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Value Investor INSIGHT

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Prime Locations

A glance at Jeffrey Kolitch's top holdings wouldn't necessarily indicate his standing as Baron Capital's real estate expert. There's a flooring company, a wireless-tower operator, a home-improvement retailer and a leader in construction materials. "Our philosophy has always been that a broader, more-balanced approach would provide long-term benefit," he says.

That approach has worked nicely for the $1.0 billion (assets) Baron Real Estate Fund he launched in 2010, which has earned a net annualized 15.4%, vs. 13.3% for the S&P 500 and 11.6% for the MSCI U.S. REIT Index. Today he's finding particular value in such areas as real estate services, housing, aggregates and data centers. See page 2

Jeffrey Kolitch
Baron Funds

In to Win

After eight years on Wall Street, Clifford Sosin in 2012 concluded that to manage money as he saw fit – holding a handful of stocks, taking a long-term perspective and accepting the potential of high volatility – he needed to strike out on his own. "I try to maximize long-term compounding," he says. "I don't think that's what most of the investing industry is seeking to do."

So far, a sound choice. His CAS Investment Partners since October 2012 has earned an eye-popping net annualized 28.0%, vs. 12.6% for the S&P 500. Targeting companies with strengths he expects to persist far into the future, he sees value today in industries such as equipment rental, sub-prime auto loans and specialty restaurants. See page 7

Clifford Sosin
CAS Investment Partners

Nooks and Crannies

As a teenager in his native country of Belarus, Pavel Begun always had a business or two going, from selling strawberries, to distributing steel rebar, to publishing an accounting trade journal. None of those, however, had the makings of a career: "I lose interest unless I'm able to learn something new every day," he says.

After coming to the U.S. for college and later earning a University of Chicago MBA, Begun in 2003 concluded investing was his true calling. His 3G Capital, launched the next year, has since then earned a net annualized 11.8%, vs. 8.3% for the S&P 500. Today he and partner Cory Bailey see far-off-the-beaten-track opportunities in such diverse areas as banking, energy and underwear. See page 13

3G Capital
Pavel Begun, Cory Bailey

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Banrisul, CBRE, Cellnext, Charter, Cimpress, Herbalife, Home Depot, MGM Resorts, NEXTDC, Red Rock Resorts, Sherwin-Williams, Simon Property, Vornado Realty, World Acceptance

Investor Insight: Jeffrey Kolitch

Baron Funds' Jeffrey Kolitch describes why he pursues an "all-inclusive" approach to real estate investing, why he thinks the commercial and residential real estate cycles have further to run than many expect, why he's stepped up his research efforts outside the U.S., and what he thinks the market is missing in Vulcan Materials, InterXion and Mohawk Industries.

You cast a fairly wide net under the banner of real estate investing. Describe your opportunity set and why you've defined it the way you have.

Jeffrey Kolitch: The vast majority of real estate strategies in the public markets tend to limit their investments to real estate investment trusts [REITs], with a dividend orientation. There's certainly nothing wrong with that, but our more-inclusive approach better allows us to do what we think we do well as a firm, which is to invest in best-in-class companies that we can buy at reasonable prices and that we believe can compound value at high rates over long periods of time. It's a more-balanced approach we think can give us an edge over time.

What that means is that while we're active in traditional categories like office, apartment and industrial REITs, we'll also invest in real estate services companies, homebuilders, hotel companies, and gaming companies where real estate is at the core of the business. We'll invest in wireless-tower operators, essentially landlords of tower space, where the long-term demand drivers are much better than they are, say, for office space. We'll invest in construction-aggregates companies who own and manage very particular real estate – quarries – where location and local supply and demand are prime drivers of success. In residential real estate, we think broadly about those companies affected by sector trends, including home-improvement retailers and manufacturers of things like flooring, doors and paint.

Talk about some investable themes you're focusing on today, starting, predictably enough, with your take on where we are in the commercial real estate cycle.

JK: Real estate, in general, is clearly past the first or second inning of its recovery. That said, we don't believe it's in the ninth inning either. We're not seeing the warning signs that typically signal the end of a cycle, such as overheated economic and business growth, spikes in construction activity, relaxed lending standards, aggressive assumption of debt, seemingly euphoric market sentiment and an over-exuberance for acquisitions. Adding to our optimism that the cycle will last longer than most is the potential for what we'd consider pro-growth initiatives, including lower taxes, increased infrastructure spending and decreased regulatory burdens.

ON CYCLES:

Real estate is clearly past the first or second inning of recovery, but we don't believe it's in the ninth inning either.

If we're right that the cycle has a number of years to run, we think the market is overly negative today on companies like CBRE Group [CBG], the largest commercial real estate services firm in the world. It is a leader in nearly all its business lines, is expanding its market shares, is shifting its business mix more toward recurring cash flows, and has a vastly improved balance sheet. But the stock, which has historically traded around the market multiple, goes for only 13x forward earnings. If the cycle isn't about to roll over, we think that discount is highly unlikely to hold up.

Are you in the camp that says U.S. residential real estate has a tailwind from pent-up demand building up since the financial crisis?

JK: The analysis always starts with demand and supply, and we simply don't believe the housing demand/supply relationship is close to equilibrium. We're building approximately 1.1 to 1.2 million new homes per year, compared to a 60-year average of 1.5 million. That's happening with a U.S. population that is more than 90% higher than it was 60 years ago. You'll hear people say the market has fundamentally changed, but we don't agree. As families grow, they'll look for more space and the economic decision will in most cases argue for buying rather than renting. Absent a significant spike in mortgage rates, sixty years of history and basic demographics argue for a meaningful long-term rebound in residential housing starts.

Our bias to benefit from that is toward building products and services companies over traditional homebuilders. The builders generate revenue by selling new homes, while a Mohawk Industries [MHK] which makes flooring, or a Sherwin-Williams [SHW] that makes and sells paint, or a Home Depot [HD] that sells a lot of home-related items, will also benefit from sales of existing homes and as people invest in their houses as values appreciate. We find such companies to be a better way to tap into improvement in the housing market.

You wrote in a recent letter about being bullish on Las Vegas. What kinds of opportunities does that present?

JK: We consider Las Vegas the hotel market with perhaps the most favorable supply/demand characteristics in the U.S. There has been no new hotel-room construction on the Strip since 2010 and the number of rooms is expected to remain flat through 2019. At the same time the Las Vegas market is showing increased business-group and convention activity along with good consumer demand on the leisure side. Part of that is due to affordability – the average daily rate for hotel rooms on the Strip last year was 30% below the combined average in New York, San Francisco, Los Angeles, San Diego and Chicago – which should still be intact even if Strip room rates rise as we expect.

We're also optimistic about the prospects for hotels and casinos catering primarily to the growing number of Las Vegas residents. No new major gaming facilities have opened for "locals" since 2009 and no new developments have been announced. That also bodes well for the supply/demand economics.

We own positions in both global and regional players that should benefit from Las Vegas's growth but we don't believe are valued accordingly. If we isolate the Las Vegas assets of MGM Resorts [MGM], for example, they appear to be trading at 8-9x EBITDA while private-market comps are typically in the low- to mid-teens. On the smaller side, we see value in a company like Red Rock Resorts [RRR], which has some 80% of its business in Las Vegas.

Are you active outside the U.S.?

JK: Since the Fund launched at the end of 2009 we have primarily invested in U.S.-domiciled companies. But over the past year or so we've broadened our geographic focus to try to take advantage of the increased growth potential, more-accommodative central-bank support and more-attractive equity valuations we're seeing outside the U.S.

Last quarter we invested in two new non-U.S. companies in sectors we know a lot about and on which we're quite bullish. One is Cellnex Telecom [Madrid: CLNX], a European wireless-tower company with operations in Spain, Italy, the Netherlands, U.K., France and Switzerland. As we think about megatrends and sustaining opportunities, we're very high on the tower companies, for which secular demand drivers are accelerating against a backdrop of limited supply. We think Cellnex, with its strong balance sheet and its management's record of prudent capital allocation, can double its tower footprint in Europe over the next several years as the industry consolidates.

Our other recent non-U.S. investment is NEXTDC [Sydney: NXT], an Australian data-center company. We expect multi-year secular growth in things like cloud computing, digital video, information-technology spending, Internet adoption, wireless-data usage and corporate IT outsourcing to keep demand on the right side of supply and benefit data-center providers. Buying into NEXTDC, which we think can double cash flow over the next few years with little incremental capital spending, allows us to build out our exposure to the sector.

ON NEW OPPORTUNITY:

In the past year we've broadened our geographic focus to take advantage of potential we're seeing outside the U.S.

On the secular-headwind front, your recent exits from Simon Property Group [SPG] and Vornado Realty Trust [VNO] would indicate concern about exposure to U.S. retail.

JK: These are both extremely well-managed companies, but we don't think the headwind from an oversupply of retail space at a time when people are increasingly buying online is going to go away any time soon. With a number of attractive opportunities elsewhere, these two positions were a logical source of funds.

Explain why Vulcan Materials [VMC] fits with your strategy and why you're so high on its prospects.

JK: Vulcan is the nation's largest producer of construction aggregates like crushed stone, sand and gravel, and is also a major producer of construction materials such as asphalt and ready-mixed concrete. It essentially owns high-quality real estate – in the form of more than 330 active quarries located mostly in strong-growth markets – and profits from it by processing and selling needed materials used in public-infrastructure projects and in residential and non-residential construction. According to Moody's, roughly 75% of the population growth in the U.S. over the next decade will occur in states where Vulcan operates.

The aggregates business has a number of long-term virtues. Permits for new quarries are difficult to obtain and the approval process can take five to ten years, discouraging competitors to take on new markets. Due to steep transportation costs of high-weight cargo, local monopolies are common, which is of incremental benefit to companies like Vulcan with entrenched positions in good markets. All this translates into consistent pricing power: over the past 30 years, aggregates prices have increased an average of 4% per year.

