervalued today but have a long runway for growth ahead of them or as Fred puts it "we're looking for 80 cent dollars, where we believe the value will grow to $3 or $5 over time." The two ideas he profiles undoubtedly meet this criterion. One is trying to take over the pet food market in Europe, while the other is a play on subprime auto credit — a market most investors are staying well away from today.

Our second interview is with Avenir Capital. Avenir uses a private market approach in public markets, looking for undervalued businesses that have a long-term strategy for wealth creation. The firm runs a high conviction strategy and its leading strategy; the Avenir Global Fund is not constrained by global borders. Since inception, the Avenir Global Fund – Class I has achieved an annualized gross return for investors of 17.1%, and over the past five years, the fund has achieved an annualized gross return of 20.9%. In our interview, Avenir profiles two ideas, one company based in Asia and another from the US.

As well as these two interviews and four ideas, we also have updates from some of the funds profiled in the winter 2016 issue. We hope you enjoy this issue and welcome any comments you may have.

Sincerely,
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& Jacob Wolinsky
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Updates From Our Previous Issues

This time last year Hidden Value Stocks spoke with Andrew Oskoui of BlueTower Asset Management who recommended Ezcorp and Nicholas Financial. As you can see on the next page, the returns from these two picks have been mixed.

According to Andrew's third quarter letter to investors, BlueTower sold its Nicholas Financial holding during the third quarter. While the rest of the portfolio outperformed for the quarter (12.9% gross return) Nicholas did not live upto expectations. Specifically:

"Our investment thesis that Nicholas would be capable of having superior underwriting compared to their competitors seems unlikely to work out. It appears that the regulations passed by the CFPB have made their collections more difficult in ways that we did not anticipate. In addition, the development of new technologies such as big data analytics of borrower behavior and ignition kill switches appears to have changed the dynamics of the subprime industry, thereby allowing their competitors to be more aggressive in lending."

In the interest of fairness, all recommended stocks are kept in the Hidden Value Stocks portfolio for 12 months before we lock in returns. However, premium subscribers can gain access to funds' letters when they're published on the HVS website at any time.

Andrew and his team have deployed the capital from exiting Nicholas into investments in Japan. Head over to www.hiddenvaluestocks.com if you want to find out more.

Ezcorp has also attracted the attention Hazelton Capital Partners', Barry Paskiov, who featured in the summer 2016 issue of this newsletter. Hazelton's third quarter letter, which features the thesis in full, is available on our site but for now, here's a snippet of the fund's bull case for the firm:

"Hazelton Capital Partners believes there to be a meaningful discount between the company's share price and its intrinsic value. The contraction in operating margins is directly related to the restructuring of the company's core pawn business. Starting in 2018, most of the write-downs, impairment and restructuring charges will have been taken, leading to increased profits and free cash flow. The improved free cash flow could be used for future acquisitions or reducing debt, allowing the company to be debt free within the next 4-5 years. Hazelton Capital Partners has mapped out a bearish, base, and bullish case outlook for EZPW's business plan execution. The fund believes there to be a conservative 65% upside to its base case outlook, a smaller return to its bear case and a meaningful opportunity if the company executes above expectations." ■

Hidden Value Stocks Portfolio

Edition	Fund	Ticker	Open Price	Date Pitched	Date Closed	Dividends	Current Price (1) (2)	Total Return
1	Foundary Capital	NYSEMKT:VISI	$7.60	1/28/16	1/28/17		$8.45	11.18%
		NASDAQ:MRVC	$11.21	1/28/16	1/28/17		$8.15	-27.30%
2	Stanphyl Capital	NASDAQ:MGCD	$5.94	3/28/2016	3/28/2017	$0.70	$8.30	39.73%
		NASDAQ:LTRX	$0.90	3/28/2016	3/28/2017		$3.31	267.78%
		NASDAQ:ELON	$5.77	3/28/2016	3/28/2017		$6.20	7.45%
		NASDAQ:BWEN	$2.87	3/28/2016	3/28/2017		$7.25	152.61%
3	S&C Messina	NYSE:PRA	$51.47	06/21/16	06/21/17	$1.24	$60.15	19.27%
4	Hazelton Capital	NASDAQ:CUI	$5.99	09/23/16	09/25/17		$3.37	-43.74%
		NYSE:CPS	$106.03	09/23/16	09/25/17		$112.30	5.91%
5	Boyles Capital	LON:SYS1	500	10/07/16	10/09/17	45.60	537.00	16.52%
		ATH:PLAT	€1.69	10/07/16	10/09/17		$2.60	53.85%
6	Livermore	CVE:JSE	$0.50	12/21/16			$0.42	-16.00%
	BlueTower	NASDAQ:NICK	$11.10	12/21/16			$7.96	-28.29%
		NASDAQ:EZPW	$10.65	12/21/16			$12.20	14.55%
7	Arquitos Capital	NASDAQ:MMAC	$21.45	03/15/17			$25.75	20.05%
		NASDAQ:MLNK	$1.87	03/15/17			$1.79	-4.28%
	Alluvial Capital	ASX:CZZ	$14.58	03/15/17			$18.25	25.17%
		TSE:CRH	$11.33	03/15/17			$3.03	-73.26%
8	Verdad Capital	TYO:4028	¥1,050	06/15/17			¥2,018	92.19%
		TYO:9994	¥1,620	06/15/17		20	¥3,085	90.43%
	GrizzlyRock	NYSE:RSO	$9.95	06/15/17		0.2	$9.70	-2.51%
		NYSE:VPG	$17.45	06/15/17			$27.20	55.87%
9	Logos LP	NASDAQ: AAON	34.85	09/29/2017		0.13	$35.70	2.44%
		NYSE: LXFT	47.8	09/29/2017			$53.15	11.19%
	Dane Capital	NYSE: DSKE	13.05	09/29/2017			$13.43	2.91%
		NYSE: MX	11.31	09/29/2017			$11.35	0.35%
				Average return				28.22%

(1) For closed positions this price is the price at time of close.
(2) Prices as of December 11

INTERVIEW ONE: HAYDEN CAPITAL

Fred Liu, CFA

founder and portfolio manager of Hayden Capital

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Fred Liu

Let's start with Hayden's investment strategy. Can you describe what you're looking for in a potential investment?

I hate style buckets, but if forced to, I'd say we tend to be "GARP-ier" than your typical value firm. We're primarily focused on the reinvestment opportunity sets a company has and the longevity / duration of that business. We're definitely not looking for 50 cent dollars, where the intrinsic value will always be a $1 or worse even declining in value. The problem we see with these situations is that you need a catalyst for the market to realize that valuation gap, and if successful we'd have to sell and redeploy that capital into something else. Time is against you. Instead, we're looking for 80 cent dollars, where we believe the value will grow to $3 or $5 over time.

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For example, I've often found it helpful to use a real estate analogy (although definitely not perfect), since the tangible and familiar nature is easier for many people new to equity investing to visualize.

Simply, I am the type of person who's more comfortable buying a good house in a gentrifying neighborhood with growth potential currently yielding a 6% unlevered return. If the neighborhood keeps developing, and say the millennial hipsters move in, rents in the area will go up and I stand to make 12% returns on my invested capital. If I'm wrong, and the neighborhood simply stays as it is, I'm still yielding a fair return in a nicer part of the city, where I'm confident the values will at least hold over time.

The opposite would be to buy in a much worse part of the city, which doesn't have the "hipster" / gentrifying optionality. You may get a 9% unlevered return, but would be worrying every day if squatters are taking over your property, if drug dealers are opening up shop around the corner, or if your tenants can even pay rent this month. You may get a higher initial return, but there's limited growth potential, and what's more likely is that the residual value of your investment may even decline over time. I see this analogous to quality agnostic, "deep-value" investing. You can make money with this style of investing, but it's a lot of headaches, a very different skillset, and something I've determined I'm not suited for.

Our portfolio is highly concentrated, with just 8 investments today.

So long as our companies are able to smartly redeploy capital at attractive rates (typically over 15% ROIC), we're happy to hold these positions until the opportunities run out. Evidence of this is in our turnover, which has been less than 20% a year. I firmly believe that great companies with these characteristics are tough to find, and we pride ourselves in getting to know them inside and out. We're also very lucky to have a client base which allows us to take the long view, often investing with a 10+ year outlook.

I think Zooplus is a great example of your strategy in action. This is one your top picks profiled later in the issue but it's not much of a value stock in the traditional sense. So, how does this business fit into your overall strategy?

When analyzing an investment, we're looking for four basic principles. First, we're looking for a growing industry, with a strong sustainable tailwind (i.e. the "pie getting bigger").

Second, we want a company that is taking market share within this industry, that we believe has a structural "right to win" (i.e. "taking a bigger piece of a growing pie"). Third, we're looking for a great management team that is entrepreneurial, has skin in the game, has the right incentives, and has a long-term view. A company can be in the right place at the right time, and have a great opportunity set in front of it. But if there's the wrong leadership in place, all of this can go to waste very quickly, and a competitor will inevitably take your spot. Lastly, of course, we want an attractive valuation, based upon our analysis of what a company's normalized earnings power would look like today if it stopped its growth investments, as well as at maturity. As explained in detail later, we believe Zooplus enjoys four of these.

