ValueInvestor INSIGHT

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The Leading Authority on Value Investing

Under Control

"The market is less efficient at assessing risk than reward," says Steve Goddard, whose investment strategy has been constructed to take full advantage of that.

Brian Campbell's summary description of the research process at $9.5 billion (assets) The London Company neatly sums up a defining characteristic of a value-investing approach: "Almost everything we do," he says, "revolves around trying to figure out where we can be wrong."

This mindset has served investors well since founder Steve Goddard launched TLC's defense-first strategy in 1994. The firm's large-cap portfolio has earned a net annualized 11.0% since then, vs. 9.9% for the S&P 500. Its small-cap strategy, launched in 1999, has beaten the Russell 2000 by 400 basis points per year.

Goddard and Campbell today are finding opportunity in such diverse areas as building products, wireless communications, lithium, auto retail and semiconductors.

INVESTOR INSIGHT

The London Company
Stephen Goddard (*l*), Brian Campbell (*r*)

Investment Focus: Seek predictable, high-return-on-capital companies that may be overlooked by the market because their higher-growth years are behind them.

We believe

1	Markets are much less efficient at assessing risk than reward.	The real opportunity lies in evaluating risk.
2	Protecting client assets in down markets will deliver superior long-term performance.	Our process is designed to mitigate downside risk.
3	No one can predict the future.	We rely on facts, not speculation.
4	Most investors over-diversify.	We are active managers who invest with conviction to mitigate risk and maximize opportunity.
5	Companies should be evaluated as if we are buying the entire company.	We take a long-term perspective, giving our businesses time to appreciate.

These core principles inform every investment decision.

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Investor Insight: Stephen Goddard

Stephen Goddard and Brian Campbell of The London Company describe their relatively unique approach to valuation, why they're unlikely to average down if a position goes against them, what sector they see as ripe for consolidation, and why they see mispriced value in Crown Castle, Versum Materials, Albemarle, Penske Automotive and Armstrong World.

You've said as an investor you don't tend to gravitate to very exciting stories. To what do you gravitate instead?

Stephen Goddard: Our screening focuses primarily on three factors: the company's return on tangible capital, the current multiple of EBIT to enterprise value, and the free-cash-flow yield. We look for high-cash-return businesses that earn in excess of their cost of capital, are well managed and have relatively sustainable and predictable businesses. But we also want the valuations to be attractive, so we don't find much opportunity in companies with the higher growth and momentum the market tends to favor. In our companies the higher-growth years are likely behind them, which doesn't attract as much attention and multiples can get compressed.

Brian Campbell: We spend a lot of time in our research and analysis trying to prove the bull thesis is incorrect. Mitigating downside usually starts for us with a high-return-on-capital business, ideally when that metric is improving. Maybe the industry is evolving for the better or the company is raising prices or capitalizing on increased scale. We want to buy businesses like that at a discount and then we typically own them for the long haul. One of our recent investments, Southwest Airlines [LUV], has quadrupled its return on invested capital since 2012. At the right price, high-ROIC businesses tend to make excellent investments. If ROIC's are high and increasing, that's even better.

Copart [CPRT] would be another example that fits our process well. The company runs online car auctions, primarily selling extensively damaged vehicles for insurance companies looking to recoup what they can after an accident. It's the larger player in a duopoly U.S. market, earning 30%-plus operating margins and returns on capital in excess of 20%. Barriers to entry are high, because of scale advantages and the fact that land for salvage yards that Copart already has in urban areas is tough to come by for others.

Management compensation here is unique, with the top executive bypassing base salary and bonus in lieu of options. Five years ago the stock was trading below the then-latest grant strike price and the company announced a Dutch auction to retire 14% of its shares, which we felt created a good entry point. Looking back you can debate the generosity of the number of options granted, but we put a lot of emphasis on management compensation being aligned with our interests as shareholders, which was clearly the case here.

ON OPPORTUNITY:

In our companies the higher-growth years are likely behind them, which doesn't attract as much attention.

The business has done well in recent years as the aging car population, increasing miles driven, and the higher prevalence of expensive-to-repair electronics in cars has resulted in more vehicles coming to auction. The stock as a result has done well, but while we've taken some profits, we still consider it a core holding. They continue to do accretive bolt-on acquisitions and are starting to more aggressively try to replicate overseas, primarily in Europe, the success they've had in the U.S. [*Note*: CPRT shares now trade around $56, up from the mid-teens on a split-adjusted basis five years ago.]