What makes Vulcan's prospects particularly attractive today is that the three key demand drivers for its business – government spending on infrastructure projects, residential construction levels and non-residential construction levels – are all moving in the right direction. We see a long runway for growth as the company's aggregates' shipments, which last year were around 180 million tons, continue recovering toward the prior annual peak of just over 300 million tons.

Are you relying on Congress to pass new infrastructure-spending legislation?

JK: Legislation has already been enacted that will positively impact Vulcan's public-construction business, which accounts for nearly half its revenues. The Fixing America's Surface Transportation Act (FAST) was passed in late 2015, providing multi-year funding to state and local governments for roads, bridges and public-transportation projects. This bill increases annual federal funding for such projects from $40 billion in 2015 to $47 billion by 2020. There's typically a 12-to-24-month lag between when a bill is passed and when the money starts flowing, so we are just starting to see the impact on spending.

California has enacted an infrastructure bill that provides $50 billion in spending over ten years through 2027. The state is a very important market for Vulcan, accounting for 15% of revenues, and we estimate the company's EBITDA will grow by an incremental 5% annually over the next several years just from this bill.

Finally, the Water Infrastructure for Improvements to the Nation Act, signed into law at the end of last year, authorized nearly $16 billion in federal funding for projects to upgrade harbors, locks, dams, drinking-water infrastructure and flood protection. Vulcan is well positioned to benefit from that spending as well.

These bills have nothing to do with President Trump's promise of a large federal spending bill. We aren't counting on it, but if something like that did happen it would obviously be good news for Vulcan.

How are you looking at fair value for the stock, now trading at around $119?

JK: Management a year ago presented a credible path to doubling the company's cash flow over the next five years, without relying on big federal infrastructure legislation. The plan calls for mid-single-digit annual volume growth, mid-single-digit annual price increases and 60% incremental margins. With that math, assuming the weather cooperates, EBITDA can grow close to 20% annually. We recognize the short-term trends are likely to be negatively impacted by the recent hurricanes in Texas and Florida, but within five years, assuming no change in the current 14x EV/EBITDA multiple, we think the shares could be worth at least $200.

Describe another of your non-U.S. investments, in Europe's InterXion [INXN].

JK: InterXion owns and operates nearly 50 data centers across Europe, strategically positioned near key city centers such as Paris, London, Frankfurt and Amsterdam. It's structured as an operating company not a REIT, which may bother investors focused on dividends, but doesn't bother us in the least.

Our enthusiasm for the company stems from a number of factors. Europe is at an earlier stage in outsourcing information technology, so the data-center market there is growing approximately twice as fast as it is in the U.S. Estimates put the outsourcing of information-technology workloads at 10-20% in Europe, compared to 30-40% in the U.S. Competitive barriers to entry are high, as it can take up to four years for a new entrant to obtain approvals to build a data center, and heterogeneous markets present challenges due to different languages, tax regimes and permitting processes. InterXion and Equinix [EQIX], which we also own, are the only two companies with a pan-European footprint and that hasn't changed in more than a decade.

InterXion also has plenty of growth upside from continuing to build out its portfolio and from increased occupancies and rents. It has a highly capable management team to allocate capital wisely to internal development or acquisitions. In the end, we wouldn't be surprised if the company itself became an attractive acquisition candidate for larger global players looking to expand in Europe.

Data-center markets have been prone to oversupply in the past. How do you assess that risk here?

JK: We're razor-focused on this issue, but actually see the potential for a more rational environment going forward. Ten-

INVESTMENT SNAPSHOT

Vulcan Materials
(NYSE: VMC)

Business: U.S. supplier of construction aggregates such as gravel and crushed stone, with more than 330 quarries that serve 75% of the country's fastest-growing markets.

Share Information (@9/28/17):

Price	**119.12**
52-Week Range	105.71 – 138.18
Dividend Yield	0.9%
Market Cap	$15.76 billion

Financials (TTM):

Revenue	$3.70 billion
Operating Profit Margin	17.5%
Net Profit Margin	11.3%

Valuation Metrics
(@9/28/17):

	VMC	S&P 500
P/E (TTM)	38.3	24.2
Forward P/E (Est.)	24.5	19.1

Largest Institutional Owners
(@6/30/17):

Company	% Owned
Vanguard Group	10.1%
State Farm Inv Mgmt	9.6%
T. Rowe Price	6.5%
BlackRock	4.6%
State Street	4.2%

Short Interest (as of 9/15/17):

Shares Short/Float	2.6%

VMC PRICE HISTORY

THE BOTTOM LINE

The key demand drivers for the company's competitively advantaged, high-barrier-to-entry business are all moving in the right direction, says Jeff Kolitch, who believes that can translate into 20% annual EBITDA growth over the next five years. Assuming today's 14x EV/EBITDA multiple persists, he thinks the stock by then could be worth at least $200.

Sources: Company reports, other publicly available information

ants have become more sophisticated, requiring data-center operators to offer a broader suite of services over a wider available range of geographies. We expect that to help contain new construction relative to prior cycles. So far, that appears borne out by InterXion's high pre-leasing levels – at the beginning of this year it had customer commitments on approximately two-thirds of the capital it was planning to deploy.

The stock doesn't appear to have eluded the market's attention. What upside do you see from today's $49.75 price?

JK: Consolidation in the data-center industry has accelerated in the last two years. Digital Realty Trust earlier this month closed on its acquisition of DuPont Fabros for almost 19x 2018 EV/EBITDA. Based on that type of comp, we believe InterXion, which has a far superior platform, is worth at least 20x EV/EBITDA, which on our 2018 estimates would result in a share price of $70.

If the company continues along its organic growth path by selectively building out and leasing up its existing footprint, we believe it can increase annual EBITDA by 50% over the next three years. On top of that, we estimate that through development it can increase its data-center footprint by an additional 25%, which translates into an almost doubling of annual EBITDA in approximately five years. With that type of growth, the stock price should move materially higher.

We're not overly fixated on the possibility of a takeout, but we do believe company CEO David Ruberg will act in the best interest of shareholders. He created tremendous shareholder value when he built Internet-infrastructure company Intermedia Communications through the 1990s from $1 million to $1 billion in revenues, eventually selling it in 2000 for around $3 billion.

Describe your broader investment thesis for global flooring manufacturer Mohawk Industries.

JK: Mohawk is the worldwide leader in almost all flooring categories, including carpet, ceramic tile, laminate, wood, vinyl and stone. In addition to considering the company a prime beneficiary of the positive cyclical trends we see both in housing and non-residential construction, we also think it's poised to continue to benefit from a years-long investment program. Since the beginning of 2013, it has invested on the order of $6.5 billion on acquisitions that extend its geographic and product reach, and on internal initiatives to increase capacity, upgrade equipment and broadly reengineer its products and processes.

These investments have already begun to bear fruit. Mohawk's annual revenues, at $5.8 billion in 2012, now exceed $9 billion. More importantly, EBITDA margins have increased from 11.7% in 2012 to more than 19% last year, and we believe they can continue to grow from here. We also like that the company still has plenty of dry powder to continue to invest in order to consolidate its position. The cash-generative nature of the business model has funded the recent-year investments without putting a chink in the balance sheet, as net debt to EBITDA is still less than 1.5x.

INVESTMENT SNAPSHOT

InterXion
(NYSE: INXN)

Business: Operates, maintains and services cloud and carrier-neutral data centers, serving more than 1,600 customers located in population centers in 11 European countries.

Share Information (@9/28/17):

Price	**49.78**
52-Week Range	32.21 – 52.15
Dividend Yield	0.0%
Market Cap	$3.54 billion

Financials (TTM):

Revenue	$541.4 million
Operating Profit Margin	21.8%
Net Profit Margin	9.2%

Valuation Metrics
(@9/28/17):

	INXN	S&P 500
P/E (TTM)	72.5	24.2
Forward P/E (Est.)	56.6	19.1

Largest Institutional Owners
(@6/30/17):

Company	% Owned
Eminence Capital	6.7%
Principal Global Inv	5.1%
Echo Street Capital	3.5%
Norges Bank Inv Mgmt	3.3%
Rivulet Capital	3.1%

Short Interest (as of 9/15/17):

Shares Short/Float	1.4%

INXN PRICE HISTORY

THE BOTTOM LINE

The data-center company should benefit as European information-technology outsourcing moves closer to current levels in the U.S., says Jeff Kolitch, allowing it to more effectively utilize as well as expand its footprint. Based on buyout values in the consolidating industry, on his 2018 estimates he believes the shares today are worth at least $70.

Sources: Company reports, other publicly available information

The company's growth aspirations would appear rather audacious. What type of growth are you expecting?

JK: Management has said they want the company to win 25% of its collective $300-billion global market, which, as you say, sounds pretty audacious given the 3% collective share today. It sounds a little less out there compared to the company's 24% share of the U.S. flooring market, but our base case is for the business over the next several years to grow organically at a mid-single-digit rate. With operating leverage, continued synergies from prior acquisitions and continuing benefit from process reengineering and future investment, we're expecting low-teens annual growth in EBITDA.

How cheap do you consider the shares at today price of around $248?

JK: The shares trade at 10.5x EV/EBITDA on our 2018 estimates, which is a discount to other high-quality building-product companies that trade at 12-13x EBITDA. Our base case assumes no multiple expansion, which would translate into a high-teens annual total return on the stock after adding in the free-cash-flow yield. In our bull case, the company continues to reinvest in the business at attractive rates of return – driving closer to mid-teens annual growth in EBITDA – and the market rewards it with a one-turn increase in the multiple. In that scenario, our annual return on the shares over the next few years would be closer to 30%.

Do you have a view on interest rates that's reflected in your portfolio?

