Value Investor INSIGHT

June 30, 2022

The Leading Authority on Value Investing

Ports in a Storm

Stephen Goddard and Samuel Hutchings of The London Company describe their long-standing – and highly relevant today – focus on downside protection, how they emphasize balance sheets in arriving at a company's worth, and why they think the market is mispricing Nintendo, Starbucks, Fidelity National Information and Air Products & Chemicals.

INVESTOR INSIGHT

The London Company
Stephen Goddard *(l)*, Samuel Hutchings *(r)*

Investment Focus: Seek companies with sustainably high returns on capital as well as balance sheets that support shareholder-oriented management in creating value.

It was sounding rather old-fashioned until recently, but Steve Goddard has always highlighted protecting client assets on the downside as a key driver of long-term outperformance. That's exactly what the primary strategies of his $15.2 billion (assets) The London Company have delivered. By outperforming in down markets more than it underperforms in up markets, its Income Equity strategy, for example, has since 1999 earned a net annualized 8.9%, vs. 7.2% for the Russell 1000 Value Index.

In a market where investors appear to be increasingly fearful, Goddard and co-portfolio manager Sam Hutchings are finding what they consider downside-protected opportunity today in such varied areas as coffee shops, videogames, industrial gases and financial technology.

It's a good time to speak with someone who puts as much emphasis as you do on downside protection in seeking out investments. Why do you consider that important and how in practice do you do it?

Stephen Goddard: The rationale is fairly straightforward. We believe that by better protecting client assets in down markets we increase our chances of delivering meaningful excess returns. That's consistent with what we've done. We've generally outperformed in down markets to a greater extent than we've underperformed in up markets, resulting in long-term performance over full cycles that has been better than the market.

As for how we do it, we try to embed downside protection into our process by focusing on companies with two primary characteristics, sustainably high and improving returns on capital as well as strong balance sheets. These afford management the financial flexibility to create value. Our time horizon is much longer than most – we prefer to hold companies for five years or more that can consistently compound value.

We manage concentrated portfolios – the Income Equity strategy, for example, owns 30-35 names – and if you look at the holdings in that strategy on an aggregate basis, the pre-tax return on invested capital as of the end of March was 23.2%, vs. 9.3% for the Russell 1000 Value index. Net debt to EBITDA was 1.4x, vs. 2.2x for the benchmark. With respect to valuation, despite our holdings' superior fundamentals, EV/EBITDA is usually at or below the market level.

You also have a rather unique valuation process, focused on what you call balance sheet optimization. Does that help "embed" downside protection as well?

SG: With balance sheet optimization, we determine how shareholder value could be enhanced just by optimizing the capital structure – typically lowering the cost of capital by adding debt and buying back equity. Given that optimal capital structure, we'll then do a discounted-cash-flow analysis assuming conservative growth, little or no margin expansion, and the reduced share count implied by the BSO exercise. If the current share price is at least 30% below the resulting intrinsic-value estimate, there's a margin of safety we could find interesting.

We don't expect every company to optimize its balance sheet as our model may imply, but it focuses us on well-capitalized companies with high-quality, sustainable businesses and with the tools under management's control to increase shareholder value. I'm not a big believer in our, or anyone's, ability to estimate the long-term growth rates for any company or industry, so we actively try to minimize speculation around that with the balance sheet optimization process.

Samuel Hutchings: The lion's share of our fundamental analysis is focused on understanding the competitive dynamics in a company's industry, the sources of the company's competitive advantages, and how sustainable those competitive advantages are. We're perfectly fine owning companies that aren't buying back shares

as long as they're putting their great balance sheets to work investing in high-return projects.

Air Products & Chemicals [APD], for example, has a balance sheet that could very well be optimized in the way we talk about it. But they also have a $20 billion backlog of large-scale energy-infrastructure projects – most in some way related to gasification technology – that allow countries to more fully utilize their existing energy resources in a more environmentally friendly way. There is and should continue to be tremendous demand for that. As long as they maintain the disciplined, ROI-focused approach that seems ingrained in their culture, that demand should translate into growing, long-lived cash flows over time. They can certainly do both, but that type of spending should take precedence over repurchasing shares.

You've spoken of Texas Instruments [TXN] as a good example of the kind of business you want to own. Explain why.