Another representative example is Progressive [PGR], the direct-sale auto insurer like GEICO. Those two companies continue to take market share and have been leaders in using technology and data to better and more efficiently market and price their policies. Progressive has also been successful in expanding its product line, most notably with homeowners insurance. From an industry perspective, we saw added upside from competitive pricing becoming more rational. Given all that, we bought in a year and a half ago when the book-value multiple on the stock relative to history was attractive. [*Note*: Trading in the low-$30s in the fourth quarter of 2016, PGR shares now trade near $63.] It is also still a core holding.

What else besides relative neglect can make the stocks of companies you target attractively priced?

BC: We try to take advantage when market volatility results in something being unfairly punished. Earlier this year when the market was so concerned about rising interest rates, stocks tied to housing like Home Depot [HD] were incrementally hit and we thought excessively so. It's in a duopoly with Lowe's in the U.S., earned double-digit operating margins even during the financial crisis, and has been improving its return on capital – from 27% last year, to around 36% this year. As the stock fell more than 15% from its January highs, we established a position.

Frequently the issue is more company-specific. One example is Crown Castle [CCI], which operates in an industry – cellular communications towers – that we've long found attractive, but where valuations were too high for us. The company has been deviating from competitors by spending capital on fiber assets to support small-cell wireless transmission that's done through small devices affixed to things like buildings and light poles in dense urban areas. The key question is whether this effort will be a source of incremental value for Crown Castle or will turn out to

be less profitable than the traditional business and end up destroying value. As we dug in to understand how the small-cell fiber assets were going to be deployed and work, we concluded it was more likely to be a tremendous source of value. We were able to buy the stock at an attractive price because the market doesn't appear to be as confident about that.

We'll come back to Crown Castle, but for now describe your somewhat unique approach toward valuation, focusing on what you call balance-sheet optimization.

SG: We believe the market is less efficient at assessing risk than reward, so balance-sheet optimization is our primary way to determine intrinsic value, based on the strength of a company's balance sheet. We basically look at how shareholder value could be enhanced just by adjusting the capital structure, typically by adding low-cost debt and retiring higher-cost equity. We'll then do a discounted-cash-flow analysis using very conservative growth assumptions, little to no margin expansion, and the lower weighted-average cost of capital and new share count implied by the hypothetical recap. If the share price is at a 30-40% discount to the resulting estimate of intrinsic value, we think that gives us an interesting margin of safety.

Why come at it this way?

SG: The goal is to build our investment thesis on what exists today on the balance sheet and to limit our speculation about future earnings growth. To my mind, it's better to base valuation on things that are under management's control than to try to outguess 1,000 other analysts on what the growth rate of Apple or Microsoft is going to be over the next five years.

We also with valuation look at private-market values based on where transactions have been done. We find that a useful check on our balance-sheet optimization work. If private-market values are way below our estimate of intrinsic value, we need to take another look at what we might be missing. If we're doing it right, private-market values should be considerably higher than our value estimates.

Two of your ideas from our last conversation [*VII*, February 28, 2013], Cabela's and Lorillard, have been bought out in the interim. Is that a frequent outcome?

SG: It's not uncommon. Companies we own are often in the middle to mature stages of their lifecycles, which is when you'll often see consolidation. If they're utilizing cash flows correctly and capital allocation is done in a shareholder-friendly way, the value should come out in one way or another. Sometimes that's through an acquisition.

ON DOUBLING DOWN:

I believe that if a stock gets too far below what we paid for it that generally means we've missed something.

BC: Our balance-sheet optimization process is not unlike what a private-equity buyer would do to identify opportunities. They will likely make more aggressive assumptions than we do, but they're also looking for high returns on capital, strong free cash flow and balance sheet flexibility. It's not surprising companies like that would attract either financial or strategic buyers. We have more recent examples than Cabela's and Lorillard. DST Systems was recently bought by SS&C Technologies. Orbital ATK is being acquired by Northrop Grumman. USG is in the middle of a takeover fight with German building-materials company Knauf.

Consumer-staples stocks, a long-time focus of yours, haven't been faring well in the market of late. Are they as interesting to you today as they were five years ago?

SG: The group certainly hasn't been in favor. There's not much if any organic growth, while the market is more focused on technology names with momentum. In general, we still see ample room for these companies to create value through optimizing their capital structures and – on the subject of acquisitions – I would expect to see accelerated consolidation throughout the space. They've optimized their expense structures. They don't have much pricing flexibility. The next rational move in such situations is often to try to combine with a competitor.