JK: We generally don't try to make macroeconomic forecasts, but because real estate tends to be a more highly leveraged asset class, the pace of change and the ultimate level of interest rates can have a significant impact on real estate operations and ultimate asset value. Our working assumption is that decent global economic growth and some pullback in the Federal Reserve's accommodative stance are likely to push rates a bit higher over the next few years. At the margin, then, our portfolio probably has a bit more of a growth bias to economically sensitive companies and to shorter-lease-duration real estate. We see this as a key advantage of our broader mandate – we don't have to be as exposed on the downside as traditional real estate managers might be if interest rates don't stay at generational lows.

You mentioned earlier the potential for pro-growth governmental policies lengthening the real estate cycle. How strong is your conviction on that front?

JK: The President campaigned on themes that appear more pro-business and pro-economic growth, so we're not excluding the possibility of things like tax cuts, a federal infrastructure-spending bill and fewer bank and business regulations. If the economy directionally continues to improve and interest rates move up a bit, generally speaking that should be a bullish environment for stocks and more of a bearish environment for bonds. But clearly no one has a crystal ball on how things are going to unfold – maybe more so today than ever. VII

INVESTMENT SNAPSHOT

Mohawk Industries
(NYSE: MHK)

Business: World's largest flooring manufacturer, with leading positions in the U.S., Europe and Russia and across categories including carpet, tile, laminate, stone and vinyl.

Share Information (@9/28/17):

Price	**248.08**
52-Week Range	175.52 – 259.91
Dividend Yield	0.0%
Market Cap	$18.44 billion

Financials (TTM):

Revenue	$9.15 billion
Operating Profit Margin	14.5%
Net Profit Margin	10.5%

Valuation Metrics
(@9/28/17):

	MHK	S&P 500
P/E (TTM)	5.0	24.2
Forward P/E (Est.)	16.8	19.1

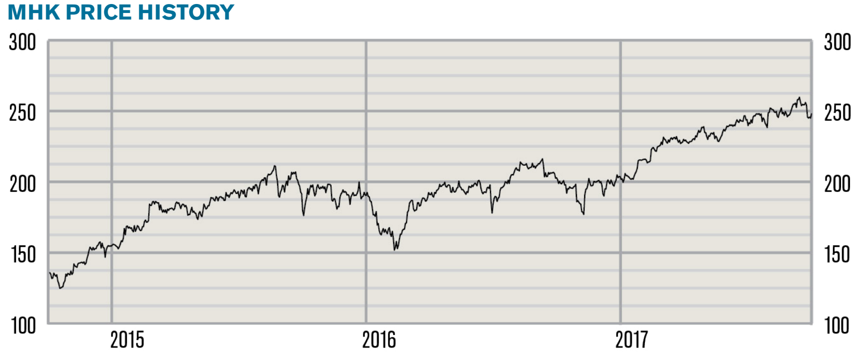
Largest Institutional Owners
(@6/30/17):

Company	% Owned
Vanguard Group	8.3%
JPMorgan Inv Mgmt	6.1%
BlackRock	4.0%
State Street	3.7%
Fidelity Mgmt & Research	3.5%

Short Interest (as of 9/15/17):

Shares Short/Float	1.5%

MHK PRICE HISTORY



THE BOTTOM LINE

Jeff Kolitch believes the company will benefit from positive trends in housing and non-residential construction and from a large investment program that has expanded its footprint and reengineered its operations. His base case for the stock assumes low-teens annual EBITDA growth translating into a high-teens total annual return over the next few years.

Sources: Company reports, other publicly available information

Investor Insight: Clifford Sosin

Clifford Sosin of CAS Investment Partners explains how he handicaps companies' very-long-term success, why he lets what interests him serve as a primary guide to the new ideas he pursues, the added precaution he's taking to better respond to trouble, and why he sees significant upside in Ashtead Group, Credit Acceptance and Fogo de Chao.

You describe your strategy succinctly as looking for businesses you understand that you can buy for less than they're worth. What does "understand" mean to you in this context?

Clifford Sosin: When we think about understanding a business, we follow the scientific method insofar as we look for general theories and mental models that might explain what's going on in the business, apply those models to make predictions about how the business works, and then look for actual evidence that supports or disproves the predictions.

I'll give you a simple example. We owned Mattress Firm, the largest retailer of mattresses in the U.S. The key element of the hypothesis was that in mattress retail, local scale is a winning strategy, driven by the efficiency of marketing spending. To test that hypothesis, we looked to see if there was a positive, non-linear relationship between store density on the one hand and brand awareness and store profitability on the other. Our prediction was supported by real-world data, reinforcing our view that by increasing its density, Mattress Firm became an increasingly formidable competitor, which made it harder for smaller competitors to compete, which allowed it to further increase its density. This effect – getting better as it got bigger – led us to take an investment position. [*Note*: Mattress Firm was purchased last August for $2.4 billion by South Africa's Steinhoff International.]

Another example using a current holding would be Credit Acceptance [CACC], which makes subprime auto loans through automobile-dealer partners. About one-third of Americans have bad credit and just about everyone needs a car. Unfortunately, subprime auto lending is a difficult industry where the most optimistic – i.e. foolish – competitor sets lending rates for everyone else. But in an industry where the average lender earns less than 3% unlevered pretax returns on assets, Credit Acceptance earns nearly 20% and does so while taking far less risk. The key questions, which we try to use mental models to understand, are how can they do that and can they continue to do that?

One important issue is incentives. In traditional subprime auto lending, lenders compete to buy loans from dealers. After the sale, dealers have no economic exposure to the loan, so are motivated to steer the buyer into the worst car at the highest possible price and then convince some lender to buy the loan, even if that means pushing the limits of honesty.

> **ON NEW IDEAS:**
>
> **If you're going to study something and think a lot about it, it has to be something you actually enjoy learning about.**

CACC, on the other hand, partners with dealers according to an 80/20 split, where the dealer gets 80% of the total collections on the program loans, some paid up front, the rest paid as collections are made. In this model the dealer takes most of the risk and does best by steering the buyer to reliable transportation at a price and payment he or she can afford. Our theory about the power of incentives would predict that the CACC model should produce better economics. Sure enough, loans made through its programs perform better, benefitting dealers and, of course, CACC.

The business also benefits from economies of scale in the technology platform, in underwriting, and in sales and support, and the best dealers tend to renew at a high rate. All this contributes to our view that this company has a powerful competitive advantage that can produce superior results far into the future.

That's what we're trying to find: businesses where we can identify why the company has been successful and why its success should last a long time. Ultimately companies' revenues, profits and returns are a reflection of the magnitude of its economic advantage. If a business has a large opportunity and has meaningful, diverse and growing advantages over its competitors – and we're able to own it at a reasonable-to-cheap price – it's fair to think that over many years it will leverage those advantages to get bigger and make a lot of money for the benefit of shareholders.

What tends to attract your interest in a potential idea?

CS: We actually let what's interesting be a big guide. If you're going to study something and think a lot about it and then own it, it has to be something you enjoy learning about. There are enough ideas out there to focus just on those.

We for years have owned Cimpress [CMPR], which was originally named Vistaprint. The company makes custom-printed products like business cards, pamphlets, t-shirts and mugs, and because of its size receives large quantities of heterogeneous orders which it can sort into still-large homogeneous work orders that can be efficiently executed. It benefits from economies of scale in a business that is highly fragmented and which we think will remain highly relevant to small-business marketers well into the future. There's a lot of interesting research in psychology about how people like things that are familiar, so putting your brand logo on shirts and pens and hats can really impact purchase behavior.

I've always found this company interesting. The problems are hard and the company is always evolving, but the pace of change and the basic goals are stable enough that any insights we have can be useful and enduring. It just draws me in.

We also like to look at businesses that should be crummy but aren't. At first blush you wouldn't think construction-equipment-rental companies like United Rentals [URI] and Ashtead Group [London: AHT] would have enduringly high margins and high returns on capital, but they do. It took a few years, but eventually we believe we figured out why these businesses are so good (more on that later). It has been an interesting, enjoyable and profitable puzzle to solve.

Anything recently you thought might be interesting but wasn't?

CS: After its stock fell sharply earlier this year I spent some time on Revlon [REV], the cosmetics company, and just couldn't bring myself to care. I find brands that make people feel good about themselves potentially very interesting, as that can be a powerful motivator to keep buying the product. With makeup that generally doesn't seem to be the case. If it were, the business wouldn't be as dependent as it seems to be on the latest new-product introductions. If the business' future success was a consequence of new-product innovation, I found that less interesting to think about and I didn't have much in the way of insight to bring to the topic.

Your portfolio has had a fair representation – Herbalife [HLF] and World Acceptance [WRLD], to name two – of companies that have been popular shorts. Is that a coincidence?

CS: Investing in highly shorted companies is not something we systematically pursue, although I certainly don't mind investing in companies that others dislike. We're looking to buy into great businesses with bright futures at very cheap prices and the market doesn't usually offer those up. There typically have to be reasons why a shareholder would choose to sell us their shares at what we think is the wrong price. Those same reasons can make people want to take short positions as well.

With Herbalife, we're fully aware of the arguments that Bill Ackman and others have made, but think they're just plain wrong. Once past those concerns, we see the company benefiting from two powerful motivators of human behavior. First, its business model has an incentive structure designed to attract, motivate and retain talented salespeople and entrepreneurs. Second, maybe less obvious, we think the business thrives in no small part because it fosters a belief system or community. People join because they want to lose weight and live a healthy, active lifestyle. They commit to doing that by joining. They get reinforcement from the community to achieve their goals. They provide reinforcement to others, and as they have success they share the message and look to grow the community. This system of motivation is in many ways similar to how religious organizations, volunteer fire departments or political movements operate. So Herbalife has two motivating drivers working together, the combined impact of which has produced tremendous results in many markets over a long period of time.

ON DISLIKED COMPANIES:

It's not something we systematically pursue, but I certainly don't mind investing in companies others dislike.