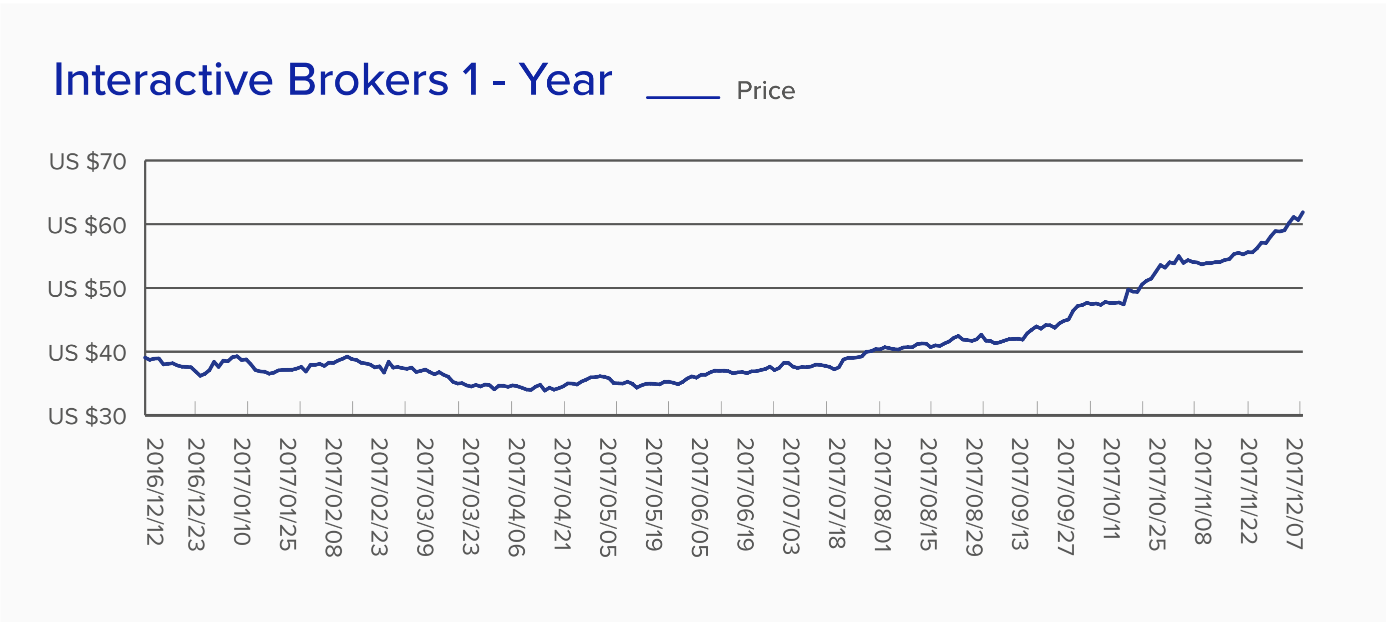
The core of our analytical process centers on the idea that earnings growth is determined by the future ROIC times the reinvestment rate of a company. Our analysis indicates that Zooplus' ROIC on current and future opportunities for capital deployment, such as acquiring new customers, price improvements, improving their customers' mobile experience, etc is very high. Given this, we're happy to see they're plowing just about every dollar of earnings power back into the business, and thus the reinvestment rate is close to 100% (hence the lack of earnings and high multiple).

You also like Interactive Brokers, a company that again hardly fits the value template. Could you talk a bit about this investment?

What you'll notice about our portfolio, is that almost none will fit the traditional "value template", if that's defined as low-multiple stocks. And Interactive Brokers is just one example of this. We're interested in companies that are reinvesting capital back into the business internally at high returns. Many of these investments are expensed, so by definition profits today will be low, and multiples will be high. The question we're always trying to answer is, what does the true underlying earnings power look like, when this business is at maturity and no longer needs / has room to invest in its business?

> *"The question we're always trying to answer is, what does the true underlying earnings power look like, when this business is at maturity and no longer needs / has room to invest in its business?*

What attracted us to Interactive Brokers, is its focus on low-prices in a semi-commoditized industry. While speed of execution and service matters, it's really



the pricing that first attracts brokerage customers, especially among the day traders and retail investors that IBKR originally started with. As the firm grew, it moved "up-market" and added suites of products for the smaller professional fund managers – services like performance reporting, managed accounts services, portfolio rebalancing, tax reporting, etc. These are products that before IBKR, fund managers had to purchase on their own, often costing tens of thousands each. Interactive Brokers single handedly lowered the barriers to entry for starting an investment firm.

Usually when competitors see a disruptor as successful as Interactive Brokers encroaching on their space, they rush to take market share back. For example, the company is growing new accounts at +25% y/y. But with prime brokers, the opposite is happening. Regulations and capital requirements since the financial crisis have caused many of investment banks to deem sub-$50 million investment managers too costly to service. They've essentially given up on the market. Additionally, this space has traditionally been a high touch, labor-intensive field. The industry was always operated under a very manual structure, requiring large sales teams, operations, and compliance professionals.

But Interactive Brokers in many ways has the DNA of a technology company. An overwhelming proportion of their headcount is in software developers, whereas most prime brokers would be skewed towards sales people. This culture has allowed Interactive Brokers to automate a formerly labor intensive process, and thus have the lowest cost structure and therefore the ability to offer the lowest pricing in the industry. Low pricing, a comprehensive suite of services, and competitors who don't want their business, has meant smaller investment firms have few other options when starting out besides Interactive Brokers.

We've also noticed the company is starting to make headway with larger funds in the last few years. Anecdotally, we've seen many hundred million to several billion dollar funds "multi-priming" with Interactive. We've spoken with many of them, who claim Interactive Brokers has better services, more functionality, and greater depth of borrow for shorting, versus many of their other (larger) prime brokers. But they're forced to keep the other prime brokers, because these investment banks have better "brands", which their investors trust and is an easier sell to institutional investors. However, we believe it's only a matter of time before Interactive Brokers become more well-known itself.

When it comes to discovering stocks, what makes you say "yes" or "no"? What's one essential trait that you believe makes a winning business?

All else equal, I'd say quality of management and their ability to recognize opportunity and execute is most important. Imagine a company had 100 different projects it could invest in. 99 projects generate 20% returns on capital. The last project generates 5%, but will create a much larger company, bring more prestige to the CEO role, and justifies a larger salary for the C-suite. Which do you think the lousy manager is going to take, and which would an exceptional manager take?

I've talked a lot about finding companies and industries with lots of options available to them for high-returning projects. But this is just the first step. On top of this, you need to find a smart manager, with the right incentives, who you trust will always take that 20% project vs. the 5% one.

You'd be surprised how many professional CEO's choose the latter. As an investor, you can't babysit a manager and double check every decision they make (although many activist investors try). It's far easier and less stressful to find a good partner from the get-go.

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IBKR and Zooplus are hardly cheap stocks. Would it be fair to say that you're more interested in finding high-quality businesses and paying the price no matter what rather than just buying cheap stocks?

If you buy these types of companies at a fair multiple, they reinvest all their capital back into the business to widen their moat, and they earn say 15 - 25% annually on their underlying projects, your portfolio over a long enough time period will produce similar results.

You certainly don't want to overpay. But if you determine a fair multiple is 15x for the company, it really doesn't matter if you buy it at 15x or 12x, if you're invested for the next 10 years. A substantially larger driver of returns, is getting the answer to "will this company be able to earn above average margins for the next 15 years vs. only 5 years" right (i.e. are margins structural or temporary to the industry). Another crucial question may be "What gives this company the right to win?" We spend a lot more time on these business model-type questions, than predicting where the stock is going to trade next year.

Why have you chosen this strategy over a more traditional value style?

Simply, I think the world has evolved, as have the business models along with it. Whether it's an open-air market, a neighborhood convenience store, or Amazon, the goal is still facilitating a sale between Supplier A to Customer B. It's just the most efficient method of doing so has changed.

On top of this, I think many investors underestimate the pace of change in today's market. They make the simplistic assumption that the historical returns a company has achieved, is what they can expect to earn going forward. Basically betting that the economics of an industry won't change, or those that capture 80% of an industry's profit pool will always do so. That may have been true 50 years ago, when competition tended to be more localized, both industry and geography-wise. Certainly you wouldn't have the risk of a retailer like Amazon getting into Amex's payments space like today.

But nowadays, unit economics and the competitive landscape are always changing. So you have to keep tabs on the competition – not just within your backyard but also halfway around the world.

The growth curve is also much more exponential today than the super-linear trend in prior decades. Value creation in the old days tended to come from owning the hard assets – factories, retail stores, trucks, etc. It required a lot of capital to become the largest. Due to the law of large numbers, this growth curve was more linear, as it was hard to grow 20% a year if it meant you had to devote mindshare and resources to train, hire, and launch 100 new factories.

Today, the best companies tend to be asset-light. Value comes from owning the intellectual property, or facilitating a connection between parties better than competitors. This is much more scalable. For instance, we've been studying the marketplace business model in the last year. This type of business is interesting, since it lends itself to a "winner-take-all" dynamic, so long as customers also participate in the benefits of larger scale (i.e. you keep the customers happy, rather than them screaming "Monopoly!!"). These businesses are likely to actually grow faster, since the bigger they get, the faster the "flywheel" spins. The key is catching that inflection point – that initial stage when a company emerges as a clear winner from the pack.

"Today, the best companies tend to be asset-light. Value comes from owning the intellectual property, or facilitating a connection between parties better than competitors. This is much more scalable.

But to "win", these businesses require a lot of investment in intangible factors. Often this flows through the income statement, in the form of lower prices, higher payroll for developers, marketing costs, etc. These companies aren't going to "screen well" on traditional value metrics.

