THE
LONDON
COMPANY

April 5, 2016

To clients and friends of The London Company:

"March is a month without mercy for rabid basketball fans. There is no such thing as a "gentleman gambler" when the Big Dance rolls around. All sheep will be fleeced, all fools will be punished severely. ... There are no Rules when the deal goes down in the final weeks of March. Even your good friends will turn into monsters. They will watch you intensely for any sign of emotional commitment to your bets, and then jump you like snakes on a toad. Loyalty is a fatal weakness in this business. This is an open invitation to a Beating."

- *Hunter S. Thompson*

Hunter S. Thompson, the counter-culture icon and pioneer of 'gonzo' journalism, had a flair for drama. He didn't mince words nor shy away from madness. The self-proclaimed 'King of Fun' often included himself in his writing and the stories he covered reflected his varied interests *and* his varied vices. His admitted addictions to basketball and politics and to other legal and illegal iniquities suggest his only fear and loathing was a life of boredom. If he were around today, it would be a safe bet to assume his interest in the most recent March Madness basketball tournament (gambling results notwithstanding) and our current presidential race would be high. The first couple rounds of the bracket were some of the most dramatic ever played. Late game heroics were nonstop, and those vested into the Big Dance were captivated by the outcomes. On a separate dance floor, the political scene has provided drama, nonstop entertainment, and a madness of its own variety as well. Presidential candidates from both parties have turned this election into a spectacle, and the results have been so surprising and hotly contested that even Hunter S., sober or not, may have struggled rationalizing the current state of affairs.

While the equity markets this past quarter may not have been complete madness, the ever-present volatility and up and down pace certainly resembled an entertaining game. If the market is our opponent, it took a Beating at the start. Through mid-February, the S&P 500 and Russell 2000 Small Cap Index traded down 10% and 16%, respectively. Fools were punished and sheep were fleeced during the first half of the quarter, but second half heroics eased the pain and a fast-charging rally led the market to finish the period practically where it began. For the full quarter, the S&P 500 finished up 1.3%. The Russell 2000 returned -1.5%. Both indices saw sizeable moves and the market recovery since the low on February 11th was one of the quickest on record. It may not have been the equivalent of a 12-point comeback in under 44 seconds (sorry Northern Iowa fans), but it was impressive nonetheless. Volatility has been a recurring theme and one we see continuing for some time, but the noise it creates is void of real long-term concern.