What's a prospective example?

BC: We've been long-term holders of Altria [MO], as well as of Philip Morris International [PM] since it was spun off from Altria in 2008. Tobacco stocks have come under the same pressure as consumer staples, but there's also a twist from the introduction internationally by Philip Morris of non-combustible cigarettes using what's called the IQOS heating system. IQOS has been a big hit in many non-U.S. markets, offering the taste of heated tobacco without some of the negative health effects. In the U.S., Altria and Philip Morris have been lobbying the FDA to get the technology approved, but the authorities have made any approval contingent on reducing nicotine levels in traditional cigarettes as well. All that has put additional pressure on the stock price, even though approval in the U.S. would likely ultimately be a real positive for the business.

Our bull thesis for both stocks is not without risk, but we remain attracted to the companies' pricing power and very high margins and returns on capital. To address your question, there has been strong speculation that Altria and Philip Morris combine again. It may not happen, but it wouldn't surprise us if it did.

You're less likely than many investors we speak with to double down when something goes against you. Describe why.

SG: We have a soft stop-loss rule in place, in which we fully challenge our original thesis if a stock from our original cost has a 1% or more negative impact on the

entire portfolio. Based on my own experience of getting it wrong too many times, I believe that if a stock gets too far below what we paid for it that generally means we've missed something. When we reconsider the position then, the conclusion is almost always to either keep it where it is or sell it. Rarely will we average down. We're simply trying to prevent small mistakes from becoming big ones.

Is General Mills [GIS] an example that didn't make the cut?

BC: This did recently go through a stop-loss review. The company has struggled to grow with its traditional yogurt and cereal brands. What really tested our patience, though, was its agreement to buy Blue Buffalo Pet Products for $8 billion. When management concludes the path ahead requires large, diversifying acquisitions, that raises the risk profile for us. We decided in this case to cut bait and move on.

Coming back to Crown Castle, how did it originally get on your radar?

BC: Crown's stock had traded down 15-20% in the latter half of 2016 on rumors of a Sprint/T-Mobile merger further consolidating the carrier business. That in and of itself got our attention, but in mid-2017 it was disclosed that the company's chairman, Landis Martin, had increased his stake by 40% through open-market purchases of stock at around $100 per share. We look for certain signals that might indicate companies are worth paying attention to, and significant insider buying tends to be near the top of the list.

Crown operates as a real estate investment trust and is the second-largest operator of wireless-communication towers in the United States, behind American Tower. The customer base is concentrated, with the four large U.S. wireless carriers providing the vast majority of revenues, but barriers to entry, switching costs and incremental margins in the tower business are very high. There's also a tremendous tailwind from ever-increasing wireless data demand.

As I mentioned earlier, the uncertainty on Crown Castle revolves around whether the company's heavy investment in small-cell fiber networks – it paid $7.1 billion last year to buy Lightower Fiber Networks, for example – will generate the returns necessary to justify the expense. We believe it will.

Please explain that a bit further.

BC: The way the business works is that Crown owns the fiber and then partners with the carriers to deploy what are called "nodes" to distribute signals across urban areas. The company has 30,000 nodes in use and another 30,000 in backlog, with assets in 23 of the top 25 metro markets. We don't think there's much debate about the ultimate deployment of all the nodes their fiber can handle, as carriers increase the densification of their networks to meet rising demand, reduce latency and roll out next-generation services. We also believe that because Crown is sharing the cost of node deployment, its returns on investment on the fiber will be highly attractive. The company says its returns on these assets are actually higher at the same stage than they were for macro towers.

INVESTMENT SNAPSHOT

Crown Castle
(NYSE: CCI)

Business: Provider through towers and small-cell fiber networks of wireless-transmission infrastructure utilized primarily by the four large wireless carriers in the United States.