The fear investors traditionally had with growth, is that it may be value destructive. For example, growth isn't worth anything if it costs you $1 in advertising to generate $0.50 of profit. To tell the difference between good vs. bad growth, investors need to dig deeper. They have to analyze the unit economics of these projects on an individual basis. Much of the data necessary to run these calculations won't be readily available. You're not going to find it in a 10K.

Often you need to talk to customers, read trade journals, talk to city officials, etc. to get the data-points you need. Sometimes, you'll also need to "tease" / reverse engineer the financials to find the KPI's you're looking. It's like a math equation (say, X + Y = 80), where the financials tell you the answer's 80, and you have a good idea of what X is because of your conversation with a supplier, and you're solving for Y. Y tells you the underlying principle of how they generated those returns, and whether your thesis is on track.

Back to the original question of "why I chose this route", the answer is it just makes the most sense to me. It's common knowledge how to effectively find the most thoughtful investors – look at their underlying portfolio, understand their research and thought process behind their top positions, and evaluate if you think this is smart. It's the best way to evaluate an investor's stock picking abilities. Almost all funds do this as part of their analyst interview process, and the best institutional investors do it when selecting external managers.

But why haven't investors applied this method to finding the best operating companies and CEO's as well? After all, everyone is allocating capital, and an investment manager picking companies is no different than companies picking which projects to invest in. Allocators give capital to investment managers, who give capital to companies and their management teams, who then deploy that capital into new projects, where project managers allocate it to the most effective talent, supplier partners, and so on. Everyone is investing in some way.

The difference is that investors tend to have a wider opportunity set, in the form of an entire universe of stocks to choose from (unless your strategy constrains you to say Australian Microcap stocks). Meanwhile companies can only choose from the projects available to their business.

Nevertheless, I believe the process is the same. The best way to determine if an industry is attractive is by looking at the potential returns of available projects. Some industries are simply more attractive than others. Some companies also have high return projects available to only them, and not their competitors. Lastly, finding the best company or management within that, requires confidence that they'll pick the highest returning ones (the 20% project, and not the 5% one).

You tend to hold a large portion of your portfolio in cash. The average cash weighting of the last 12 quarters is 23.6%. Do you think this has held back your returns?

Judging by our performance during that period, it definitely has. For example, we're currently up ~26% year-to-date, which would be over 30% if we were fully invested. So the cash drag has caused a few points of performance this year, and much more if looking across the last three years.

What is your cash weighting today and are you finding any opportunities to deploy capital further?

Cash is at ~14% today, and has been around that level for several quarters. But note, the cash level isn't really a market timing call. Rather, we just have very high barriers for new investments. New investments need to be superior to our current investments, to make it into the portfolio… and we have a pretty high quality roster of existing positions.

Cash has slowly declined in the last few years, as we've deployed capital into new ideas. For example, we've made two new investments in the last 15 months, which has helped lower our cash balance by over 15%.

We're pretty happy with the position sizes across the portfolio right now, and have an internal limit on how much we're willing to invest in a single position at cost. Our highest conviction ideas are already at or near that limit.

Regarding new ideas, we're always on the hunt for interesting businesses. We're seeing more opportunity internationally, especially in Asia. There's a large tailwind of a growing mass-affluent consumer base, which makes for some interesting situations. So that's where we're fishing right now.

“Regarding new ideas, we're always on the hunt for interesting businesses. We're seeing more opportunity internationally, especially in Asia. There's a large tailwind of a growing mass-affluent consumer base, which makes for some interesting situations. So that's where we're fishing right now.

Additionally, my thesis is that we're reaching an inflection point in the “China Tech” story. In the prior decade, Chinese companies were known largely as “copycats”. But over the last year, we've seen Western media start paying attention to these companies, especially in the technology space, partly due to Alibaba and Tencent rapidly ascending the list of the largest companies worldwide. And this attention is for good reason.

We're seeing more “innovation” come out the country, like we've never seen before. For example, a lot has been written about Amazon's cashier-less convenience stores, or their integration plans for Whole Foods. But this is already happening in China, and at a large scale.

Go to Shanghai, Beijing, or any of the large Chinese cities, and you'll find “unmanned” convenience stores already operating, where customers can just walk in and grab whatever snacks they want, with no interaction with humans necessary. Alibaba has over a dozen Hema grocery stores, where consumers can use their phones to scan QR codes of produce, get all the information / cooking instructions / even which farm it was grown from on their phone, and have the groceries delivered to their door-step within the hour. This is happening in fashion too, with many brands partnering with the online platforms to try and purchase in-store, then seamlessly have it delivered from a warehouse to your door. In the US, Amazon is only starting to trial this business model, most recently with their Amazon x Calvin Klein pop-up stores in NYC and LA.

The online-offline integration is happening much faster in the region, since Chinese consumers are used to adopting new technology / form new habits very rapidly, and there was little existing infrastructure to overcome. This doesn't even include the huge mobile payments trend, where in a few short years, people have literally stopped carrying cash for their daily needs. I just heard a story the other day from a family member, how taxi drivers refuse to take them if they try to pay with cash. China's dockless bike sharing model is going international also, and is the first model where US companies, like LimeBike, are actually copying their

Chinese counterparts. You can sense a change in the innovation landscape, and I expect that to accelerate over the next decade.

On top of this, many of the most innovative and market-leading Chinese companies are listed outside of China – many on the New York exchanges. Alibaba, JD.com, Ctrip, among them. They list here not only due to the prestige of a US listing and the deep capital pool here, but also due to the capital controls in China. It's harder to acquire or invest capital internationally, if you're listed in China vs. abroad.

The primary customers of these companies, the Chinese consumer, face similar capital controls. Unlike in the US, retail investors still constitute the majority of volume for public markets in China. So that creates a situation where the natural buyer, who knows these companies very well and understands the products, can't buy shares in them. Many US-based investors are still wary of Chinese firms, due to what happened with the reverse-merger frauds around 2009-11. Even though the Chinese tech behemoths of today are very different than the $50 million market cap Chinese biotech companies of 7 years ago.

All of this creates some interesting technical factors for US-listed Chinese companies, and we believe is a good pool for finding under-appreciated, market leading, companies.

What has been your biggest investment failure so far?

There's been a lot of them throughout my investing career. But, most recently, that award goes to Baidu. We ended up making close to a +30% profit on it, but it was still a mistake nevertheless.

I had underestimated how quickly the shift in ad revenues from search engines to other platforms like WeChat or Alibaba would be. Today, 60% of mobile time is spent on WeChat / Tencent, and mobile is the dominant method which Chinese users access the internet.

Users are skipping search engines, and increasingly remaining within WeChat's ecosystem and its plethora of "mini-programs". You can shop online, read blogs, order a taxi, pay your bills, order food, and more all within one app. More specifically, I underappreciated just how superior the ROI was on the competing platforms, due to the specificity with which ads could be targeted, combined with the increasing amount of time spent within the WeChat universe vs. outside of it.

However, we got lucky with the investment, due to the company's narrative transitioning to an "Artificial Intelligence" company. While it's true that Baidu is recognized as having some of the best AI technology globally, it's still a very nascent field, and the potential distribution of outcomes are very wide. The structure of the industry profit pool, how big the profit pool will be, how these profits will be distributed across various players, and the return on investment for going after this market is even murkier.

The company promoted its AI-focus more this year, which has gotten the market excited and driven the price up a lot. It's still early stages for the initiative, and since we don't have confidence in the outcomes of this field, we've sold the majority of the position into the market's enthusiasm.

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Did this scenario cause you to change your investment strategy?

This particular situation hasn't – in fact I think it may be the opposite – as it actually validated our process. There's certainly been other mistakes that we've learned from, but there's enough content in that topic alone for another interview.

With Baidu, we were able to catch the mistake relatively early on, since our process involves constantly tracking the underlying economics of the business, especially from a customer's perspective and also in relation to competitors, on a very frequent basis. We're always asking, why should customers use this service vs. competitors, and what are competitors doing better? And we try to put hard numbers around these questions.

Just because someone was a customer last year, doesn't mean they aren't looking for a better alternative this year. This is especially true for today's constantly changing business environment. Most importantly, we're not waiting for the numbers to show up in the financials before realizing that something is wrong – by then it's often too late, and the stock price has already reacted. If there's a mistake, hopefully we catch it early, before the lower economics start showing up in the financials and the rest of the market catches on. ■

Hayden Capital: Stock Idea One

Your first stock pick is European company Zooplus AG. Can you give us some background for this business?

Zooplus is the leading online retailer of pet food and supplies in Europe. Pet food is the largest category, at ~80% of sales. In Europe, e-commerce pet supplies sales make up ~8% of the industry, and Zooplus has ~50% market share in that space. Close to 90% of the business is focused on dogs and cats supplies.

The company has been growing at 27% - 33% y/y the last few years, as customers realize the convenience and lower prices of buying pet food online. It's the largest online pet supply retailer in Europe, and will become the second largest retailer overall this year.

So the company is a pet food retailer. What attracted you to this opportunity?

What's interesting is that the online penetration for e-commerce pet food is much lower in Europe than that of the US and other developed markets. In most developed countries, broadband will be / already is ubiquitous. Our thesis is that over time, penetration will track population density. For example, China only has 53% internet penetration, but has the highest online pet food adoption. GfK found that 48% of China's pet food sales are conducted online. Comparatively urban cities in the US are ~19%, while Europe is just 8%.

It's clear that for heavy, bulky products such as 40lb bags of dog food, urban density and difficulty of public/private transportation is a factor. China has a much denser population, concentrated in urban areas, where carrying a heavy bag of dog food home is a hassle. The same is true for pet owners in cities around the world. Living in NYC, I personally know I wouldn't want to carry a 40lb bag of dog food home on the subway or Uber. I would much rather it order it to my door, especially if online is the same price or often even cheaper than the large chain pet store.

