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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing with a Focus on Downside Risk

STEPHEN M. GODDARD is Managing Director and Founder of The London Company of Virginia, LLC, and heads the firm's investment committee. He has over 28 years of investment experience, beginning his career as an analyst for Scott & Stringfellow, followed by senior portfolio management positions at CFB Advisory, and Flippin, Bruce & Porter. A CFA charterholder, member of CFA Society Virginia, and a former board member of the Virginia Asset Management Investment Corporation, Mr. Goddard earned his B.A. in economics — Distinguished — from Virginia Military Institute and his MBA with a concentration in finance from the University of Richmond. Mr. Goddard is a member of the Executive Advisory Council — EAC — of the Robins School of Business at the University of Richmond and also serves as a member of the Virginia Military Institute Foundation Investment Committee.

SECTOR — GENERAL INVESTING

TWST: Tell us a little bit about The London Company.

Mr. Goddard: The London Company was founded in 1994. It was basically a dedicated subadviser to a life/annuity insurer, First Colony Corp. First Colony was sold to GE Capital several years later, and I took The London Company and grew it from there. We have gone from a one-man shop to 28 or so employees, $20 billion in assets under advisement, including non-discretionary model assets, with the following client types: endowments, corporate and public pensions, and high net worth families/individuals.

TWST: How long have you been managing the midcap strategy?

Mr. Goddard: We started in about 2011. The strategy is an extension of the same discipline that The London Company applies in managing our Small Cap; Small-Mid; Large Cap; and Income Equity portfolios.

TWST: What is your investment focus?

Mr. Goddard: We focus on downside risk and try to look for companies that have predictable cash flows, recurring revenues and underlevered balance sheets. We don't rely so much on growth or speculation. We seek factors that can create value under management's control, particularly on the balance sheet. If they can modestly lever their balance sheet, buy back equity or pay out more in dividends, then they could be a candidate for us.

Currently, many companies have excess capital and have not optimized their capital structure. They could easily borrow at 3% to 4% and materially accrete earnings by repurchasing their higher-cost equity. We like to go through this balance sheet optimization exercise and analyze the potential to create value through recapitalization.

TWST: Then is management itself an important factor when you look at a company?

Mr. Goddard: Yes. We look at management closely and specifically at their track record. It is very important that management has an audit record that shows that they return capital to shareholders and don't dilute shareholders through dilutive acquisitions or option creep, because this can destroy the investment thesis.

TWST: What is your process for actually finding what you call winners? Do you start by looking at the entire midcap universe and screen from there?

Mr. Goddard: We basically focus on the midcap names that have the highest returns on capital and attractive valuations. Using those metrics, we screen for the top 20% of the midcap universe. We end up with companies that are market-share leaders or operate in oligopolistic environments. They usually have pricing power, generate abundant free cash flow and typically have underlevered balance sheets.

TWST: Can you talk more about your emphasis on minimizing the downside?

Mr. Goddard: Successful investing is more about avoiding losers rather than trying to pick winners. It is more about making sure we don't invest in companies that have material downside risk. If we diversify with roughly 30 positions, a quarter of them will perform better than expected, with the majority performing roughly in line with the benchmark. But the key is focusing on the ones that underperform and making sure we minimize the mistakes.

TWST: How do you minimize those mistakes?

Mr. Goddard: If an initial position underperforms, we do not add to the position. Initial positions start with a 3% to 5% weighting. If it

declines and causes a 1% negative impact to the overall portfolio, we will not average down, and likely begin to sell. On the other hand, we are not going to rebalance every quarter. So if a 3% outperforming position increases to 5%, we do not necessarily rebalance to 3% if we are comfortable with the valuation. This leads to relatively low turnover and high tax efficiency. In addition, our risk-adjusted returns have been very high over the last two decades.

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TWST: What is the overall situation in the midcap space right now? Are you still finding plenty of opportunities?

Mr. Goddard: We are still early in the cycle where companies have plenty of capacity to modestly lever the balance sheet and lower their cost of capital. We have already observed several years with excess capital being returned to shareholders through accelerated buybacks and increasing dividends. But many companies are still underlevered, leaving ample flexibility to create more value to their shareholders. There is also an opportunity for accretive M&A, and we suspect this will continue to accelerate as organic growth slows. Boards and management have been too conservative with their balance sheet/capital structures the past five years, but every year we are seeing incrementally better shareholder-oriented capital allocation.

TWST: Do you consider yourselves active managers?

Mr. Goddard: Yes, we have very high active share and don't build the portfolio around a benchmark. We look for our best undervalued opportunities, which can result in a portfolio that varies from the benchmark. We believe this is a necessary action to outperform consistently longer term. We can't mimic the benchmark and expect to outperform.

TWST: Right now, you have fairly high exposure to consumer discretionary. Why is that segment providing opportunities?

Mr. Goddard: Part of the reason is that we are seeing more opportunities in the consumer-discretionary space but also have a few positions in the sector that have appreciated meaningfully. **Dollar Tree** (NASDAQ:DLTR), our largest holding, has done very well and is currently about 6% of the strategy. We have confidence in the management team meeting many of the metrics we are seeking: high returns of capital, shareholder-oriented capital allocation and a reasonable valuation.

They recently announced a major acquisition with **Family Dollar** (NYSE:FDO), which will more than double their store base. Usually we are wary of acquisitions, but **Dollar Tree** has been very disciplined. We believe they have a large opportunity to accrete significant value through margin enhancement and synergies.