Share Information (@5/30/18):

Price	**104.02**
52-Week Range	93.14 – 114.97
Dividend Yield	4.0%
Market Cap	$43.15 billion

Financials (TTM):

Revenue	$4.64 billion
Operating Profit Margin	26.3%
Net Profit Margin	9.5%

Valuation Metrics
(@5/30/18):

	CCI	S&P 500
P/E (TTM)	103.0	24.4
Forward P/E (Est.)	62.7	17.1

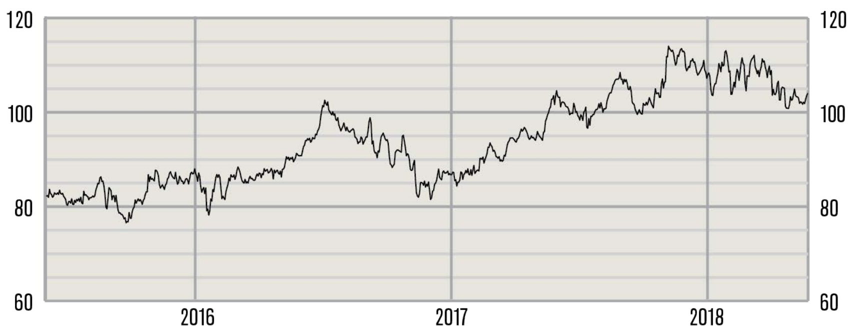
Largest Institutional Owners
(@3/31/18):

Company	% Owned
Vanguard Group	8.9%
T. Rowe Price	8.4%
BlackRock	4.8%
Capital Research & Mgmt	4.7%
State Street	4.0%

Short Interest (as of 5/15/18):

Shares Short/Float	2.4%

CCI PRICE HISTORY



THE BOTTOM LINE

As the company's traditional cell-tower business continues its solid growth and its heavy investments in small-cell wireless transmission networks in denser urban areas start to bear real fruit, Brian Campbell believes the combination of earnings growth and dividend yield can generate annual shareholder returns in the mid-teens over the next few years.

Sources: Company reports, other publicly available information

One proof point here is that Crown's competitors seem to be changing their tune around small-cell technology. American Tower and SBA Communications, for example, never showed much interest in it, but if you read their recent call transcripts, that tone has changed and they've mentioned it as a potential use of capital.

From a recent share price of $104, how are you looking at potential upside?

BC: The company's debt is at a level that we're not seeing much to do with respect to balance-sheet optimization. At the current price, though, the stock trades at 17x this year's run rate of $6 per share in AFFO [Adjusted Funds From Operations], which is one turn lower than the five-year average. So you're paying a reasonable multiple for a company we believe can increase AFFO at a low-teens rate over the next few years as the traditional tower business continues its solid growth and the fiber assets come on line. Add in a 4% dividend yield and the total annual shareholder return could be in the mid-teens.

One additional thing I'd mention is a management culture clearly focused on creating value for shareholders. The CEO, Jay Brown, has come up through the ranks and is only in his mid-40s, and his and other managers' compensation plans actually have absolute total shareholder return as an important criterion. That increases our confidence that our interests are aligned with theirs and that they're going to be disciplined with capital.

How does semiconductor-manufacturing supplier Versum Materials [VSM] fit your profile of an attractive investment?

BC: The company was spun off from parent Air Products in October 2016 and is one of three leading global suppliers – with Entegris and a division of DowDuPont – of specialty gases, chemicals and materials used in the manufacture of semiconductors. Its part of the industry has high entry barriers, and once material suppliers win a piece of business they are usually locked in with long-term contracts on favorable terms. The products are low-cost to the end customer but of critical necessity, which allows Versum to compete on service and reliability and not just price. Operating margins run above 28%.

The primary driver of the business is demand for semiconductors, for which there's a strong secular growth story. The industry has consolidated and the increased digitization of almost everything – think mobile phones, cloud computing, artificial intelligence, the Internet of Things – is likely to drive less-cyclical growth going forward. In addition, as wafers get smaller and include more layers, demand for the types of materials Versum sells to make them increases.

Insider buying was also important here. Air Products' Chairman and CEO Seifi Ghasemi remained Chairman of Versum's board after the spinoff, which isn't common, and he was buying a significant amount of shares on the open market just after the spin. We had some experience with him, as another of our holdings, Albemarle [ALB], had acquired a business he ran, Rockwood Holdings, at which he'd created considerable value for shareholders. That he's involved and committed gives us more conviction in the idea.

INVESTMENT SNAPSHOT

Versum Materials
(NYSE: VSM)

Business: Global supplier of specialty gases, chemicals and materials to original-equipment manufacturers of semiconductors such as Intel, Samsung and Taiwan Semiconductor.