“Our thesis is that over time, penetration will track population density. For example, China only has 53% internet penetration, but has the highest online pet food adoption. GfK found that 48% of China's pet food sales are conducted online. Comparatively urban cities in the US are ~19%, while Europe is just 8%.

This is especially true for a “commoditized” product like dog food. Consumers typically get the same brand for their pet month after month. There's no “joy of discovery” with the product, unlike you might

get finding a fashionable new jacket you didn't know about at Bloomingdales or TJ Maxx. Buying pet food is a chore, which should be as efficient and least time consuming as possible. Zooplus provides this, and recently announced a subscription service to make it even easier.

On top of this, there's secular industry tailwind for ordering pet food online at 15% y/y growth, and Zooplus is taking share even within this. So the pie is growing, plus Zooplus' slice is getting bigger.

We've seen this show up in the company's financials. The company has doubled sales in the last 3 years (27% CAGR), and expects to double again by 2020. More importantly, customer retention is steadily increasing, while our analysis indicates basket sizes and annual order frequency are rising as well (7% CAGR and 6% CAGR, respectively). This is evidence the company is doing something right, and consumers find value in the service.

Do you think it has the scale to beat Amazon? Is there a risk from Amazon to the business?

Amazon is certainly a risk, and they've been slowly pushing into Europe. However, I think a lot of investors overestimate the impact of Amazon around the world – especially investors based in the US. Travel around, and you'll find that many consumers in continental Europe still aren't familiar with Amazon yet. For example, Amazon Prime has 80 million members in the US, but estimated at 10 million or less internationally. The Amazon value proposition isn't as strong internationally, as it is in the US. At least not yet.

But it's coming. It would be dumb for us to assume Amazon isn't making progress internationally. However, there are certain niches where Amazon has not traditionally focused, and has lagged behind. For instance, even in the more mature US market, Chewy.com has done a fantastic job of competing against Amazon. Chewy.com is a very similar business to Zooplus, both did ~$1 billion in sales last year, and both capture ~50% of the online market. It's interesting that Amazon and Chewy started their pet supplies business around the same time, but Chewy has been growing much faster, by having a singular focus on serving the pet customer.

Additionally, shipping heavy, bulky, 40lb bags of dog food requires a different logistics infrastructure than Amazon's. Amazon's typical package is less than 10 lbs, and less than a cubic foot in size. As evidence of this, Amazon recently announced they were entering the furniture and auto parts businesses, and would be required to build 4 new warehouses to ship "heavy & bulky" goods in the US. If successful, they would certainly be able to ship pet food to US customers out these facilities as well. However, at the same time it gives credit to the idea that a different type of logistics system is required. It's something we're watching, and seeing if it carries over to Europe. Currently, we estimate Amazon only sells ~€350M in European pet supplies, which is less than a third the size of Zooplus. Additionally, many of Amazon's top sellers fall in the "easy to ship" category, like pet medications, toys, etc.

We view Chewy.com almost as a "canary in the coal mine", since the first battle will likely be in Amazon's backyard and most mature market. In the meantime, the goal is for Zooplus to gain enough scale and customer loyalty, that by the time Amazon arrives, it will be much tougher for them to take share in the pet food vertical. This is why there's such an intense focus on customer acquisition, and improving the pet owner's online experience.

You've spoken about the importance of management a lot in this interview. What is it that attracted you to Zooplus' management?

The CEO was one of the original founders, and has been with the company for 18 years. The CMO has been there for 17 years, and the CFO for 4 years. Occasionally I think they've been slow to launch what I see as "no-brainer" initiatives (such as the subscription service or investing more in their mobile experience). However, overall, I think they've done a fine job of shepherding the company through the last two decades, and the more recent international expansion.

> *"The CEO was one of the original founders, and has been with the company for 18 years. The CMO has been there for 17 years, and the CFO for 4 years.*

But more important to us is who is on the board and who are our fellow shareholders. I've met a few of the large shareholders in company, and have found them to be very bright. Often the fear is that with the wrong board composition or large shareholders, sometimes the incentives would be misaligned and push the company to pursue short-term initiatives that inflate near-term earnings, at the detriment of the business's long-term competitive advantage.

The opposite is the case here. Many shareholders have been large investors in the company for a long time, are all reputable in their own right, and have a proven understanding of value creation with other investments. They understand there's still a lot of work ▸

and investment to be done, before the company can rest on its laurels. The recently announced initiatives to invest in mobile and hire more IT developers, at the expense of lowering this year's earnings guidance, is evidence of this mentality.

Let's move on to valuation. The stock isn't particularly cheap so why have you picked this as a value play?

It depends on how you define "cheap". It's hard to simply look at the headline multiple, since the company is reinvesting heavily in the business, and doesn't make much in the way of earnings. During this period, the earnings multiple is going to look outrageously expensive. The more important question is, if successful, what will this company's profile look like at maturity? This is especially true for "winner-take-all" business models, such as a marketplace model.

I think getting a dominant position company, growing mid-20%'s y/y going forward, with a strong secular tailwind, at 0.9x sales or 22.5x normalized EBIT is attractive. Especially when compared to the traditional brick & mortar retailers, which are growing at GDP+ (if that), and still trading at 0.5x sales or 12x EBIT. With the current valuation, we only need to underwrite three years of growth, before we get the remaining excess growth for "free". We're pretty optimistic on the pet food e-commerce space over the next 3 years.

Most of the value typically lies in a business' terminal value (i.e. long-term earnings power). Sometimes it's cheaper / safer in the long-run to own a business with longevity and staying power, rather than a low headline multiple.

> *"With the current valuation, we only need to underwrite three years of growth, before we get the remaining excess growth for "free". We're pretty optimistic on the pet food e-commerce space over the next 3 years.*

What's your long-term price target?

We don't typically have price targets for these types of investments. We invest in companies with the goal of them growing more valuable year after year. As long as it's a reasonable multiple, we're more concerned with what this rate of change looks like going forward. If successful, it doesn't make sense to put a static price target on these businesses whose intrinsic values are increasing every year.

So if you don't have a price target, what would make you sell the position?

Most of the time, we're looking at what a business would be worth once it hit maturity, and grows into its addressable market. Typically our holdings are trading at what we deem to be a "fair" multiple for them, and will simply compound at a rate similar to the growth in earnings power (or what we estimate the business is worth if they shut off all growth investments today). What drives value creation, is the incremental return on invested capital. Or said another way, future Earnings Growth = ROIC x Reinvestment Rate.

There are a few criteria that would cause us to sell. First, we're constantly looking for information that disproves our thesis. The opportunity set for companies to redeploy capital is constantly changing, so we must constantly evaluate the current projects a company is investing in. We're always examining the unit economics of these initiatives and asking "are we getting an attractive return"? For current holdings, if the new initiatives are significantly less attractive than the projects the company was investing in when it first entered the portfolio, then we will likely sell.

Second, it's always possible that the market gets ahead of itself and prices the company very expensively. Defining "expensive" typically involves analyzing what the company would be worth at maturity, plus if it fully captured its addressable opportunity. If the market is pricing the stock like it's already "won" its industry, when in fact it still has a long ways to go and ample execution risk, we'll take the opportunity to sell.

Lastly, companies can't grow forever and eventually they'll hit maturity. Since these companies no longer have attractive opportunity sets to invest into, they'll often start returning capital to shareholders. Worse yet, they may enter other markets they have no reason to be in, probably at subpar returns, in order to keep the growth alive.

It's very hard from a behavioral or incentive standpoint, for your typical management team to admit their job is done, and it's time to start milking the cash flow out of a company. Only exceptional leaders with a strong sense of capital allocation can do that. At this point, either management will be smart and return our capital via buybacks or dividends, or we'll take the capital away ourselves by selling. We'll then redeploy the capital into companies with more attractive reinvestment opportunities. ■

Hayden Capital: Stock Idea Two

Your second pick is Credit Acceptance Corp (NASDAQ: CACC). This company provides auto loans, a business that right now is under pressure from rising delinquencies. So my first question has to be, why do you like the company? What differentiates the company from its competitors?

There's a natural "gag" reflex from other investors, when you tell them you own a subprime auto lender, whose primary customers have FICO scores less than 550. Credit Acceptance is a subprime automotive financing company that offers loans through a network of auto dealers nationwide. Typical customers are those who would not otherwise be able to obtain financing through traditional means due to poor or no credit history. These "subprime" borrowers currently make up 45% of the auto market.

What makes Credit Acceptance different, is that their primary business is what they call the "Portfolio Program". Typical lenders will buy a loan outright from a dealership, for instance at $0.80 on the dollar. If the consumer pays back the loan in full, the financing company will make $0.20.