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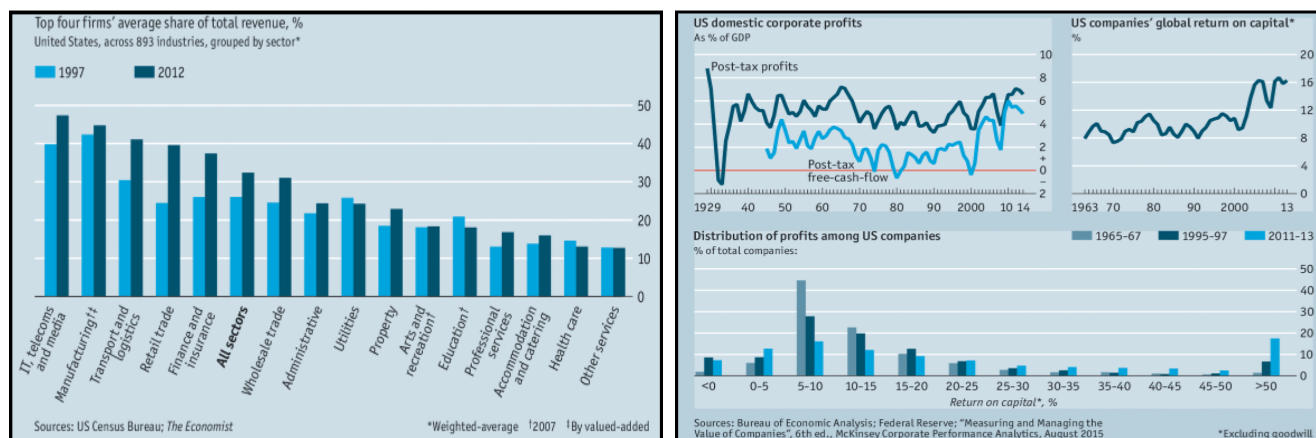
The London Company fared pretty well this time out, despite the volatility. Our large cap strategies were steady and surrounded their benchmarks, with Income Equity slightly ahead and Large Cap slightly behind. Our Small Cap, Smid, Mid Cap and Concentrated portfolios played good defense and handily beat their indices. It is important to note, especially for those that don't know us well, that we don't really change all that much from quarter to quarter, so the relative performance in these shorter-term time periods is mainly a reflection of which direction the market winds are blowing. Thus after withstanding a difficult environment in the fourth quarter of 2015, this past quarter was much more tolerable. Market returns were less concentrated, momentum less frothy and value finally preferred over growth. Much of this reversion happened during the early quick downturn, when defensive sectors (i.e., Telecom, Utilities, and Consumer Staples) outperformed. Post mid-February, the more economically sensitive sectors (i.e., Technology, Consumer Discretionary, Industrials, Materials and Energy) started to show strength. Correlation to oil prices remained elevated and the market rally closely aligned with that commodity. As fears dissipated and credit spreads narrowed, the flight to quality faded. Stocks resumed their trek upward but not in lockstep fashion. Company-specific factors contributed to returns and helped separate the leaders of the pack from the field. Additionally, we noticed demand for dividends spike during the second-half rally as investors looked for bond proxies within the equity market. Higher-yielding stocks outperformed lower-yielding stocks in every sector since mid-February. Sentiment is fickle and can change quickly like it did this quarter, but longer-term we favor dividends and believe their percentage of total return grows over time.

A Jekyll and Hyde market is only worrisome if you are trying to outguess its every move. As longer-term investors, we only adjust to what the market is giving us. Our philosophy and process is disciplined and stringent, yet we aim to be opportunistic in periods of distress and continuously position the portfolios in our highest conviction holdings. Stock selection is how we add alpha, and finding the right companies with the right leadership at the right price is paramount to our success. The attractive candidates we are vetting today are a result of what the market is providing, and is consistent with our general outlook. Specifically, we believe our downside risk is mitigated by remaining focused on those companies with pricing power, copious cash generation and prudent capital allocation. Global growth remains tepid but margins and returns on capital are stable and attractive.

A recent article from *The Economist* lays out a compelling rationale for this long-tailed development. *("Too Much of a Good Thing", 03/26/2016)* Academia has historically stated that surplus gains are self-correcting because new competitors will enter the market and erode away excess profits. Fortunately or unfortunately, depending on your view, massive consolidation and a dearth of new enterprises are making this cyclical phenomenon passé. To be explicit, the article claims Corporate America has undergone roughly $10 TRILLION in mergers and acquisitions since 2008. This insanely large consolidation of businesses has led to much more focused enterprises, making it inherently more difficult for smaller, less competitive entrants to gain traction. Simply put, the number of concentrated industries has grown while the number of fragmented industries has fallen significantly over the past 20 years. The lack of competition allows leading companies the ability to maintain pricing power. It also affords them the flexibility to cut costs and defer capital spending, thus leading to higher profits and returns on capital. Almost every American industry has seen the largest players gain market share. Looking at the charts below, it is clear that revenue is consolidating in most end markets and free cash flow is rising. Return on capital

gains have accelerated and the distribution of those profits is moving towards the more profitable right tail – sharply so for the "exceptional" businesses, those with returns on capital above 50%.