Share Information (@5/30/18):

Price	**40.23**
52-Week Range	30.56 – 42.74
Dividend Yield	0.6%
Market Cap	$4.38 billion

Financials (TTM):

Revenue	$1.19 billion
Operating Profit Margin	28.1%
Net Profit Margin	13.5%

Valuation Metrics
(@5/30/18):

	VSM	S&P 500
P/E (TTM)	27.5	24.4
Forward P/E (Est.)	15.7	17.1

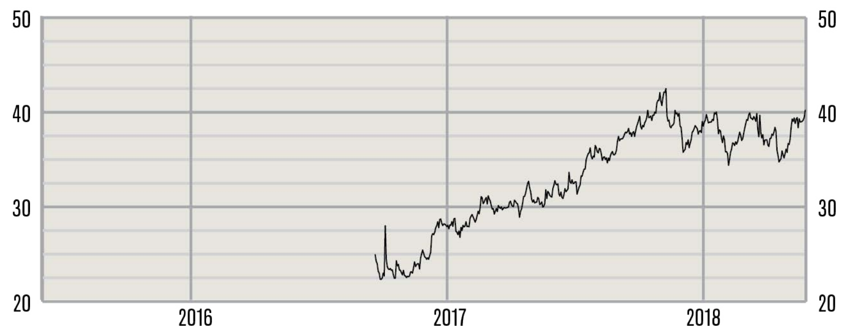
Largest Institutional Owners
(@3/31/18):

Company	% Owned
Vanguard Group	8.4%
BlackRock	8.3%
State Farm Inv Mgmt	7.1%
Barrow, Hanley, Mewhinney & Strauss	5.8%
Iridian Asset Mgmt	5.2%

Short Interest (as of 5/15/18):

Shares Short/Float	2.5%

VSM PRICE HISTORY



THE BOTTOM LINE

The company's high-entry-barrier business provides high-value, low-cost products to a semiconductor industry that is likely to benefit from strong, less-cyclical growth in coming years, says Brian Campbell. Assuming an "optimized" balance sheet, only 2% annual revenue growth and no increase in margins, he estimates intrinsic share value at $54.

Sources: Company reports, other publicly available information

How attractive do you consider the shares at today's $40.25 price?

BC: The company has been underpromising and overdelivering, but the shares still trade at less than 12x EV/EBITDA on next year's estimates, which we think is more than fair for a company that can grow EBITDA at a mid-teens annual rate and that has in our opinion become less cyclical. We don't see the digitalization of the world slowing down any time soon.

For our balance-sheet optimization, we assume the company could take on an additional $800 million in debt, increasing debt to total capital to 36%, and use the resulting proceeds to buy back 20% of its shares. Building in the lower cost of capital and share count, and assuming no improvement in EBIT margins and only 2% annual revenue growth, we arrive at an intrinsic value estimate of $54 per share. Again, we arrive at that with very conservative assumptions about the business, focusing on what management could actually do tomorrow to improve shareholder value.

Describe your investment case today for specialty-chemical company Albemarle.

SG: Brian mentioned the company's acquisition of Rockwood Holdings, which made Albemarle one of the leading global suppliers of lithium, with roughly one-third of the market. That business, which earns 40% EBITDA margins and is growing rapidly due to high demand for its use in batteries, today produces roughly half of the company's $1 billion in annual EBITDA. The rest comes from two other businesses: bromine, which is primarily used in flame retardants, and chemical catalysts that are used mostly in oil refining. Each division generally has main products that have #1 or #2 positions in consolidated markets.

We're assuming the central aspect of the story is lithium, where the outlook for demand is a bit clearer than the outlook for supply. How are you thinking about all that?

SG: For the time being, demand for lithium is far outstripping supply as manufacturers of electric vehicles and portable consumer electronics and other devices want more of it than they can get their hands on. Spot lithium prices last year rose more than 20% and have continued to rise since. Just considering electric vehicles and assuming as the company does a 12% adoption rate of those by 2025 – about the midpoint of where most estimates are – that would require roughly 800,000 metric tons of lithium production per year. Right now the market is about 260,000 metric tons. Adoption may turn out faster or slower than expected, but the trend line is pretty attractive.

It is true that a number of new suppliers have announced plans to enter the market to compete with the three or four major producers today that can provide an assured supply of lithium to major OEMs, and that has clearly weighed on Albemarle's stock price. Our general view is it's not that easy to extract lithium and convert it for battery-grade production, and that it will take quite some time for meaningful competing production to come on line. With demand growing as it is, OEMs aren't going to be that interested

INVESTMENT SNAPSHOT

Albemarle
(NYSE: ALB)

Business: Producer of specialty chemicals and materials sold through three operating divisions: Lithium and Advanced Materials, Bromine Specialties and Refining Solutions.