With World Acceptance, the leading installment lender to individuals in the U.S. with bad credit, we don't see a company preying on society's most vulnerable to turn ill-gotten profits. While World turns down 50% of its loan applicants, it provides much-needed cash to the other half, most of whom are in dire financial situations and have no alternatives. Nearly 80% of its borrowers ultimately repay their loans and exit the relationship, with World reporting that to credit-rating agencies, helping these individuals rebuild their credit. There is a technical and detailed legal and regulatory rabbit hole we could go down here, but in general you're much more likely to do well with the authorities in our society if you contribute to the social welfare, and we think World Acceptance and similar lenders are very good for society. That makes us willing to underwrite the risk of regulatory challenge.

The company's enduring economic advantage comes from its relationships with its customers. World employees have an average tenure with the company of five years and live in the communities they serve. Given their credit situation, borrowers feel they will be treated more fairly by World than they might be elsewhere. Nearly 40% of new lending volume is from former borrowers, who have proven to be better credits, and a large chunk of the remaining new volume comes from referrals from previous or current customers. This dynamic has served World well and driven its remarkable financial success over the past 55 years.

World's shares haven't done much over the past five years. Is your thesis still intact?

CS: Our returns have been helped because we increased our position by 50% in 2015 after the stock price had been cut in half. That said, this is a riskier investment for us and the outcomes haven't matched what we forecast five years ago. Prior management was slow in modernizing the business – the website didn't provide information on where to find a store until 2014, for example – which has had a negative impact on growth. We believe those issues have largely been addressed and that earnings growth going forward will be a good deal faster than over the past five years.

You've held five to eight positions at a time since starting your firm. Why that level of concentration?

CS: If you could be the world expert on 10 stocks and own the best combination of six or seven of them at any given time, you'd likely do pretty darn well over time. We follow more stocks than that, but there's an element of what we do that looks like that.

We obviously try very hard to make investments where we think the probability of total loss is negligible. But to arrive at the lower bound of stocks to hold, I think about how much I'd be willing to own of something that could go to zero. Would I hold 50% in such a position? No. But I could hold a 25% position that goes to zero and still feel that we could perform well enough over five, ten or more years to recover from that and still put up attractive returns. Based on this, four positions would be our lower bound while still being fully invested.

As to the upper bound, the benefit of having fewer holdings is that you can concentrate on the ones you think are truly great. That's usually meant our holding around six or seven positions.

How do you think about valuation?

CS: The conceptually right way to think about valuing a company is to do a discounted-cash-flow analysis. The challenge of that is that DCFs are highly assumption-laden and lend themselves to overly precise, overly confident estimates that can contribute to bad decision-making.

We don't just have one valuation method, but at some point we're putting pencil to paper and making estimates about what the company with the market opportunity and competitive advantages we see can do over the next five years or so, and then what the stock might be worth under various scenarios. The range of outcomes tends to be wide, but that allows us to estimate the long-term compound return potential we have from the current share price. Our goal is to be invested in stocks that maximize our overall long-term compound returns.

Describe in more detail your investment case today for equipment-rental company Ashtead Group.

CS: The company offers a wide selection of rental equipment, consisting of things like manlifts, small earth-moving equipment, generators, light towers, pumps and hand-held tools. It is the largest equipment-rental company in the U.K. and is the #2 player behind United Rentals in the very fragmented North American market, where it operates under the brand Sunbelt Rentals.

The core element of the thesis is the observation that economies of scale are really important to the business. Ashtead competes on product range and availability, level of customer service, and ability to service large national accounts. The bigger player has significant advantages in all these areas, has greater bargaining power with equipment manufacturers, and can generate higher utilization rates on its equipment inventory. That all translates into higher returns on capital, which over time allows Ashtead to add more branches and equipment categories, purchase a larger equipment fleet and acquire its smaller competitors. As a result, we see its North American market share doubling in 10 years, from 8% today. It was 2% in 2007.

There is also, due to the multiple economic benefits of renting, an ongoing secular shift from equipment ownership to equipment rental. In North America, about 50% of equipment is rented, compared to 30-40% 10 years ago. The U.S. rental level is still well below the European norm, where 80% to 90% of equipment is rented.

INVESTMENT SNAPSHOT

Ashtead Group
(London: AHT)

Business: Offers for rent a variety of construction and industrial equipment through company-owned stores located primarily in the United Kingdom, U.S. and Canada.

Share Information
(@9/28/17, Exchange Rate: $1 = £0.74):

Price	**£18.03**
52-Week Range	£12.02 – £18.28
Dividend Yield	2.5%
Market Cap	£8.79 billion

Financials (TTM):

Revenue	£3.36 billion
Operating Profit Margin	27.5%
Net Profit Margin	15.9%

Valuation Metrics
(@9/28/17):

	AHT	S&P 500
P/E (TTM)	18.0	24.2
Forward P/E(Est.)	13.6	19.1

Largest Institutional Owners
(@6/30/17):

Company	% Owned
Harris Assoc	5.0%
Abrams Bison Inv	5.0%
Standard Life Inv	5.0%
Legal & General Inv Mgmt	2.7%
Vanguard Group	2.6%

Short Interest (as of 9/15/17):

Shares Short/Float	n/a

AHT PRICE HISTORY

THE BOTTOM LINE

Cliff Sosin believes the company can double its North American market share over the next ten years, which combined with other factors could lead to annual EPS growth of some 20% per year. If he's right and five years' out the stock's P/E increases to around 17x, his estimated annual percentage return on the shares would be in the mid-20s.

Sources: Company reports, other publicly available information

Does the cyclicality here worry you?

CS: End demand for rental equipment is obviously cyclical for non-residential construction and for industrial applications, but I'd argue that investors overestimate the impact of the economic cycle on Ashtead. As demand falls due to an economic slowdown, competitors with thinner margins suffer much worse than Ashtead and are forced to purchase less fleet. Rental assets have a seven-year average life span, so as competitors stop buying, supply and demand comes back into equilibrium relatively quickly. In weak economies like 2002-2003 and 2009-2010, equipment-rental prices and utilization rates began rising even as demand for non-residential construction was declining. In a normal slowdown we'd expect Ashtead's profits to fall 50% for about one year and then recover the next year. At those times we'd also expect them to have increased opportunity to buy struggling competitors at attractive prices.

How attractive do you consider the stock at today's price of £18?

CS: We view this as a long-lived business with much-below-average risk of disruption or obsolescence. If the company doubles its market share over the next 10 years, that would translate into about 7% annual top-line growth. We also expect the market to grow in line with nominal GDP, or roughly 4% per year. Factor in another point or two from expanding rental penetration and the company's organic growth rate should be in the low teens. What's more, since the returns on tangible capital are high, it can maintain that growth while deploying nearly 90% of its profits to bolt-on acquisitions, share repurchases or dividends. Taken together, we think earnings per share can compound at nearly 20% per year.

For that we're paying at today's share price around 13.7x next year's estimated EPS of £1.32, well below overall-market multiples. With our earnings-growth assumptions, if the stock in five years sold at maybe 17x earnings, our annualized percentage return over that time would be in the mid-20s.

You described earlier the virtues you see in auto-lender Credit Acceptance. Why has its model proven difficult to replicate?

CS: Over the years many competitors have tried and failed. The most recent high-profile attempt was GO Financial, which was partly funded by a division of Cox Enterprises and shut down in 2016 after five years. What CACC does isn't easy. Hiring and training a sales force to sign dealerships to the network and then supporting those dealerships as they try to make it work is an expensive and complex challenge. Dealerships are resistant to change and many can't adapt to working within CACC's guidelines – nearly two-thirds of the dealers who sign up drop out in the first five years. Finally, any competitor to take business needs to offer better terms than CACC, and because they don't have the experience and scale that often means poor financial performance as they try to get up to speed. The barriers to entry have proven to be quite high.

How well do you expect CACC to weather downturns?

CS: When market conditions worsen, availability of credit declines and the

INVESTMENT SNAPSHOT

Credit Acceptance
(Nasdaq: CACC)

Business: Offers, underwrites and services auto loans made to subprime borrowers through partnerships established with automobile dealers located throughout the U.S.

Share Information (@9/28/17):

Price	**279.00**
52-Week Range	160.63 – 281.67
Dividend Yield	0.0%
Market Cap	$5.40 billion

Financials (TTM):

Revenue	$840.3 million
Operating Profit Margin	68.9%
Net Profit Margin	43.5%

Valuation Metrics
(@9/28/17):

	CACC	S&P 500
P/E (TTM)	15.2	24.2
Forward P/E(Est.)	13.0	19.1

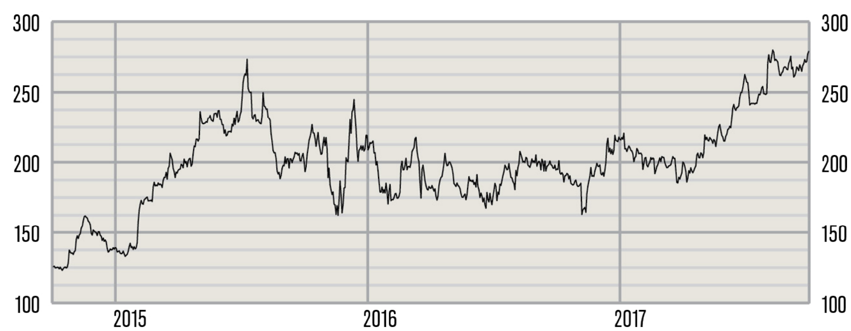
Largest Institutional Owners
(@6/30/17):

Company	% Owned
Prescott Inv	12.1%
Hound Partners	6.3%
Abrams Bison Inv	6.1%
Ruane, Cunniff & Goldfarb	5.6%
Vanguard Group	4.8%

Short Interest (as of 9/15/17):

Shares Short/Float	34.7%

CACC PRICE HISTORY



THE BOTTOM LINE

The company has a long runway for growth as it increases its market penetration due to what has proven to be a sustainably superior business model, says Cliff Sosin. Assuming mid-teens annual revenue growth, operating leverage, share buybacks and an increase in P/E to 15x, he believes he can earn an annualized return on the shares of 25%-plus.