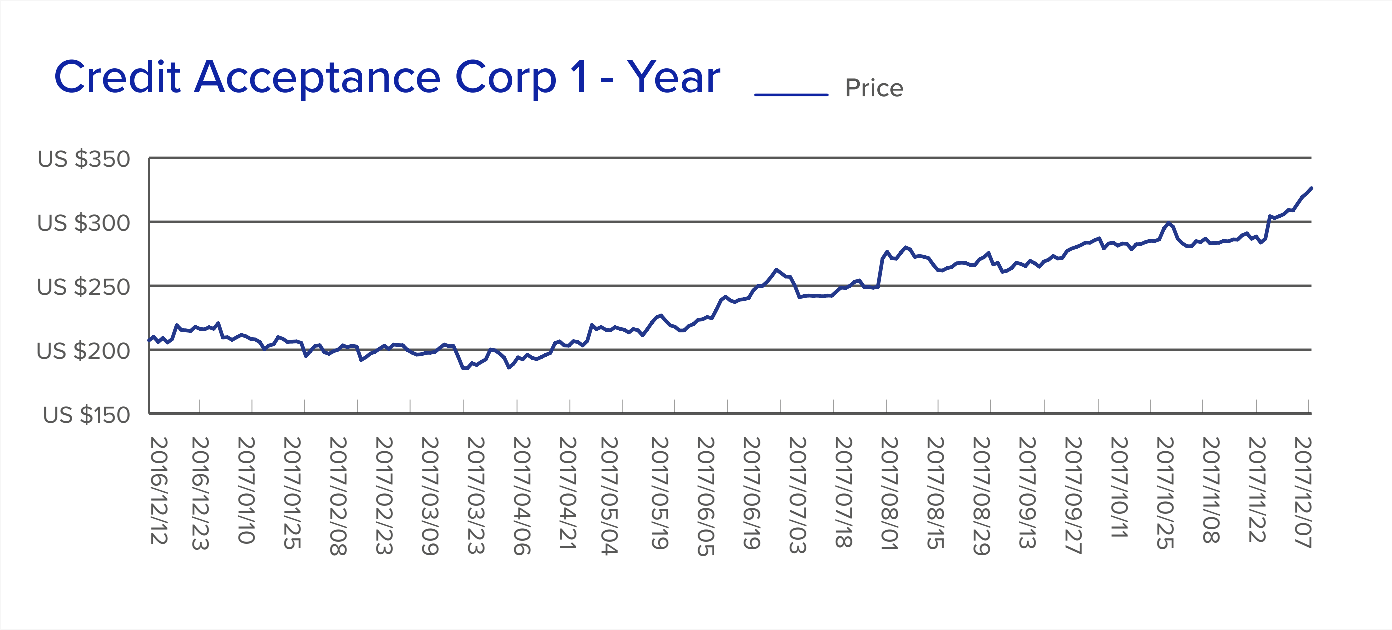
Credit Acceptance on the other hand, takes a different approach. Their Portfolio Program partners with dealerships, to share in the economics of the loan. This ensures the dealer's incentives are aligned with CACC's, and the loans are of adequate quality. This type of mutual interest doesn't exist with the traditional purchase model.

How it works, is CACC provides the Dealer with a non-recourse cash advance in exchange for the right to service and collect the underlying loans. For example, on a $12,000 car, the customer may contribute a down payment of $2,000 and take out a loan with CACC for $10,000. Over a term of 48 months, and interest rate of 22%, the total loan would be $15,123, including interest. The car likely cost the dealership $8,000 at wholesale.

Remember, these are highly risky customers, where on average only ~70% of the loan is paid back. So while the interest rate is high, it needs to adequately compensate for this risk, and is likely better than the consumer's other financing alternatives (if any).

Credit Acceptance will then give the dealer an advance, historically ~47% of the loan amount, for $7,108. This, combined with the consumer's $2,000 down payment, covers the dealer's cost of the car, plus allows them to make an immediate profit (but a smaller profit than if they sold the loan outright to a traditional lender).

Subsequently, Credit Acceptance collects a 20% servicing fee every month, in addition to keeping the



remainder of the monthly payment until they recoup their initial advance. Once Credit Acceptance makes their advance back, future cash flows are shared 80% / 20% with the dealer taking the majority.

As you can see, the real profit for the dealer is in the subsequent monthly payments. The more reliable a customer is, the larger the profit the dealer makes. Thus dealers want to keep the economics of the best loans for themselves, and are happy to use Credit Acceptance to service the loan for them. For Credit Acceptance, the risk of losing their initial capital is very low, given they are the first to be paid back, and they can maintain an adequate margin of safety between the amount they advance (~47%) and the percentage of the loan forecast to be paid back on average (~70%).

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We view industry-wide delinquencies rising as actually a good thing for Credit Acceptance. In fact, we thought the industry was overheat, with too much easy capital sloshing around when we started looking at the space three years ago. It's something we've been expecting, and is actually a core reason for our investment in CACC.

Due to Credit Acceptance's business model, they are highly insulated from any downside in individual loans. On top of this, we've heard from many dealers that Credit Acceptance has become the "second lender of choice" in the space, since dealers have gotten greedy and can make more money selling off their loans outright in today's environment. This has meant lower loans per dealer for CACC, and a slower growth in the number of active dealers. During this period, Credit Acceptance has actually pulled back their underwriting due to the competitive environment. They would rather sit back, than chase after poorer quality loans.

But as we start to see the marginal player face higher delinquencies and get washed out, more dealers are turning to Credit Acceptance to finance their business. Customers are still going to buy cars to get to work, and will need a loan to help cover the costs. Don Foss, the company's founder, once said in an interview, "I can't think of a lot of barriers to entry, but I can think of a lot of barriers to profit… It's easy to give money away, it's harder to collect it back." Being the rational player in a commoditized market, and having the capital to provide loans at the bottom of the cycle, when your competitors can't, is very attractive.

You're saying that the business has traits that insulate it from wider market trends?

I think the strength lies in Credit Acceptance's unique business model, of ensuring dealer incentives are aligned, and being in a senior position on an individual loan level. I'm not sure a lot of the short sellers fully understand the business model, and I've met quite a few who are simply shorting it as a proxy for the industry.

Higher delinquencies don't necessarily mean higher losses. For CACC, profits are determined by the difference between the predicted payback rate, and the actual payback rate. Over the last few years, the company has expected lower payback rates (from 74% in 2010 to 64% in 2017), and have advanced a lower amount as a result. The risk lies in them getting the forecasted rate wrong, and being hit with higher than expected delinquencies. But again, much of this impact is mitigated by their senior position. CACC essentially pioneered the subprime auto space 40 years ago, and thus they have more data and deeper insights than everyone else, which leads to better forecasts.

It's interesting to note, industry downturns have historically been great opportunities for the company. The business is almost "counter-cyclical" in this sense.

When the cycle last turned in 2008-11, and delinquencies shot up, this caused hundreds of marginal lenders to exit the industry. Meanwhile, Credit Acceptance actually gained market share and grew EPS by 227%. In those three years, average volumes per dealer rose 18%, the number of active dealers rose 23%. The spread it could charge on its loans doubled.

We may not see as drastic of an uplift this time around, but it will still be meaningful. Our estimates are that the company has an additional $1.8 billion of dry powder, in the form of maturing loans, cash, and untapped credit facilities. This will be available when the time is right… all at better economics than the loans on the balance sheet today.

This is a $5.9 billion company, but you don't believe that is an accurate of the company's market value?

When investors focus on market cap, they're mainly asking "is this stock undiscovered"? For example, looking at the market cap in isolation tells you nothing about the size of its addressable market, how much runway the business has left to grow into, or where the business is in its maturity cycle. It's possible for a $100 million market cap company to be closer to maturity, than a $10 billion market cap company.

In terms of market awareness, I think Credit Acceptance is still on the lower end of the spectrum. For instance, despite the $5.9BN market cap, the founder and his family still own over 50% of the shares. Another institutional investor who has been invested in the company for over 20 years, owns another ~25%. Other members of the C-suite, along with board members own another 5%. If you look at the actual float, it's roughly $1.2BN.

"For instance, despite the $5.9BN market cap, the founder and his family still own over 50% of the shares. Another institutional investor who has been invested in the company for over 20 years, owns another ~25%. Other members of the C-suite, along with board members own another 5%. If you look at the actual float, it's roughly $1.2BN.

On top of this, the short interest is equal to the entire float (in the last 6 months, the short interest has ranged from 3.8 – 4.7M shares, out of a total 19.3M shares outstanding).

For these reasons, it's much more volatile than your typical $6 billion company. We believe it's a very misunderstood situation, and for an investor willing to take a long position, the rewards will be even higher due to these technical factors.

When we started looking at it 3 years ago, it was even less followed. There were very few investors looking at the subprime auto financing space, and those who did were looking for short candidates (especially after the movie "The Big Short" came out). In my opinion, Wall Street didn't start seriously covering the name until last year.

Let's talk about valuation. What's the valuation today, and where do you see the stock going over the next few years?

The question I always ask myself with this company is, how much would I pay for this stock, if I didn't know it was a subprime auto lender? As I mentioned before, there's a large "gag" factor associated with this business, which I hypothesize has caused it to trade at a lower multiple than if it had the same characteristics, but in a more "reputable" industry.

Despite this, the company has grown EPS at 18% CAGR the last 5 years, and all during what was arguably the "trough" period of the cycle for CACC. At ~15x P/E, I believe the multiple is fair – especially for a company in a defensive second-loss position, and still in the early innings of its competitive cycle. We also think the street may be underestimating the earnings power and the dealer sign-on rate over the next few years.

But the primary drivers of the stock over the long-term, will be answering 1) How many more dealers can Credit Acceptance sign up, before they hit maturity, 2) Will dealers finance more loans through CACC during an industry down-turn, and if so, by how much, and 3) Can Credit Acceptance penetrate adjacent businesses (such as larger, franchise dealers instead of their traditional base of mom & pop independent used car dealers) by the time they hit maturity on the core business?

Getting these three questions right will have a much bigger impact on the company's valuation than what the multiple will be next year. The longevity and durability (i.e. terminal value) is the most important driver for these types of businesses.