Share Information (@5/30/18):

Price	**93.59**
52-Week Range	86.75 – 144.99
Dividend Yield	1.3%
Market Cap	$10.37 billion

Financials (TTM):

Revenue	$3.17 billion
Operating Profit Margin	23.3%
Net Profit Margin	4.3%

Valuation Metrics
(@5/30/18):

	ALB	S&P 500
P/E (TTM)	191.0	24.4
Forward P/E (Est.)	15.9	17.1

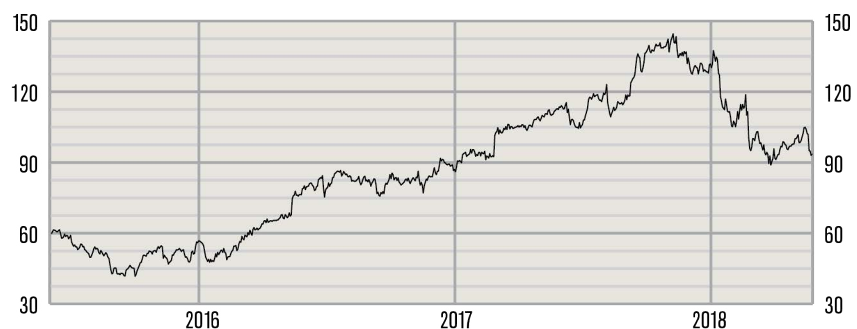
Largest Institutional Owners
(@3/31/18):

Company	% Owned
Vanguard Group	11.3%
Franklin Advisers	8.1%
Jennison Assoc	5.5%
BlackRock	5.0%
State Street	4.7%

Short Interest (as of 5/15/18):

Shares Short/Float	11.5%

ALB PRICE HISTORY



THE BOTTOM LINE

Steve Goddard believes the market is overreacting to the potential of new supply coming on the market to impact the company's high-profile, high-growth and high-margin lithium-production business. Assuming balance-sheet changes to lower the overall cost of capital, flat margins and only inflationary growth, he pegs the stock's intrinsic value at $130.

Sources: Company reports, other publicly available information

in testing which new suppliers are going to be reliable. That will favor incumbents – almost all of Albemarle's production is already contracted out through 2021.

Is there a case to be made that the company should just focus on lithium?

SG: Management has hinted at that possibility, but whether it does or doesn't happen, as the lithium business expands it will drive higher overall top-line growth and margins. The overall EBITDA margin today is just under 30%, but we see that increasing as lithium, with its materially higher EBITDA margins, accounts for a bigger piece of the pie. That should help the stock at least somewhat re-rate, regardless of what happens with the other two businesses.

How inexpensive are the shares at today's price of around $93.50?

SG: The company is going to leverage up on its own to fund aggressive lithium capacity expansion and also to accelerate share buybacks, which can reduce the overall cost of capital by 200 basis points. If along with that we assume inflation-type growth and flat margins, our balance-sheet optimization value comes to around $130 per share.

If we go a step further and assume they sell at reasonable prices the bromine and catalyst businesses – both of which are healthy and well-positioned – and then factor in the resulting higher margin profile the business would have, we arrive at an intrinsic value estimate closer to $150.

From batteries to building materials, explain your interest in Armstrong World Industries [AWI]?

BC: We often find interesting ideas by asking managers of our portfolio companies what other companies and managers they admire. In this case we started looking into Armstrong World on the recommendation of the people at USG, a long-time holding which is also in the building-materials space.

AWI is the largest global producer of ceiling systems for the new-construction and repair-and-remodel markets. In North America it has 55% of the market, followed by USG at 30% and CertainTeed at 10%. It's a tough business to enter, as producers typically have exclusive long-term contracts with the large distributors who account for as much as 80% of industry sales. Warranties on the installed base also usually require that contractors use the original manufacturer for repair and remodel work. The nature of the market affords AWI pricing power that drives overall operating margins of more than 20%.

While overall U.S. non-residential construction has recovered fairly well from the dramatic fall after the financial crisis, there's still pent-up demand for the types of buildings that require more extensive and sophisticated ceiling systems – for offices, retail, education and healthcare. That should drive continued volume recovery for AWI in the U.S. and also generate higher margins as it sells more systems with higher-end acoustical, light and weight characteristics compared to traditional ceiling tiles.

There's also a self-help aspect here. The company has agreed to sell its businesses

INVESTMENT SNAPSHOT

Armstrong World Industries
(NYSE: AWI)

Business: Supplier of commercial-building ceiling systems in North America, serving both the new-construction (25% of sales) and repair-and-remodel (75% of sales) markets.