Sources: Company reports, other publicly available information

company takes market share at higher returns. Its worst vintage of loans was issued in 2007, right before the financial crisis when lending was highly competitive. Even for this vintage of loans, actual collections were only about 3% less than what was forecasted when the loans were underwritten. While a number of competitors were going bankrupt, CACC wasn't even close to losing money.

The company remains very well capitalized, with more than 26% tangible equity to tangible assets, well above average for subprime lenders. It also maintains substantial and long-term credit lines that it would likely deploy in an economic downturn to further enhance its competitive position.

With the shares now around $279, close to an all-time high, what upside do you see from here?

CS: The stock currently trades at only 11.6x our $24-per-share earnings estimate for 2018. We think there's still a huge runway for growth as the company increases its 3.5% share of the overall U.S. market closer to the 15% share it has in states like Michigan, where it was founded and is still growing. We believe that for the foreseeable future revenues can grow at a mid-teens rate, translating with operating leverage and share buybacks to around 20% annual EPS growth. With those numbers, if the stock traded in five years at a 15x P/E, our annualized return would be 25%-plus.

From subprime auto loans to restaurants, explain your enthusiasm for small-cap upstart Fogo de Chão [FOGO].

CS: The company operates a chain of Brazilian-style steakhouses, or *churrascaria*, currently with 36 restaurants in the U.S. and 10 in Brazil. It's known for its distinctive service model, known as *espeto corrido* (Portuguese for "continuous service"), in which chefs cook and deliver, from table to table, a variety of fire-roasted meats including beef, lamb, pork and chicken, all cut from skewers.

This format has both supply- and demand-side advantages over traditional steakhouses. Labor costs are reduced because the gauchos both cook and serve the meats. Cooking on a spit requires a fairly small kitchen. It's an all-you-can-eat, fixed-price format, so customers don't sit around reading menus, leading to a quicker dining experience and increased restaurant throughput. While it's a high-end dining experience, it costs roughly 20% less than a similar traditional steakhouse.

All that translates into positive economics: Fogo earns 14.5% EBIT margins after pre-opening costs, almost double the industry average. Its returns on capital are high, resulting from the fact that it costs around $4.5 million to build a restaurant that, after a three-year ramp, is earning $1.8 million on average pre-tax.

We basically believe that Fogo has three attributes that give it a good shot at becoming a large and very successful restaurant chain. First, it has shown that the model works across multiple sites and geographies. Second, it has compelling unit economics. Third, it is addressing an unmet market need for a high-quality, lower-cost, all-you-can-eat steakhouse experience. The target is for 100 restaurants in the U.S. and the company is also methodically expanding globally through asset-light joint ventures with local partners in major capital cities.

INVESTMENT SNAPSHOT

Fogo de Chao
(Nasdaq: FOGO)

Business: Owns and operates a chain of high-end Brazilian steakhouses, or churrascaria, currently with 36 wholly-owned locations in the United States and 10 in Brazil.

Share Information (@9/28/17):

Price	**12.50**
52-Week Range	10.50 – 17.05
Dividend Yield	0.0%
Market Cap	$352.9 million

Financials (TTM):

Revenue	$304.0 million
Operating Profit Margin	11.7%
Net Profit Margin	7.5%

Valuation Metrics
(@9/28/17):

	FOGO	S&P 500
P/E (TTM)	15.8	24.2
Forward P/E(Est.)	12.8	19.1

Largest Institutional Owners
(@6/30/17):

Company	% Owned
Private Capital Mgmt	3.4%
683 Capital Mgmt	2.7%
TIAA-CREF Inv Mgmt	1.9%
Thomson, Horstmann & Bryant	1.8%
BlackRock	1.6%

Short Interest (as of 9/15/17):

Shares Short/Float	2.7%

FOGO PRICE HISTORY

THE BOTTOM LINE

Cliff Sosin thinks the company has a "good shot at becoming a large and very successful restaurant chain," having shown its ability to meet an unmet market need with a concept that has worked across multiple sites and geographies with compelling unit economics. If he's right, he believes EPS – and the share price – can grow at better than 20% annually.

Sources: Company reports, other publicly available information

If the market need is unmet, won't Fogo have plenty of competition in trying to meet it?

CS: Fogo has a superior service model, which means it has established a set of norms, incentives and expectations which cause its employees to go the extra mile to delight customers. That isn't so easy to copy. The company pays in the top decile and usually promotes from within, leading to employee turnover that is one-third the industry average. They actually moderate square-footage growth so as not to grow their employee base too fast and potentially compromise their service culture. That shows some of the difficulty in getting this right.

It's ultimately hard to say how big Fogo can get before serious competition comes in. Once Fogo "occupies" a city with several restaurants and builds a reputation, it has so far been harder for competitors to follow with much success. We think that will continue to work to the company's benefit for some time.

The stock closed at $25.75 on its first day of trading in June 2015. It now trades at $12.50. What happened, and how cheap do you consider the shares now?

CS: I could give you any number of supposed explanations for why the stock is down, but it would just be an exercise in narrative bias. We certainly care if there are good reasons we should be concerned about the business, but often stocks are just volatile for any reason or no reason at all. I should note that we only purchased the shares after they declined – I don't think we ever paid over $14.

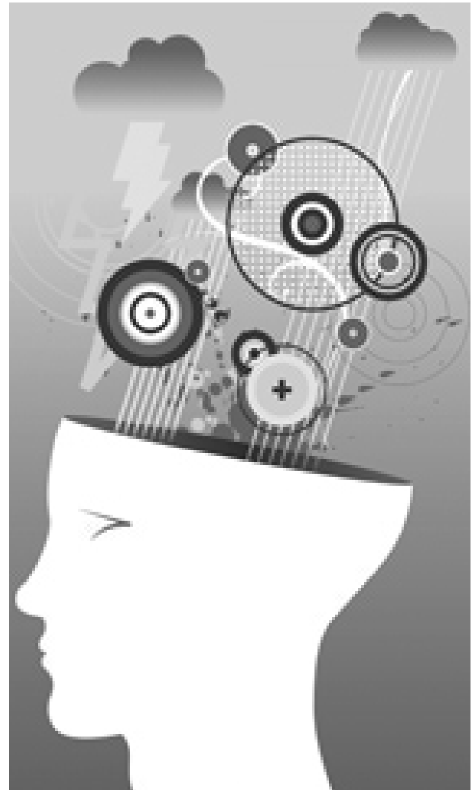
The stock currently trades for just 9.3x our $1.35 estimate of normalized 2018 EPS. That normalized estimate includes an adjustment downward in annual depreciation expense per restaurant to reflect the actual capital spending the company incurs, which we believe is close to one-third the book depreciation level.

Assuming square-footage growth of 10% per year, same-store sales growing slightly better than inflation, and steadily expanding global joint ventures, we think revenues here can grow at a high-teens rate. With some operating leverage and assuming constant 2x debt-to-EBITDA leverage with remaining cash used for repurchases, EPS can grow above 20% annually. Assuming the current trailing EPS of less than 16x remains constant, that would be our expected return on the stock.

You've written about being slow to recognize that your growth thesis for an earlier holding in electronics-distributor Avnet [AVT] had been flawed. What lessons have stuck from that?

CS: When we invested in Avnet, we expected lumpy profits owing to the cyclicality in the semiconductor industry. We were in one of those less-good periods and I remember speaking with an investor friend about Avnet's business being down, and explaining why it wasn't germane to the long-term investment case. He asked, "What would you have to see in order to change your mind?" I hadn't really thought about it in that way, but answered that if I ever saw margin weakness due to price competition – which I didn't really consider possible – then my thesis would likely be wrong. I didn't realize it at the time, but both by answering that question and by articulating the answer to another person, I gave myself the best chance of spotting that I was wrong and changing my mind in the future – which I eventually did when margins did start to decline due to competition a few quarters later.

The lesson is that it's important to think rigorously at the outset of an investment and periodically over time about what would constitute disconfirming evidence to your thesis, writing it down and even articulating it to other people. If we have a hypothesis that can't be disproved, recasting it into one that can is a powerful way to sharpen our thinking. No set of precautions guarantees good decision-making, of course, but we'd like to think experiences like this make us incrementally more likely to avoid trouble the next time. VII



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Investor Insight: 3G Capital

Pavel Begun and Cory Bailey of 3G Capital describe why they have broadened their investing universe, why they don't equate "difficult" with "risky" in investing in non-Western markets, why they typically own fewer than 10 stocks at a time, and why they see mispriced value in Turkey's Halkbank, Estonia's Silvano Fashion and Tatarstan's Tatneft.

While your field of play as an investor has changed quite a bit over the years, what you're fundamentally looking for hasn't. Describe the types of companies that attract your interest.

Pavel Begun: We're looking for businesses that generally fit the following criteria: They occupy leading positions in their respective industries and those industries have long track records of leadership sustainability. They generate returns on invested capital in excess of 15%, can pay off their debt with cash flow in less than three years, and are run by management teams that are both skillful operators and intelligent capital allocators. Last but not least, their stocks are available at single-digit – the lower, the better – multiples of normalized free cash flow.

We have changed our field of play. We initially only invested in the U.S., but over time we concluded that to reliably find unusual bargains in high-quality companies we needed to broaden our investing universe. While there's no shortage of intellect in the investment profession, most managers by inclination or mandate don't even look at the nooks and crannies of global markets – which is where we think the most-attractive bargains are.

Aren't those nooks and crannies also prone to greater risks?

PB: We frequently hear that underwriting the quality of businesses in non-Western markets is difficult, making such investments risky. We don't disagree with the notion that research in these markets is hard. It can take considerable effort to get at all the relevant information you need to understand a company, its business and the political and cultural context in which it operates.

Equating "difficult" with "risky," however, is inaccurate. As a result of that difficulty, far fewer intelligent value-oriented investors who like to apply a rigorous research process invest in many of the markets we do. This in our experience gives rise to a higher likelihood of market inefficiency, which on occasion allows us to purchase assets with much higher margins of safety than we can find in the domestic market.