TWST: Another holding is NetApp, which is a little different. What is it about that one that you like?

Mr. Goddard: NetApp (NASDAQ:NTAP) trades at less than six times EBITDA and is a sizable player in the storage industry. They have an abundance of cash on the balance sheet, nearly a third of their market cap. While they haven't grown materially in recent years, they have relatively stable cash flow. The switching costs are high, creating a stable client base. **NetApp** has the potential to create value by returning their substantial excess capital to shareholders through more aggressive buybacks. This is much more about the opportunity on the balance sheet than speculation on future growth prospects. We view it far easier to analyze the balance sheet opportunities rather than trying to speculate on growth projections.

TWST: What about NewMarket? Why do you like that name?

Mr. Goddard: NewMarket (NYSE:NEU) is another large holding we have had for a very long time. We first started buying at $5 per share, and it's $457 a share now. The company operates in an oligopolistic-type industry where they provide additives to gasoline/lubricants. The industry has significantly consolidated down to only four suppliers over the past few decades. Volumes are primarily driven by global mileage, and they have seen material growth in Southeast Asia. With only four players in this market, competitors have become more rational, allowing for higher returns and margins.

NewMarket earns roughly 40% return on capital and throws off well in excess of $300 million of cash flow annually. It is still run by members of the shareholder-oriented founding family, who own well over 20% of the stock, been buying back shares and increasing the dividend consistently. So unless gasoline goes out of favor and everybody moves to battery-powered cars, they have a healthy, predictable cash flow stream that can continue to be utilized for more shareholder-friendly actions. Valuation is not inexpensive relative to its historical valuation, but it is a company that has done an excellent job of improving its returns and creating value over time.

TWST: Do you invest internationally?

Mr. Goddard: Not directly. Our portfolios have roughly a third of their sales coming from overseas, so we get our international exposure in that manner.

Highlights

Stephen M. Goddard discusses The London Company and its Mid Cap strategy. Rather than relying on growth or speculation, Mr. Goddard focuses on downside risk when building his portfolio. He believes that success is more about avoiding losers than picking winners. Mr. Goddard is looking for companies with predictable cash flows, recurring revenues and underlevered balance sheets. A company's management team is an important factor when evaluating a company. Mr. Goddard wants to see a management team with a strong track record and with a history of returning capital to shareholders.

Companies discussed: Dollar Tree (NASDAQ:DLTR); Family Dollar Stores (NYSE:FDO); NetApp (NASDAQ:NTAP); NewMarket Corporation (NYSE:NEU) and Atwood Oceanics (NYSE:ATW).

TWST: You are underweight energy. Is that changing with the decline in oil prices?

Mr. Goddard: We haven't made any changes based on the oil drop. We think the hysteria is overdone. We only have one holding in energy, which is **Atwood Oceanics** (NYSE:ATW). If we look at the replacement costs of their drilling rigs and the present value from the cash flows from their multiyear contracts, the stock is trading below private market value. A significant percentage of their revenue is locked in over the next three to four years. Insiders have also been buying the stock recently. So far this year, **Atwood** has been one of our top performers.

1-Year Daily Chart of Dollar Tree

Chart provided by www.BigCharts.com

TWST: You have a fairly concentrated portfolio. Is diversification important?

Mr. Goddard: We do optimally diversify. But beyond a certain point, overdiversification hurts you. Once we reach 30 to 35 positions, adding more doesn't decrease the risk relative to the expected return dilution. We prefer having our top 10 positions making up 40% to 50% of the overall portfolio — and usually where we add significant alpha to a portfolio. Given that we are so focused on decreasing risk in other ways — by concentrating on underlevered balance sheets, predictable cash flows and reasonable valuations — our volatility has been far less than many strategies that have hundreds of names in a portfolio.

TWST: What prompts you to sell something?

Mr. Goddard: If our thesis doesn't work out, we will sell. For example, if we expected a company was going to return excess capital to shareholders but, instead, spent the capital on a dilutive acquisition, we will likely sell or reduce our exposure. Significant insider selling and valuation concerns would be other reasons we may sell. Our turnover is low, roughly 25% a year, so we invest for the long term, holding positions four years or more.

TWST: Tell us about your background.

Mr. Goddard: I started as a sellside analyst in the 1980s, following primarily banks and financial services. I transitioned to the buy side in the latter part of the decade, employed by a few value-oriented investment advisers as a portfolio manager. In 1994, I had the opportunity to start my own firm, and 21 years later, I am still focused on managing our firm and always working to maintain our top-tier performance record. I believe our success has been tied to our focus on downside protection and never becoming complacent.

TWST: What are some of the trends you are seeing evolving in the market this year?

Mr. Goddard: One thing we are seeing is an acceleration in mergers and acquisition activity. Companies are not seeing much topline growth, and margins are at record peaks, so the only major levers left to create value are more aggressive, shareholder-oriented capital allocation, strategic spinoffs/sales or be acquired. I think we'll see a lot more consolidation in virtually every industry.

TWST: What advice would you give investors right now?

Mr. Goddard: The consensus believes equities are fairly valued based on historical norms. But interest rates are at 2% to 3%, not the normal 6% to 8% we have experienced over our careers. On a relative basis, equities are undervalued based on normalized equity risk premiums of 300 to 500 basis points. With current low rates and a normal risk premium, equities should trade well over 20 times. All assets are discounted and based off interest rates; it's just a matter of the risk premium one believes is appropriate for the asset.

TWST: Thank you. (LMR)

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