The London Company has traditionally sought oligopolistic industries and companies with few competitors. We are being presented with more of these opportunities today. Business combinations have become smarter and are no longer constructed to build wide-wielding conglomerates, but rather aimed at concentrating an industry into a handful of players, making it more focused so share gains and profits can be maximized. Synergies are the main draw for mergers, particularly when growth is scarce. Since 2008, an estimated $150bn in annual recurring expense has been eliminated due to consolidation, a talking point likely shared in most boardrooms these days. *(Source: Economist, 03/26/2016)* The examples are expansive, but look no further than the airlines, appliance assemblers, battery makers, cable distributors, chemical creators, health care insurers, packaged food producers, paint sellers, power transmitters, railroad operators, and tobacco players as evidence of rapid consolidation. The cycle is contagious and self-propelling, a common reactionary response from competitors trying not to lose a step, or from buyers/suppliers attempting to keep negotiating leverage fair and competitive. If one part of an industry consolidates, it's usually not long before another follows suit. And although the above references mostly American firms, the trends are increasingly global in nature.

Deal announcements have slowed the last few quarters, but premiums offered continue to rise. M&A cycles usually end when economic conditions deteriorate and/or prices paid become stretched or at the extreme, ridiculous (think 1999-2000 and 2007). This doesn't seem to be the case today. Elevated premiums on deals still being consummated is a good sign, and warranted if less competition means more visible cash flows and higher returns on capital across industries. Currently, the average multiple paid for large cap companies is 12x EV/EBITDA (meaning the multiple a buyer pays per operating profit relative to a company's total enterprise value). This is a historically healthy average but is even less than what a leading company or an "exceptional" one would demand. Another fuel adding to the consolidation fire has been cheap financing. Low interest rates make deals more accretive and although the Federal Reserve would like to raise rates sooner rather than later, they appear somewhat trapped. Inflation expectations have been stubbornly low and negative interest rates in Japan and Europe further complicate the matter.

The lasting question is will this consolidation and higher profit structure trend continue and for how long? If it doesn't, what changes? Profit margins have remained elevated longer than most

thought possible, so what would cause them to revert? One answer would be labor costs. So far, employment gains haven't pressured wages and thus margins. Human capital is less important in most industrial firms today due to a heavier reliance on automation and robotics. Service companies still hire humans but in many cases can draw from a global labor pool, which has helped suppress wage inflation and reduce bottom line impact.

So, if interest rates, economic conditions and deal multiples don't slow the tide, how about overzealous activists? In the past, we have addressed how easy it has been for activists to gain a foothold into a company and then use that entrance to influence board members and management teams. Activism has instigated a lot of change, some of which has unlocked significant shareholder value and some of which has unleashed disastrous unintended consequences. The latter creates the headlines and fuels the anger against Corporate America, and particularly Wall Street. It's then repeated ad nauseam in political debates. Perhaps it may take a couple of disasters to see these activist campaigns cool. There have been some hiccups in the past but the recent immolation of Valeant Pharmaceutical seems to take the cake. The stock was championed by a handful of activists and touted as a revolutionary pharmaceutical company. It compounded 1000% over four short years to plummet 90% in just months. Alleged price gouging, channel stuffing, accounting irregularities and excess leverage are taking a toll. It is not a position we have ever held, but its success, then failure, complicated by its complexity and well publicized concentrated ownership have been nothing short of dramatic. We know better than to throw stones while living in glass houses, but Valeant could be a great future case study. It correlates well with Hunter S. Thompson's gambling warnings on letting emotions and loyalty cloud your vision. We don't gamble here and we aim to keep emotions in check, but the line in the sand is fine when loyalty transitions from a virtue into a curse.

Our main goal at The London Company is to avoid those Beatings, so we remain humble, cynical and demanding at all times. Hubris is a fatal weakness in this business, so we remind ourselves of the mythical Icarus who flew too close to the sun. We attempt to avoid madness, think critically, and invest strategically over longer-term periods, where sanity generally prevails.

Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

The London Company

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