The business at its core is simply a function of the number of active dealers x the number of loans per dealer. Our research and conversations with dealers gives us confidence that the business can continuing growing through at least another cycle, before growth starts slowing. There's still a lot of demand from dealers for CACC's product, especially if the easy money from competitors continues drying up, as it has over the last year. We're estimating the business will grow 12 - 15% annually over the next cycle, and expect the stock price to follow this trajectory.

Are there any headwinds that could derail this thesis?

There are several factors that potential investors need to be aware of. First, it's entirely possible that we're over-estimating the number of dealers who would be interested in partnering with Credit Acceptance. The company has already grown from just 843 dealers in 2002, to close to 11,000 today. Our conversations with dealers lead us to believe the company can still double this number before growth starts slowing. However, a number of competitive factors can impact this and is something we're constantly re-evaluating.

Additionally, the risk of autonomous cars is real. Especially if this leads to a decline in car ownership rates, as people shift to ride-sharing, and the cost of ride-sharing becomes lower than that of car ownership for lower-income households.

In this scenario, it's likely that there will be scale benefits to owning large rental fleets, and the cars used by the likes of Uber or Lyft will be consolidated in the hands of a few large corporations. These corporations won't need subprime financing. Even though this is probably still a decade or more away, it's something investors should be watchful for. ■

INTERVIEW TWO: AVENIR CAPITAL

AVENIR
CAPITAL

continued from page 1

How would you describe your investment strategy?

Avenir Capital is an international, value oriented equity investment firm. Avenir follows a high conviction, research-driven investment process in seeking to deliver strong absolute returns. Avenir's investment strategy is underpinned by a background in private equity, and involves a high degree of selectivity in order to identify quality and growing companies which can be bought for significantly less than their intrinsic value. The investment process and risk framework seeks to provide a large margin of safety with the aim of minimising permanent capital loss and delivering superior absolute returns to investors.

How does Avenir go about looking for ideas?

We look for ideas from a wide range of sources that we have identified over time as having a higher probability of providing ideas that meet our criteria and are more likely to be of interest to us. There are many areas that we do not like to invest such as biotech, most commodity based business, fast moving technology, deeply cyclical business, etc. We also don't like industries with lots of competitors and undifferentiated products so we can reject many investment ideas very quickly. In fact, we spend most of our time saying no.

If a company makes it through the initial rounds of rejection, it means that it most likely has few competitors, a strong competitive position, operates in an attractive industry structure and has reasonable growth prospects. It also means that, importantly, there is a credible reason that we can identify as to why it is mispriced. We are value oriented and while we focus on quality businesses, it is important that they be mispriced for us to be interested in making them part of our portfolio.

An important way we differentiate ourselves is in our selectivity. We have roughly 15 companies in our portfolio and we invest with a 3-5 year time horizon so the bar to get into the portfolio is very high. We look at over 1,000 companies a year and 996 of those we are going to reject. We only need 3-4 ideas a year that meet our high standards and that are worthy of an investment to keep us happy.

“ *We look at over 1,000 companies a year and 996 of those we are going to reject. We only need 3-4 ideas a year that meet our high standards and that are worthy of an investment to keep us happy.*

How much of a factor is the company's management in your decisions?

Management is critical to our investment decisions.

We are long term investors and run a concentrated portfolio. The decisions and actions that management take will have a much greater impact on our returns than short term market movements. Given our private equity heritage, we also have a much greater appreciation than many of the power of incentives. We pay close attention to the track record of management in relation to capital allocation and operational performance. We are looking for a high degree of respect for shareholders and a very shareholder-oriented approach to the important capital allocation process.

Things we focus on include the degree of alignment between management and shareholders via true equity ownership (not just options), the mix of short- and long-term compensation and the metrics upon which management compensation is based.

Over the past five years, the gross value of your portfolio has grown at a compound annual rate of 17% per annum. To what would you attribute your success?

Selectivity, conviction and patience are the cornerstones of our investment strategy. We focus on buying quality companies that have competitively advantaged positions, underlying growth and are available at a material disconnect from their fair value. If we do not find something that meets these requirements, then we do not compromise and we patiently keep looking until we find opportunities that meet these high expectations.

You search for value all over the world so I'm interested to know in which market are you finding the most value today?

This year has seen global equity markets continue their relentless move upwards shrugging off ongoing geopolitical tensions, the near term prospect of higher interest rates and global central bank tightening, a host of natural disasters and ever higher valuations. The upward move by most indices serves to highlight the resilience and strength of what is the second longest equity bull market in financial history.

Many investors appear increasingly comfortable putting capital to work behind the "synchronised global growth" thesis that is holding sway over markets. And, while there is always plenty of noise to potentially upset markets, there is nothing imminent that can be pointed to as the catalyst that will bring the party to an end. Additionally, while the activity of investors does suggest a certain degree of complacency, there is not the feeling of euphoria or the completely reckless behaviour (with a few exceptions) that suggests we are in the midst of a bubble. Equity markets are, without question, high by historical standard but investors still, by and large, express an element of caution in their approach even if their actions somewhat run counter to that.

So, what to do in an environment where assets prices in general feel elevated and high by historical standards but we are not surrounded by the widespread euphoria that typically represents the final stage of a bull market and there is no obvious canary in the coal mine?

Well, we continue to do what we have always done which is to diligently and patiently look for those investment opportunities in which we can buy a partial ownership stake in a quality and growing business when we can do so at what we believe to be a material discount to underlying value. If we find one, we invest, and if we don't find one, we don't invest.

Are you holding back from the US or markets in general? What's your cash weighting?

We don't pay much attention to overall market valuations as we are very much a bottom-up manager. We only need to find a few new ideas a year to keep our portfolio positioned at a low price to value ratio. Currently, our portfolio is priced at about 65% of our view of underlying or intrinsic value. We have found that when the portfolio is priced at those levels the next few years tend to be very rewarding.

Despite that, many of the major markets around the world are fully priced and so we are being careful to maintain our absolute return discipline. We are very focused on absolute value and value compared to long-term historical norms rather than current relative valuations. It can be dangerous to consider a company mispriced simply because it is cheaper than its peers in the current environment of elevated asset prices.

With this framework in mind, we continue to look for opportunities in all markets but there is no doubt that the US is leading the pack in terms of fullness of valuation. For this reason, we are taking the opportunity to prioritise our idea generation and research activities in non-US markets although we have not forsaken the US entirely.

Our current cash weighting is about 15% of net assets which is not that unusual for us. Our cash position is simply an outcome of the flow of ideas we find that meet our criteria and the timing of sales of existing positions. We don't use cash weighting as a market timing tool.

In your last investor letter, you mentioned that you like the shares of HCA Healthcare. Could you go in a bit more in-depth on this investment case?

HCA is the largest hospital business in the United States, operating 177 hospitals, 46,000 beds, 69 freestanding surgery centres and a range of other medical facilities. The company trades at a low multiple of 7.0x EV/EBITDA. This is largely due to market noise in the United States around the repeal of the Affordable Care Act, better known as 'Obamacare'. We believe the worst case scenario of a full-repeal is more than priced in to HCA.

We are buying the company at a greater than 10% steady state free cash flow yield and we believe cash earnings per share can grow at double digit rates per year driven by an aggressive capital allocation policy focused on share buybacks. Since the IPO in 2011, HCA has generated $11.2bn free cash flow. Over the same period HCA has repurchased $9.9bn of shares (reducing share count by 21%), paid $3.2bn in special dividends and made $4.4bn worth of acquisitions. At the same time the company has reduced debt/EBITDA from 4.7x to 3.8x today.

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HCA's major for-profit competitors are in severe financial difficulty with unsustainable debt loads and are selling hospitals to buy themselves time to right the ship. We believe this will provide an attractive acquisition pipeline for HCA who have proven themselves very capable of materially improving the profitability of acquired hospitals.

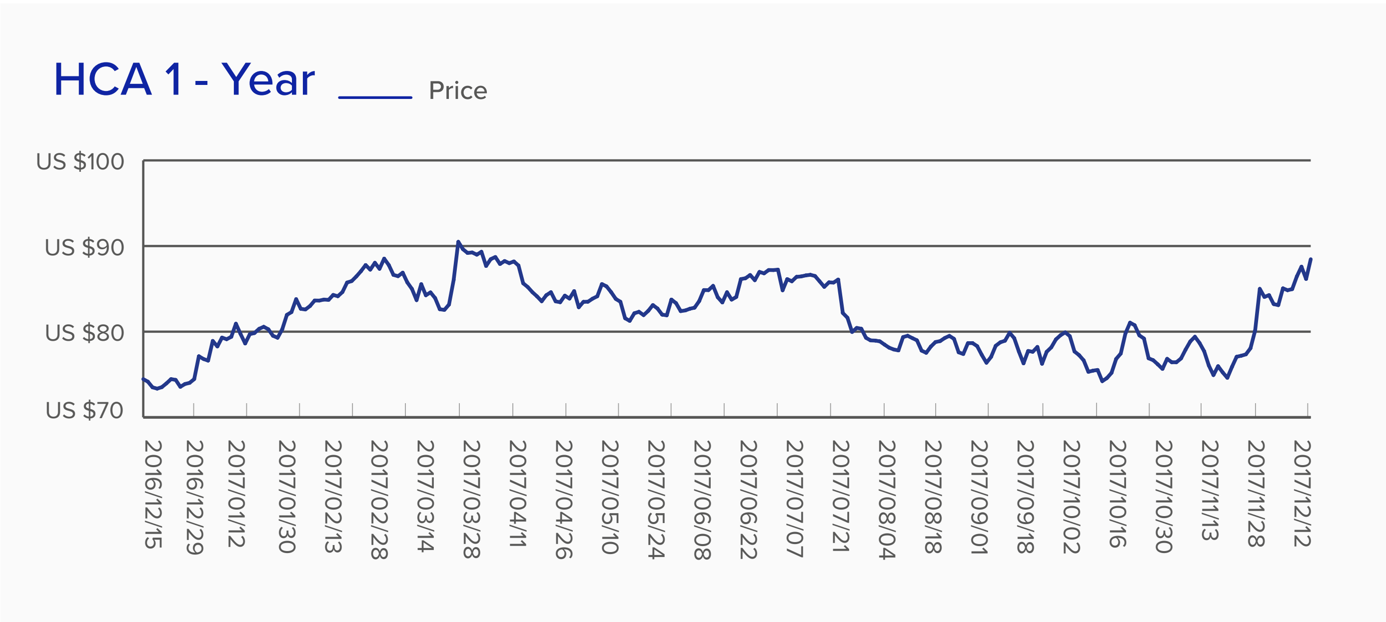
Are you worried about the impact any healthcare reform might have on the company?