Share Information (@5/30/18):

Price	**61.50**
52-Week Range	41.65 – 64.60
Dividend Yield	0.0%
Market Cap	$3.19 billion

Financials (TTM):

Revenue	$893.6 million
Operating Profit Margin	21.0%
Net Profit Margin	17.3%

Valuation Metrics
(@5/30/18):

	AWI	S&P 500
P/E (TTM)	21.5	24.4
Forward P/E (Est.)	14.3	17.1

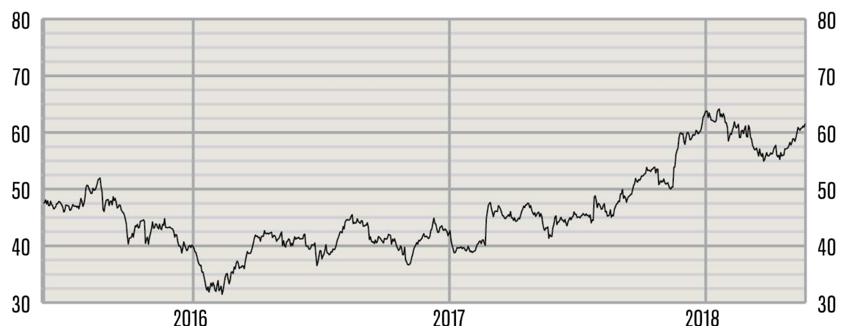
Largest Institutional Owners
(@3/31/18):

Company	% Owned
ValueAct Capital	13.2%
Iridian Asset Mgmt	9.0%
Vanguard Group	7.5%
T. Rowe Price	6.8%
Gates Capital	4.9%

Short Interest (as of 5/15/18):

Shares Short/Float	3.4%

AWI PRICE HISTORY



THE BOTTOM LINE

The company is poised to benefit from pent-up demand in the U.S. for the types of non-residential construction projects that require higher-end ceiling systems, says Brian Campbell. Assuming a balance-sheet recap, 2% annual revenue growth and higher overall margins after non-U.S. businesses are sold, he thinks the stock is worth at least $70.

Sources: Company reports, other publicly available information

in Europe and Asia – which accounted for more than 35% of revenues but no profits – to Knauf International. As a pure-play domestic operator, consolidated margins will go up significantly, capital will be freed up, and we'd expect the stock to re-rate accordingly.

The shares have done well, up more than 45% in the past year to a recent $61.55. How are you looking at valuation?

BC: The company should earn around $350 million in EBITDA this year, against an enterprise value of $3.7 billion. For an industry leader with operating margins that are likely to increase as it becomes a U.S.-only company, we don't consider that at all expensive.

If we go through a recap of the balance sheet, assume 28% operating margins and only 2% top-line growth, we arrive at a fair value estimate of $70 per share. That suggests a pretty good margin of safety for a company with secular tailwinds and what we think is an increasing competitive advantage.

Are there any key risks here?

BC: There is a court case, originally dismissed but now in appeal, that is challenging as anti-competitive one of AWI's contracts with a good-sized distributor. We don't assume any special insight in handicapping what happens, but even if this type of contract is disallowed, it shouldn't be materially disruptive to AWI's business. Distributors use Armstrong because of the availability and value of its products, not because of any undue influence.

What do you think the market is missing in Penske Automotive Group [PAG]?

SG: Penske is an international transportation-services company that has diversified from its roots in retailing import and luxury car brands into commercial-truck dealerships, used-car supercenters, truck leasing and truck parts. The market seems to treat it as if it's just a new-car dealer, but the company has actually done a good job of insulating itself from the cyclicality of annual car-sale numbers. Overall company return on equity is around 19% and returns on invested capital are in the low-teens.

Selling cars isn't a high-return business, but Penske benefits from scale in both the U.S. and U.K. markets and from high profitability from related parts, servicing, finance and insurance businesses. Going forward we think it has real potential to build out its CarMax-type used-car business and should benefit as a buyer as consolidation in auto retail accelerates.

The stock first caught our attention a couple years ago when it got hit during the Brexit scare, owing to the fact that more than a third of the business comes from the U.K. At that point we noted that the Penske Corp. holding company – Roger Penske founded Penske Automotive and is the largest shareholder – was buying heavily on the open market. The holding company bought another $50 million worth of shares last October. We like it when the founder is still so involved. He's 81 years old, acts like someone half his age, and has total command of the business and the numbers.