That's not to say that businesses located in non-Western markets aren't subject to a broader array of risks – the legal protections may be weaker, the political climate may be precarious, and the economic environment may be more volatile. While that may make the intrinsic value of the non-Western business lower than it would be if it operated in a Western market, what we care about is the discount to the conservatively estimated intrinsic value that we have to pay. Buying a "safe" asset at a price in excess of intrinsic value carries much higher risk than purchasing a "risky" asset at a price well below intrinsic value.

ON GOING FAR AFIELD:

It's not ideological, but for some time we haven't found enough in Western markets that is price appropriately.

What's the Western/non-Western mix of your portfolio today?

Cory Bailey: Defining "Western" as the U.S., Canada and Western Europe, less than 10% of our assets are in Western-market companies. There's nothing ideological about that, though. We could have all of our assets in Western companies. But for some time we just haven't found enough in those markets that is priced appropriately for us.

How do you source ideas?

PB: Very often we'll identify an industry that's out of favor across geographic markets, or a specific country that's going through a difficult time, and dive in to assess what's going on with the market leaders and see if any opportunities surface.

In 2015, for example, when Brazil's economy and political situation started to unravel, we looked at a broad range of ideas but zeroed in on banks, which we believe we understand and whose competitive advantages have historically proven long-lived. We ended up buying – and still own – Banrisul S.A. [Bovespa: BRSR6], the largest bank in the Brazilian state of Rio Grande Do Sul. It has the premier competitive position in its region, resulting in net interest margins that are more than double peer levels and returns on equity and on assets that are roughly triple what competitors earn. Because of all the upheaval in Brazil, however, we were able to buy the stock at 2x our estimate of normalized EPS, 35% of book value and with a 14% dividend yield.

We did something similar more recently in Turkey, after the failed coup attempt in 2016. We actually went through a list of all the public equities in the country and ended up identifying two candidates for investment, one of which, Halkbank [Istanbul: HALKB], we ended up buying. It is one of the best performers of the "Big Seven" banks in Turkey, but at the time we were able to buy it at just over 50% of book value and less than 4x current-year earnings.

Another way we identify potential ideas is by applying what we've learned elsewhere to new markets. The mass-market underwear industry, for example, is a surprisingly attractive business, characterized by products that change little year-to-year and strong consumer brand loyalty, resulting in market leaders tending to stay on top for decades. Many years ago I was visiting my family in Belarus and noticed a particular underwear brand that seemed pervasive, which I found out was made by a company based in Tallinn, Estonia called Silvano Fashion Group [Tallinn: SFG1T], the dominant market leader in places like Belarus, Russia, Ukraine and the Baltics. As we got to know the company better we became very interested in the stock, but at the time and for years after it always seemed too expensive. But in 2014, with all the turmoil in Eastern Europe, we finally got our chance. It's still one of our core holdings.

You've written that as you've broadened your investment universe the look-through free-cash-flow multiple on your portfolio has declined. What is it today?

CB: Our portfolio today trades at approximately 5.5x forward free cash flow, with a corresponding dividend yield of over 5.5%. On normalized numbers, the multiple would be even lower. We haven't paid more than 7x free cash flow for anything for three or four years now.

I would stress that low absolute valuations are central to our investment philosophy. We're not trying to find the next Google or Microsoft, but more to cover our downside by buying with a large margin of safety and then by owning good-quality businesses to have the upside take care of itself over time.

You generally own fewer than 10 stocks at a time. Why so concentrated?

CB: Usually around two-thirds of the portfolio is invested in five names. Given how selective we are, it would be fairly difficult for us to find a much larger number of good ideas for the portfolio. Of course, I don't want to own one stock either. We will make mistakes, but if our batting average stays high, a mistake from time to time in a portfolio with six to eight names should be manageable.

Walk through your more detailed case for Turkey's Halkbank, formally known as Turkiye Halk Bankasi.

PB: The bank was founded in 1938 to serve the needs of tradesmen and artisans, and over time has become the leading bank in the Turkish market in serving small and medium-sized enterprises [SME]. The banking market overall is a tightly regulated oligopoly – the "Big Seven" control approximately 75% of total deposits – and the balance of competitive power is such that all seven banks have solid competitive positions and operating metrics.

Halkbank's position in the SME space gives it a stable, low-cost deposit base, which it over time has complemented with conservative underwriting practices in order to generate low-risk growth. More than one-third of its SME loans are guaranteed by the state pursuant to an exclusive agreement with the government, for example, and more than half of its consumer loans outside of mortgages are structured on a payroll-deduction basis or are made to retirees, with their payments deducted directly from government pension checks.

All that has resulted in above-average profitability. The company's average return on assets over the past five years is 1.9% and its average return on equity is 18%, compared to an ROA of 1.7% and an ROE of 15% for the Big Seven overall. Second-tier competitors are even further behind.

INVESTMENT SNAPSHOT

Turkiye Halk Bankasi
(Istanbul: HALKB)

Business: One of Turkey's "Big Seven" banks, offering a range of commercial and consumer financial services, with a focus on serving small and medium-sized enterprises.

Share Information
(@9/28/17, Exchange Rate: $1 = TRY 3.56):

Price	**TRY 12.36**
52-Week Range	TRY 8.49 – TRY 15.37
Dividend Yield	1.7%
Market Cap	TRY 15.45 billion

Financials (TTM):

Revenue	TRY 9.70 billion
Operating Profit Margin	47.0%
Net Profit Margin	35.6%

Valuation Metrics
(@9/28/17):

	HALKB	S&P 500
P/E (TTM)	4.0	24.2
Forward P/E (Est.)	3.7	19.1

HALKB PRICE HISTORY

THE BOTTOM LINE

Political turmoil in Turkey has overshadowed the relative stability of the country's banking industry as well as the company's long track record of excellent growth and profitability, says Cory Bailey. At today's share price the stock trades at only 60% of tangible book value, vs. historical levels of 1.4x to 1.8x, and at just 3.1x his estimate of normalized EPS.

Sources: Capital IQ, company reports, other publicly available information

Unlike some of its large competitors, the government is the controlling shareholder of Halkbank. How do you assess the risk of that?

PB: In such cases there is always risk that a government might force a bank to finance uneconomic public projects to the detriment of minority shareholders. In this case, however, we believe the risk of large-scale meddling is fairly low. First, the government recognizes that its hold on power is dependent on having a sound financial system, which could be undermined if it involved leading banks in large-scale uneconomic activities. Second, the government plans to eventually privatize Halkbank and knows that a clean operating history would be necessary to get top dollar in any sale. Finally, while it's not unusual in emerging markets for standoffs between private-sector interests and governments to end badly for minority shareholders in the private enterprise, Halkbank's state ownership makes it relatively immune to that risk.

Is there a growth story here?

CB: The company over time has benefitted from increasing penetration of banking services across the Turkish market, driving 10% compound growth in its book value – even stated in U.S. dollars – over the past ten years. Going forward we expect it to benefit from continued increased penetration of banking services – penetration levels are still only 50% of those in developed markets – and from its leadership in rolling out new products and services. Halkbank's fee stream from complementary banking services such as payment processing, treasury-management services and credit cards is growing 15% per year, double industry averages. It also has plenty of capital to support growth: its capital-adequacy ratio is around 14%, vs. the global regulatory minimum requirement of 10.5%.

How are you looking at valuation with the shares trading at a recent 12.40 Turkish lira?

CB: The stock currently trades at roughly 60% of tangible book value, 3.7x 2018 earnings estimates of 3.35 Turkish lira per share, and only 3.1x our normalized EPS estimate of about 4.00 Turkish lira.

Just looking at book value, the valuation today compares with historical multiples for Halkbank of between 1.4x and 1.8x, and for the Big Seven overall of around 1.2x. Emerging-market peers sell at closer to 2x, and in recent buyouts in Turkey even second-tier banks have gone for 1.2-1.3x book value. No matter how we look at it, the valuation disparity is extremely large for Halkbank and we don't think it is at all justified.

How do you typically address currency risk, which would appear to be a relevant concern here?

PB: In general, we don't hedge using forward or futures markets, which we find too expensive and very difficult to effectively execute. What we do is make sure that in any business we buy there is an implicit currency hedge within the business. That means we want businesses where the top line is dollar-denominated, or where it's easy for the company to pass on to customers the negative impacts of the currency depreciation. Unless we see one of those two components, we generally do not invest.

In the case of Halkbank, as a U.S.-dollar investor we expect minimal impact over the long-term if the Turkish lira depreciates. Since the Turkish economy is highly dollarized, any local-currency depreciation tends to eventually be reflected in higher inflation, which lifts banking assets to pre-depreciation, dollar-equivalent levels while also widening net interest margins. We think that gives us natural protection against any devaluation in the local currency.

You've done well so far with your investment in underwear-maker Silvano Fashion. Why are you still optimistic about its prospects?

PB: This is a small company, founded in 1908 by a French entrepreneur whose first factory initially produced hair combs. Underwear and lingerie has been Silvano's main business since the 1960s and it is now the largest mass-market underwear concern in Eastern Europe, with more than 700 company-branded stores and strong brands, primarily Milavitsa and Lauma, in places like Belarus, Russia, Ukraine and the Baltics. The next-biggest rival has less than half its market share.

The brands and the distribution network create high barriers to competitive entry and have allowed the company to produce enviable returns on equity, ranging from 20% to 25% despite a substantial cash position. It generates excellent free cash flow that it has mostly returned to shareholders but, we think, should be increasingly put toward high-ROI expansion opportunities. The underwear market in Eastern Europe remains highly fragmented and there's a long runway of opportunity for Silvano to increase its market share. In its latest earnings report, management said it stepped up store openings in the latest quarter, which we take as an early, but positive, sign.