While the noise (and tweets) around healthcare regulation is ongoing, we think the industry structure provides a lot more protection for HCA against adverse regulatory change than the market appears to believe. Almost 80% of hospitals in the US are not-for-profit and do not have making money as a prime reason for being. In fact, 30% of hospitals in the US are breakeven or worse at the operating profit level and the majority of the rest of the industry is only marginally profitable at best. It appears to be a case of not-for-profit by charter and not-for-profit by P&L.

Furthermore, HCA's major for-profit peers make EBITDA margins 40% lower than HCA and the two largest are heavily indebted following strategic and operational missteps over the past several years. In this industry environment, it is very difficult to make any material reduction in reimbursement rates without imperilling the majority of the hospital industry which is not something that anyone would want to see.

We also see some interesting tax optionality in the case of HCA. HCA is a material taxpayer at a roughly 35% tax rate. Should the Republicans proceed with the proposed tax reform, HCA would save a material absolute dollar amount of tax per year which, when spread over a declining share count, could boost earnings per share by 30% in 3-years even assuming no underlying growth in earnings. This would reduce the effective price we are paying from about 10.9x P/E currently to about 8.5x P/E.

It is another interesting element of this industry structure that 80% of the industry are not-for-profit and so largely tax-exempt and so will not receive any



tax savings. Also, the major for-profit peers make little pre-tax profit due to their much lower operating margins and high debt burden so they will not save any tax. In fact, the major for-profit peers may lose some of the deductibility of their excessive interest payments as currently contemplated in the proposed legislation so they may even pay more tax.

So, while in many industries, tax savings may ultimately end up in the hands of customers as companies compete the tax savings away, HCA is in the almost unique situation of being one of the few companies that would receive a material tax benefit and be able to retain most of it as very few others in its industry would receive the same tax saving. It does not take many guesses to work out what this management team would do should they find themselves with an extra $500-600m in free cash flow every year and their shares trading at an effective price of 8.5 P/E - they will be buying back even more shares.

> *It does not take many guesses to work out what this management team would do should they find themselves with an extra $500-600m in free cash flow every year and their shares trading at an effective price of 8.5 P/E - they will be buying back even more shares.*

With a company like HCA, what would make you decide to sell? Do you go in with a specified price target?

All companies purchased for the portfolio have a price target established at the time of investment, which reflects our assessment of underlying value. The portfolio will typically have a spread of companies at different stages of the investment thesis playing out.

As the security approaches our price target, a decision needs to be made as to whether to sell the security. Being a high-conviction, low turnover manager, Avenir does not trade on short-term price movements, but focuses on the fundamental investment case of the company and the relationship between market price and our current assessment of underlying value.

As the underlying value of a company increases, the price target will be continually reassessed to ensure it reflects the current forward-looking prospects for the business.

We will remove a company from the portfolio when its security price reaches our target price, the original investment case no longer holds or Avenir forms the view that better risk adjusted returns are available elsewhere.

Another company you mentioned in a previous letter is Spirit Airlines. What do you like about this business?

Spirit is the largest ultra-low cost airline carrier (ULCC) in the U.S. and makes industry leading margins by pursuing a disciplined and ruthlessly focussed ultra-low cost model. We acquired our position in Spirit right at the tail end of 2015 after the company's stock price had fallen over 50% from its high of $85 in late 2014.

Spirit has been facing strong price competition from legacy carriers along with dealing with the impact of

numerous natural disasters, such as hurricanes, in some of its key markets and an ongoing compensation dispute with its pilots. Declining profitability has led some to question the sustainability of its business model in a world in which the large, legacy carriers have adopted selective "basic economy" fare structures in order to stem the market share gains made by ultra-low cost carriers (ULCC's) such as Spirit.

We believe that the ULCC business model is still very much intact and that having a 35% cost advantage over your competitors is a powerful weapon that will ultimately allow Spirit to resume its rapid and profitable growth. Even in these times of heightened price competition, Spirit grew revenue in the first half of 2017 by 12.5% with operating income margins of 19% and a 17% return on equity. At the quarter end price of $33.41, Spirit trades at a P/E ratio of 9x our estimated earnings in 2019. At 14x 2019 earnings (the company's long-term average multiple) Spirit is worth over $50 per share and we believe the company has multi-year, double-digit earnings growth ahead of it.

Are you looking to buy more at current levels?

We currently have a full position in Spirit but as new money enters the fund it is certainly up for consideration for new capital at the current depressed price.

What's been one of your most successful investments in the history of the firm?

One of the largest contributors to the fund was Bank of America. The thesis for our investment in this large, well-known but, at the time, widely hated firm was that Bank of America was an undervalued business franchise with tremendous underlying earnings power.

Despite headlines exclaiming that Bank of America was the most hated company in America back in 2012 (at the time of our initial investment); we thought the price would return to tangible book value per share of $20. At the time, BAC was suffering depressed earnings in a low interest rate environment, higher expenses due to litigation/legacy mortgage issues and difficult investment banking markets.

We felt the risk of an investment in Bank of America was low as the company had been operating for several years post the global financial crises. The average tenure of a loan is only a few years and so we felt that most of the bad news had already been taken into account and loans made in the years immediately following the financial crises would have been of very high quality. Importantly, the banks low cost deposit base (the largest in the country) was growing so Main Street clearly still had faith in the bank.

The company was earning in the order of $1 EPS and was priced at 5-6x depressed earnings. BAC was extremely cheap on an absolute basis and relative to its history. We purchased BAC at approximately $5 per share and sold around $18 per share making almost 3.6x our money.

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And on the other side of the equation, what's been the firm's worst performing investment? What did you take away from the experience and did it cause you to change your investment strategy?

One of the largest detractors for the fund was an agricultural company which was a leader in its home and regional markets at the time of our investment. Prior to a range of macroeconomic issues arising, this company was the global low cost producer and had grown revenue and EBITDA by 15% per annum in the three years prior to investment. The company had just undertaken a massive capital expenditure program and had not yet received the benefit of the increased business volumes at greater margins that would result. We often find opportunities in these "capex behind you, growth in front of you" type-situations. The company had also just received approval to export to the European Union which was the largest importing region for its products.

At our purchase price, we were paying roughly 3.5x free cash flow which we felt was very attractive for the global low cost producer of a stable product with strongly growing domestic markets and new export markets about to open.

Ultimately the company was badly affected by geopolitical and macro issues well beyond our ability to predict. These issues led to a rapid decline in the company's home currency (following many years of stability) which caused our investment to decline materially in value. Largely based on this experience we no longer invest in countries in which we feel that macro issues, in which we have no particular expertise, have a higher than acceptable probability of overwhelming the company specific merits of an investment thesis.

Lastly, I'm interested to hear your thoughts on the current active/passive debate?

We think the active investment community is partly to blame for the growth of passive investment strategies. Many so-called active managers are really passive managers in disguise having portfolios made up of many stocks designed to closely mimic the index. There is nothing inherently wrong with this other than the fact that they have been charging fees on the basis of active management and not providing true active management. The fact that a low-cost passive investment community has developed to undercut them on price should not be all that surprising.

Passive investing always gains support in periods of strong equity markets. We are now in the second-longest equity bull market in history at over 8 years so it is not surprising that many people see passive investing as an entirely appropriate approach. There will come a time, however, when overall market returns revert to long-term averages that are less exciting. That is when the value of a well-constructed active approach will be clear.

There is still an important and valuable role to play for true active managers such as Avenir. With a very selective, concentrated and long-term approach we are confident we can outperform the indices as we have done since inception. ■

Avenir Capital: Stock Idea One

Your first stock specific idea is Hong Kong listed Clear Media. Can you give some background to this pick?

Clear Media is a leading outdoor media company in China. The company is the largest bus shelter advertising panel operator in China with a market share of 90% in top-tier cities (Beijing, Shanghai, Guanzhou, and Shenzhen) and 60% in many 2nd and 3rd tier cities. Clear Media has created a standardized bus shelter network covering regions across China with over 41,000 display panels.

Why do you believe the stock is undervalued?

When we made our investment in Clear Media the company was trading at an EBITDA multiple of 4x despite a 10-year track record of revenue and EBITDA growth in the order of 10% per annum. The company also had net cash equal to 30% of the market capitalisation at the time. The company's return on invested capital had been marching steadily up during this time from around 10% to over 20% as the company became increasingly dominant in its industry.