INVESTMENT SNAPSHOT

Penske Automotive
(NYSE: PAG)

Business: Diversified transportation-services provider with operations in auto and commercial-truck retail, truck leasing, and truck parts; primary markets are the U.S. and U.K.

Share Information (@5/30/18):

Price	**48.43**
52-Week Range	38.33 – 54.83
Dividend Yield	2.8%
Market Cap	$4.12 billion

Financials (TTM):

Revenue	$21.39 billion
Operating Profit Margin	2.9%
Net Profit Margin	2.9%

Valuation Metrics
(@5/30/18):

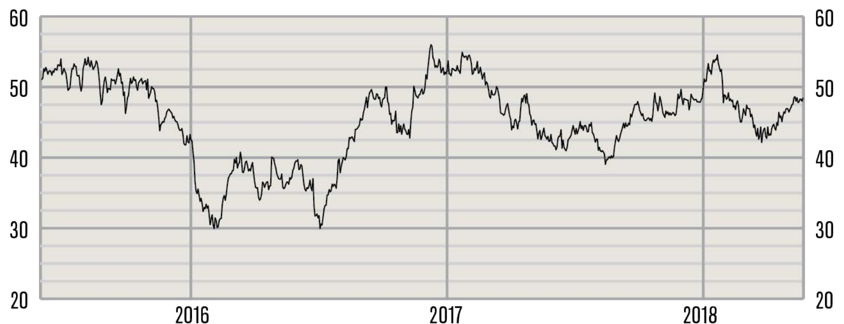
	PAG	S&P 500
P/E (TTM)	6.8	24.4
Forward P/E (Est.)	9.0	17.1

Largest Institutional Owners
(@3/31/18):

Company	% Owned
Dimensional Fund Adv	3.6%
Vanguard Group	3.3%
LSV Asset Mgmt	3.1%
London Co	2.8%
BlackRock	2.6%

Short Interest (as of 5/15/18):

Shares Short/Float	12.7%



THE BOTTOM LINE
While the market seems to treat the company as if it's just a cyclical new-car dealer, Steve Goddard believes it has intelligently diversified away from some of the volatility in annual car sales. Approaching valuation with a keener eye to the value of the company's component parts, he estimates the shares' intrinsic value at "well north" of $60 per share.

Sources: Company reports, other publicly available information

The 6.8x trailing P/E multiple on the stock, now at $48.40, would indicate the market isn't enthusiastic about the company's prospects. What do you think the shares are more reasonably worth?

SG: People seem worried about the new-car cycle peaking and to our mind aren't adequately valuing the different parts of the business. To use just one way of coming at it, if we assumed the company sold its truck-leasing assets and then levered up to an appropriate level of debt to total capital, it could retire 20-30% of its current market value. If we then run it through our BSO model assuming little to no revenue or margin growth, we arrive at an intrinsic value estimate well north of $60 per share. That to us is an attractive margin of safety, with support in addition from a nearly 3% annual dividend yield.

Can you generalize at all about where you've made mistakes?

BC: One theme that has come out in our review of past mistakes has been investing in companies with a level of complexity that we didn't appreciate. We try to keep things within our circle of competence and focus on businesses we can understand and predict. Sometimes we haven't gotten that right.

The most visible recent example would be General Electric [GE]. We thought the strength of the aviation and healthcare businesses would be enough to drive an eventual re-rating of the stock, but we didn't fully understand the challenges in the power business and certainly didn't expect GE Capital to need another $15 billion in reserves, which they announced in January. To compound that, while we knew the complexity of the business required taking somewhat of a leap of faith with management, that confidence turned out to be misplaced. While new management seems to be saying the right things, with the lower equity value reducing balance-sheet optionality and with any turnaround likely to take quite some time, we've taken our lumps and moved on.

Five years ago you thought your patience would be rewarded in California real estate company Tejon Ranch [TRC]. That hasn't happened. Have you stuck with it?

SG: We have, although it's now a pretty small position because it has underperformed and we haven't added to it. The company's primary asset is 208,000 acres northeast of Los Angeles, a land asset that can't be replicated. We think the value is still there, but when the California residential-housing market recovers enough to start to unlock it, we don't know. That's the piece we've gotten wrong so far. At some point we'll lose patience, but there's nothing going on at the company that we see as destroying value. Let's hope within the next five years there's something better to report than that. VII

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