We also like that management owns roughly 40% of the equity and behaves in a shareholder-friendly manner. The Chairman, Toomas Tool, owns more than 20% of the shares and was with us buying when the stock price fell so sharply in 2014.

How do you handicap the geopolitical and currency risks here?

PB: We'd argue that the heightened geopolitical tension is a benefit to Silvano. This is the local brand in most of its markets, and such brands have gotten a boost both as consumers increasingly buy local and as Western brands pull back.

With respect to the currency, the economics of Silvano's business protect it from the negative impacts of local-currency depreciation. Underwear pricing in its markets tends to remain consistent over time in hard-currency terms, while the bulk of the company's costs are in local Eastern-European currencies. With that dynamic, local-currency depreciation positively impacts the company's margins.

How cheap do you consider the shares at today's price of €2.60?

CB: The company has roughly 25% of its current market cap in net cash, so the net share price today is actually closer to €2. Against that, estimates of 2018 EPS are around 32 Euro cents and we believe the normalized level of earnings – assuming modest improvement in the regional economies – is around 40 Euro cents.

So for only 5x normal earnings we can own a market leader, with significant potential to increase market share in a business where leaders over time tend to remain leaders. The company historically has traded at 11-15x earnings, while similar companies around the world would trade at 15-20x. That's a significant enough disparity that without putting too fine a point on it you could imagine the shares being worth substantially more than where they currently trade.

In the meantime, there's a 9% dividend yield on the expected payout next year which, given the level of cash flow and the large net-cash position, is likely to be pretty safe.

Tatneft [TATNP], based in Tatarstan, would not seem to fit your typical profile for an investment. Is this a high-quality business?

CB: Tatneft is a regional integrated oil-and-gas company that in addition to having an on-shore, relatively low-cost reserve base also owns and operates extensive transportation, distribution, refining and chemicals assets. The company has proven skilled at squeezing more barrels from mature oil fields by applying advanced technologies. It benefits from an industry-friendly taxation system, in which decreases in energy prices are to a meaningful extent offset by lower taxes and duties. It also has tended to benefit from a favorable

INVESTMENT SNAPSHOT

Silvano Fashion
(Tallinn: SFG1T)

Business: Based in Estonia, leading Eastern-European manufacturer of mass-market underwear, selling through company-branded stores as well as independent retailers.

Share Information
(@9/28/17, Exchange Rate: $1 = €0.85):

Price	€2.62
52-Week Range	€2.12 – €3.12
Dividend Yield	7.6%
Market Cap	€97.3 million

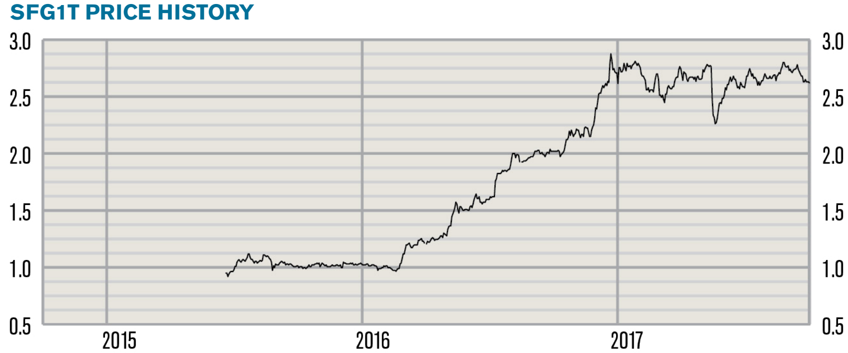
Financials (TTM):

Revenue	€60.1 million
Operating Profit Margin	22.1%
Net Profit Margin	12.8%

Valuation Metrics
(@9/28/17):

	SFG1T	S&P 500
P/E (TTM)	9.4	24.2
Forward P/E (Est.)	8.2	19.1

SFG1T PRICE HISTORY



THE BOTTOM LINE

Pavel Begun believes the market-leading Eastern European company has significant potential to increase share in a mass-market-underwear industry in which leaders over time tend to remain leaders. For that, at today's share price, he has to pay only 5x his normalized EPS estimate, which assumes only modest improvement in the regional economy.

Sources: Capital IQ, company reports, other publicly available information

currency dynamic, with revenues denominated in dollars and expenses incurred in rubles. All that has allowed it to generate resilient 16-18% returns on equity, despite a large cash position, pretty much through thick and thin.

How do you think about corporate governance, including the fact that the Republic of Tatarstan, a subject of the Russian Federation, owns a controlling position in the company?

CB: Tatneft's management has behaved over time in a shareholder-friendly way, strengthening the business by expanding downstream, producing excellent returns on equity and generously sharing the spoils with shareholders. The company last year paid out 50% of profits as dividends and the dividend yield on the expected payout for next year is currently around 11%. So while there's a perception in Russia that minority shareholders often get taken advantage of, that has so far not at all been the case here.

What oil-price assumptions are you incorporating into your analysis?

PB: We estimate that the company's 2018 per-share earnings will come in around $1.10, or about 64 rubles. That assumes oil prices stay roughly at today's levels, and we're using that 64-ruble EPS as our normalized earnings estimate as well. In general, howevery, we try to make sure any investment case like this can work under a wide range of commodity-price scenarios.

So the shares at a recent 290 rubles look fairly inexpensive.

PB: Ignoring the net cash on the balance sheet, the stock trades for 4.5x 2018 estimated EPS. Back out net cash and the P/E is less than 4x. You can also look at what you're paying per barrel of Tatneft's proved reserves in the ground, which today is less than $2 per barrel. To put that in perspective, the company at $50 oil earns about $8 in *net profit* per barrel. At the same time, the stocks of emerging-market peers, with similar or inferior profitability profiles, trade between $9 and $17 per barrel of proved reserves.

If oil prices go back to their lows of 2015, we estimate earnings would take a 25% hit, say to around 48 rubles per share. At that level the multiple today is 6x – 5x excluding net cash – for a company that earns 15%-plus on equity and can sustain a dividend yield of 9-10%. If that's what my downside looks like, I'll take it.

We see that you allow your investors to withdraw money only once every two years, on December 31st. Has that been a tough sell?

PB: One of my favorite quotes about investing is from David Swensen, the Chief Investment Officer of Yale's endowment, who says that, "Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom."

If we're going to maintain an unconventional long-term investment profile – which I think is necessary to outperform – we can't do it with short-term money. It's not going to work and will be stressful for everybody. Our structure isn't for everyone, but it's been a great filter that has allowed us to build an investor base in line with what we're doing. I'd much rather run fewer assets this way than more assets with a shorter-term bias. VII

INVESTMENT SNAPSHOT

Tatneft
(Moscow: TATNP)

Business: Exploration and development of oil and gas, and operation of varied transportation, distribution, refining and chemicals assets; based in the Republic of Tatarstan.

Share Information
(@9/28/17, Exchange Rate: $1 = RUB 57.92):

Price	**RUB 290.50**
52-Week Range	RUB 179.20 – RUB 303.50
Dividend Yield	3.0%
Market Cap	RUB 938.38 billion

Financials (TTM):

Revenue	RUB 631.00 billion
Operating Profit Margin	22.2%
Net Profit Margin	19.1%

Valuation Metrics
(@9/28/17):

	TATNP	S&P 500
P/E (TTM)	5.3	24.2
Forward P/E (Est.)	4.5	19.1

TATNP PRICE HISTORY

THE BOTTOM LINE

The company has generated "remarkably resilient" returns on equity through thick and thin, says Cory Bailey, a function of its low-cost reserve base, diversified downstream operations, friendly tax regime and adept, shareholder-friendly management. The stock at today's price, net of balance-sheet cash, trades at less than 4x his 2018 EPS estimate.

Sources: Capital IQ, company reports, other publicly available information

Back Door

Value investors can cite plenty of stocks they'd be happy to own at a lower price. Here's how one investor is getting the lower price he wants on cable-services company Charter Communications – without having to wait.

Curtis Jensen, the long-time manager of the Third Avenue Small-Cap Value Fund who recently launched a new investment partnership with Robotti & Company, sees much to like in cable-services firm Charter Communications [CHTR]. The company last year completed acquisitions of Time Warner Cable and Bright House Networks, establishing it as a major player in a consolidating, high-barrier-to-entry industry where scale is increasingly important. With its growing broadband business, it provides an essential service that he expects to have pricing power as demand inexorably rises, particularly if pricing becomes more usage-based.

Further, as the company invests in both marketing and upgrading its network, it has the potential to increase its market penetration, now at a middling 50% of the 50 million homes its network can serve. As the acquisitions are integrated, Jensen also expects a wide range of cost and operational synergies through the combination of technology systems and centralized functions such as customer service.

As for the pall over cable TV as more customers opt for less-costly programming bundles or "cut the cord" entirely on their cable packages, he believes the ultimate impact may be less negative than conventional wisdom holds. One reason is that he expects the upside from broadband to be much greater than the downside from cord-cutting. In addition, he says: "It's not clear 'skinny' bundles and other *a la carte* offerings will be economic to sponsors at the same time they provide good value to customers," he says. "Once you add together two or three or five *a la carte* services, will you actually be saving money?"

Rather than pay full price for Charter shares, Jensen says he can get them at a discount today through tracking-stock Liberty Ventures [LVNTA]. One of cable-pioneer John Malone's myriad asset concoctions, LVNTA primarily consists of directly owned Charter shares and a position in Liberty Broadband [LBRDK], whose only asset is a 21% Charter stake. To complicate things further, upon the closing of Liberty Interactive's deal to buy Alaska-based cable-services provider General Communication, Inc. [*VII*, March 31, 2017] – expected to close by the first quarter of 2018 – that business is to be combined with most of Liberty Ventures' assets and spun off into a new publicly traded company called GCI Liberty.