The company was trading very cheaply in an absolute sense and compared to its leading global peers such as JC Decaux, Clear Channel Outdoor, Outfront Media and Lamar Advertising which typically trade at 10-12x EBITDA.

This is still the case today with Clear Media trading at about 5x EBITDA compared to JC Decaux and others at closer to 12x.

We believe that Clear Media is undervalued relative to competitors due to:

- Concerns over a China slowdown;
- Limited analytical coverage with Morgan Stanley, Citi, Deutsche and Goldman Sachs discontinuing coverage over the last several years;
- Negative sentiment around other Chinese media companies due to frauds including China Media Express and Focus Media; and
- A lack of clarity over a catalyst that will lead to a rerating of the stock more in line with its global peers.

Over the past three years, it looks as if the stock has hardly budged. What has gone wrong here?

Although Clear Media, still trading at 5x EBITDA, has not materially re-rated more in line with its international peers, the company has still provided a positive return. A combination of an attractive purchase price, earnings growth and the mild rerating, along with healthy ordinary and special cash dividends, has led to a roughly 30% return to date. The share price got as high as HK$9.60 just a few months ago compared to the current HK$8.30 and we do not see any real reason for the current pull back.

George Soros once said "good investment is boring. If you are having fun you are probably not making any money." Clear Media falls into this category for us. Nothing much seems to happen but we still think it will deliver a nice return nonetheless.

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While we would like to see a full rerating of the business in line with international competitors we are willing to be patient. For many years, Clear Media has been 51% owned by the US listed company Clear Channel Outdoor (NYSE:CCO). While this has given us comfort over corporate governance, it has perhaps acted as a cloud preventing the company achieving a proper valuation as it hinders a clean market for corporate control.

Clear Channel Outdoor is a heavily indebted company and its majority parent, iHeartMedia (OTCPK:IHRT), also a US listed company, is even more indebted. We believe that Clear Channel Outdoor may be forced at some point to sell its holding in Clear Media in order to reduce debt and a properly conducted sale process could allow full value to be realised.

What's your outlook for the business?

We believe a combination of a growing market, barriers to entry and the benefit of increased digital outdoor media will allow the company to achieve mid to high single digit revenue growth and stable EBITDA margins. ▸

The company has a high and growing return on invested capital (ROIC) and increasing opportunities to reinvest in the business at high returns. The company is well financed with cash equal to 14% of the market capitalisation providing plenty of capacity to grow.

With this strong operational backdrop, we think an appropriate valuation for Clear Media is at least 9x EBITDA which is a material discount to the 12x at which comps currently trade. Assuming 6.0% annual growth in revenue and EBITDA per annum, which we believe to be achievable, a 9x EBITDA multiple yields a share price of HK$16 based on 2019 EBITDA or twice the current price.

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Does management own a large part of the company? Do they have a record of value creation?

Management own approximately 2% of shares outstanding. The company have proved their ability to continue growing the company, but without overpaying for assets, which we think is important. Historically the company has focused on paying ordinary and periodic special dividends, which we think is shareholder oriented and proves their commitment to shareholder value creation. Remember, the company is 51% owned by a very indebted parent for whom cash generation and dividend payments are very important.

Are there any pitfalls that could derail your thesis?

One of the attractions of Clear Media, along with most of our investments, is that it is hard to construct an outlook in which value is materially and permanently destroyed. The business can be somewhat cyclical and China may get into some economic difficulty at some point, but Clear Media is very well capitalised with net cash on the balance sheet, and the majority of Clear Media’s customers are large, growing and well capitalised businesses themselves.

So, even if the growth trajectory slows for a period, we don’t think we are overly exposed to a permanent loss of capital.

We have been shareholders in Clear Media since 2014. Although we have not yet seen the market price fully reflect the dominant and strengthening market position that Clear Media enjoys, as long as Clear Media continues to deliver high and growing returns on invested capital, reinvests in the business for profitable growth and periodically pays out excess cash to shareholders, we will continue to happily own the company. ■

Avenir Capital: Stock Idea Two

Your second pick is BBX Capital. This company has been on a strong run recently, so do you still see value in the shares?

BBX Capital has taken some important steps over the past 18 months. The company has favourably put SEC litigation behind them, simplified the corporate structure and uplisted to the New York Stock exchange. This has led to the company rising 54% this year.

On November 18th 2017, BBX listed 10% of the equity of the company's wholly-owned vacation ownership or timeshare business on the NYSE. This is a positive development to help to further highlight the undervaluation of BBX Capital.

Management took advantage of a favourable window of opportunity to list Bluegreen with the share prices of the major competitors (Marriot Vacations (VAC), Hilton Grand Vacations (HGV) and ILG (ILG)) up 55% - 65% YTD. The comps now trade on trailing EBITDA multiples of 15.7x, 12.9x and 14.3x respectively, and Bluegreen trades around 8.4x or an almost 50% discount to the average multiple of competitors.

There is also roughly $1 per share of various real estate assets offset by a $0.40 per share of net debt at the holdco that are unrelated to Bluegreen. This gives a combined value of $14 per share for BBX Capital compared to the current price of $8 per share or 75% upside.

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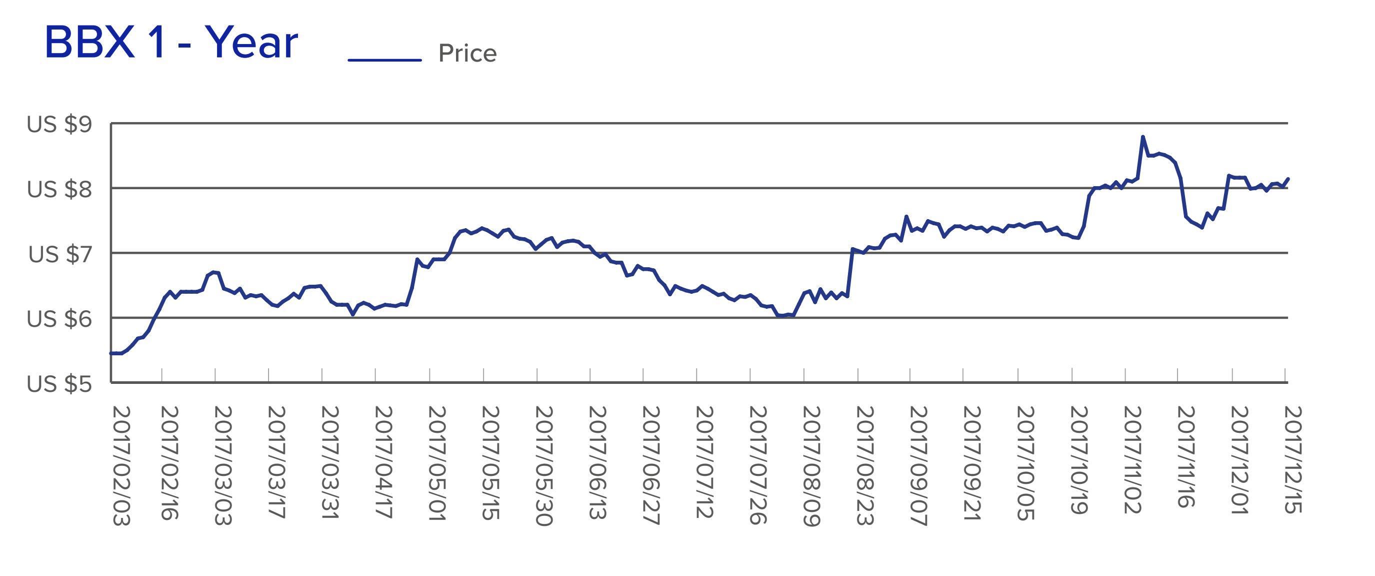
What's your investment horizon?

All of our investments are underpinned by what we believe to be first, a growing underlying or intrinsic value and, second, significant upside to what we regard as fair value. This allows us to be very patient because even if it takes longer than we anticipate to receive our reward, the reward will be large enough to still be very worthwhile.

Initially, when we invested in BBX Capital (at the time the company was known as BFC Financial), we expected certain catalysts to play out over 1-2 years. We have now owned the company for almost 4 years, so while things have taken longer than we expected, we have made a roughly 140% return to date as the management team have continued to deliver economic value and to take steps to have that value recognised by the market.

Throughout our ownership underlying value has



continued to grow and we now see fair value as roughly $14 per share. So, while we have already made 140% on our investment or 30% per annum, we still think there is material upside in the position. It may take more time to reach out target price of approximately $14, but as with our initial investment in BBX's predecessor company, BFC Financial, we are willing to be patient.

Could you give our readers a brief rundown of what the business does?

BBX Capital is made up of various businesses:

- A core operating business, Bluegreen, which operates a vacation ownership interests (VOIs) business. This business is performing well and generating strong cash flows;
- BBX Capital, which holds a range of real estate related assets; and
- Mid-Market, which is a selection of private equity-style, control investments in middle market operating companies.

Is management heavily invested?

Management of BBX currently own approximately 30% of shares outstanding, however the company's Chairman & CEO, Alan Levan, and the Vice Chairman of the company, John Abdo, own shares of the Company's Class A Common Stock and Class B Common Stock representing approximately 77% of the Company's total voting power.

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This can work in our favour as it historically has, with management taking initiative to create shareholder value – due to the management being large shareholders themselves. But we also see this as a minor risk, that a strategic or private equity buyer cannot easily seek to take control of the company. Additionally, it restricts our ability to easily take action to protect our interests should management start to act more in their own interests rather than in the interests of all shareholders – of which, fortunately, we see no evidence to date. ■

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