Jensen argues that Liberty Ventures' current $57 share price inordinately discounts the sum of its component parts. Just valuing the stakes in Charter, Liberty Broadband and GCI at their market values would translate into an estimated net asset value for LVNTA shares of $69, he says. Making two further adjustments – correcting for the 9% discount at which Liberty Broadband trades to the market value of its underlying Charter stock, and valuing Charter stock itself at 10.5x his estimate of 2018 EV/EBITDA, or $400 per share – he pegs LVNTA's fair value at $78. "I'm paying less than 75 cents on the dollar for a cable company controlled by John Malone at a time of considerable uncertainty and change in the industry," says Jensen. "I'll take those odds." VII

INVESTMENT SNAPSHOT

Liberty Ventures
(Nasdaq: LVNTA)

Business: Liberty Interactive Corp. tracking stock whose primary assets are public share interests in U.S. cable-television and broadband company Charter Communications.

Share Information (@9/28/17):

Price	**56.95**
52-Week Range	36.54 – 62.41
Dividend Yield	0.0%
Market Cap	$15.81 billion

Largest Institutional Owners
(@6/30/17):

Company	% Owned
FPR Partners	10.0%
T. Rowe Price	9.9%
Vanguard Group	7.5%
BlackRock	4.2%
Principal Financial	4.2%

Short Interest (as of 9/15/17):

Shares Short/Float	11.4%

LVNTA PRICE HISTORY

THE BOTTOM LINE
This tracking stock, whose primary value stems from shareholdings in Charter Communications, inordinately discounts the sum of its component parts, says Curtis Jensen. Correcting for holding-company discounts and assuming Charter is reasonably worth $400 per share – vs. today's market price of $361 – he values LVNTA stock at around $78.

Sources: Company reports, other publicly available information

First, Do No Harm

Any number of influences in today's world can make inaction on the part of investors seem conspicuously old-fashioned, if not downright slothful. In this client-letter excerpt, Clifford Sosin argues that patience is still a virtue.

Editor's Note: *Among the many behavioral biases with which investors must necessarily grapple, one of the more insidious is a bias for action. From pressure we put on ourselves – as well as pressure others put on us – there's a natural inclination to be doing something, making things better. And with 24-hour news cycles, how can we not be responding? CAS Investment Partners' Clifford Sosin, whose interview is featured in this issue, recently reflected in a client letter about this bias for action that investors inevitably feel. This excerpt from that letter is reprinted with his permission.*

It is fair to say that we have been fairly inactive over the past two years in terms of finding new ideas. As you would expect, we examine many potential investments and while we've found a few that are good enough in a vacuum, of late, none have covered the very high opportunity cost we perceive in selling what we already own. Put another way, we think that the investments we currently own have a very bright future and refuse to mess it up by selling them in order to buy something new with less-exciting prospects.

If we were private business owners/investors, long spans of inactivity would raise no eyebrows. No reasonable person would expect a farmer to sell his farm in order to buy a different farm every decade, let alone every year or several times a year. As public-market investors, however, this "sitting on our hands" behavior is unusual.

While different, we think our approach will probably prove to be wealth-maximizing over time. Good ideas are rare and can take a long time to "play out." Thus, just as it makes sense to concentrate our holdings at any one time, it also makes sense to maintain concentration in the number of investments we make over time. Moreover, inactivity should over time be much more tax efficient. So, hopefully, inactivity will produce superior pre-tax returns and even more superior post-tax returns.

Of course, there is a risk that we are systematically overestimating the expected returns of our existing holdings and are thus missing better opportunities. While we try to mitigate this risk by constantly questioning our views, in the end, this possibility represents an irreducible risk. Hopefully we have made good judgements and have sufficient margin of safety to protect against mistakes.

Another potential risk of long spans of inactivity might be that they stem not from rational selectiveness but from declining productivity in finding new ideas. This risk highlights the practical challenges of how best to allocate time in this business. For example, how does one determine when best to move on from a new idea that doesn't seem to be good enough, or how should one balance time spent learning general tools (microeconomics, psychology, business history and so forth) with time spent studying specific potential investments?

If investing were a short-cycle, deterministic system like building cars or serving lattés, we could attempt to answer these questions through systematic experimentation. There are a number of effective techniques to institutionalize innova-

"Actually, I was hoping for a more inspiring mission statement."

tion and feedback-based learning within organizations resulting in continuous improvement. (I recommend Eric Ries' *The Lean Startup*, Jeffrey Liker's *The Toyota Way* and Jeff Sutherland's *Scrum* if you want to learn more about these ideas.)

Unfortunately, investing is a long-cycle activity with noisy/probabilistic feedback loops and small sample sets. Time spent reading a book on the history of the construction of the Panama Canal could lead to insights about human behavior that help in handicapping the future of J.C. Penney years in the future, and a sensible investment predicated on that insight may (or may not) work out years after it is made. (This is actually a true story from my time at a previous employer.)

With so much time and noise between action and impact and with so few data points, we effectively don't have meaningful feedback to work with in order to improve our processes using the techniques mentioned above or other techniques of which I am aware. I don't have a solution for this problem; I don't know how to measure or improve our productivity over time. This is just another irreducible risk we take.

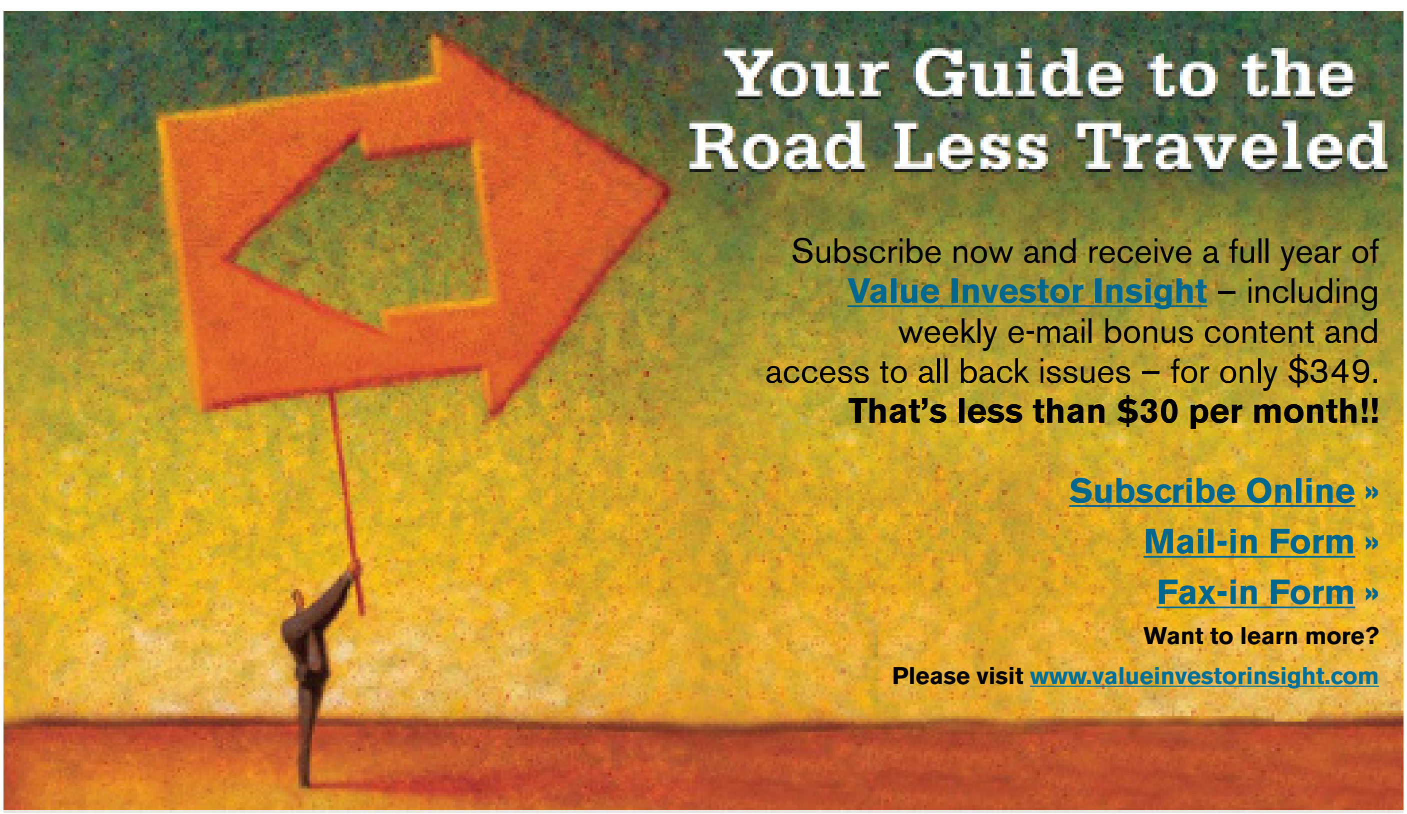
That said, even if our productivity has fallen (and I have no reason to think it has), so few good ideas are required to achieve a great result (just a handful in a lifetime will do) that we should still do pretty well over time (provided that we don't get impatient).

ON DISCOMFORT:

While I think inactivity is wealth-maximizing over time, I can assure you it can be unnatural and uncomfortable.

While I think, but cannot assure you, that our relative inactivity is wealth-maximizing over time, I can assure you that long spans of inactivity are unnatural and uncomfortable. New ideas are exciting, and passing on a new idea after investing time and effort into it is discouraging. What's more, the tough calls aren't in situations where the potential investment is crummy, but where the potential investment is probably very good, just not quite as good on average as what we currently hold. Given the vagaries of business and stock markets as well as our fallibility and finite circle of competence, inevitably, some of these "passes" work out quite well and we, at least as judged by outcomes, miss out. In these cases, while the decision to pass may have been completely correct based on the evidence available at the time, the missed "opportunity" still doesn't feel good.

Humans (myself included) simply did not evolve to make these sorts of slow-feedback, probabilistic, opportunity-cost-driven trade-offs. The good news is that by training ourselves to resist the pull of these emotions better than others do, we can hopefully make better decisions that result in a higher rate of compounding over time. VII



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