SH: It does meet a lot of the criteria. Pretax ROICs are close to 35%. Operating margins have been coming in around 50%. There's net cash on the balance sheet. It's the global market leader in an analog-chip industry that has consolidated significantly over the past decade, with strong secular growth drivers and attractive reinvestment opportunities. Rich Templeton, the Chairman and CEO, is one of the best capital allocators out there, with a record of buying competitors in industry downturns to gain scale and of repurchasing shares in market downturns.

The market is understandably concerned about the cycle, but we'd argue the nature of the business is becoming less cyclical and that as a market leader, TI will likely come out of the other end of any downcycle stronger than it was going in. Using our balance sheet optimization valuation, the stock today [at around $153] trades at a roughly 30% discount to our estimate of intrinsic value.

Are dividends typically important in your judging individual stocks?

SH: There's one research team, applying the same process across our different strategies. For Income Equity, we focus on business quality and downside protection first, but we do aspire to own a portfolio that has a higher yield than the S&P 500. Today that premium is about 100 basis points – with our portfolio generating a 2.5% yield, vs. 1.6% for the S&P. Berkshire Hathaway [BRK.B] is the only stock in that portfolio that doesn't pay a dividend, but we believe the downside protection there more than compensates for the lack of a dividend.

ON STRATEGY:

Typically our strategy does best at the onset of a recession and through a tough economic environment.

SG: Historically, dividends since the 1930s have accounted for close to 60% of the total return for stocks in the U.S. In the 2010s it was 26%, and in the first two years of the 2020s, it was less than 10%. If, as it now appears, we're at the end of the market period where the majority of return comes from speculative growth and multiple expansion, we believe dividends are likely to again become a more important component of total return. Our holdings usually generate considerable excess capital and have more flexibility to increase dividends and buy back shares. Those with more levers to pull to increase value should increasingly stand out over the next decade.

Are there other ways you think your approach is particularly well tailored to the current investment environment?

SG: The companies we own are chosen in large part because of their relative prospective financial strength through the cycle. So typically our strategy does best at the onset of a recession and through a tough economic environment. High-return, competitively advantaged businesses should be better able to weather general economic weakness and inflationary pressures. If interest rates increase, their valuations should hold up better than those of more highly levered, speculative or lower-return companies.

SH: We've done a lot of back-testing on business-quality factors and have found that quality generally tends to outperform in flat, down or slightly positive markets. GMO also recently published a report looking at inflationary environments and found that high-quality stocks outperformed the S&P 500 in six out of eight historic inflationary periods. If you add a value overlay to the quality, it outperformed in seven of the eight. You learn something new every time, but we're comfortable that our approach should be fairly well suited to the environment we seem to be in.

Turning to some individual ideas, describe why you're high on the prospects for Nintendo [NTDOY].

SH: Nintendo is a clear leader in the videogame industry, distinguishing itself competitively through its innovative hardware – its latest device is the Switch – and its valuable intellectual property, including brands like Mario, Zelda, Donkey Kong, Pokémon and Animal Crossing. The company has been around since the late 1800's, earns over 30% operating margins, returns on invested capital are over 20%, and net cash and investments on the balance sheet make up about 25% of the current market cap.

In addition to generally finding the gaming industry attractive and with significant growth tailwinds, we think investors have failed to realize the extent of the company's ongoing transformation on a variety of fronts. One big one is their effort to smooth out historical booms and busts tied to hardware. They're elongating the Switch's product life by coming out with incremental upgrades every year or two rather than putting out an entirely

new console every five or six years. They have built a thriving online subscription service, Nintendo Switch Online, for users to access games online – including the substantial library of old Nintendo games – as well to buy downloadable add-on game content. The Switch itself is more flexible in where and how it can be used, which has fostered increased third-party game development. The previous console, the Wii, had roughly 1,600 games. The Switch already has more than 6,700. All of this is meant to help create incremental, higher-margin and more-recurring revenue streams.

The company has gotten more serious about capitalizing on its intellectual property, pursuing more aggressively a variety of initiatives including merchandise and toys, theme parks, movies and digital ads. They have a significant collaboration with the toymaker Lego. NBCUniversal is rolling out Super Nintendo World sections at its theme parks. In partnership with Illumination Studios, there's a big-budget Super Mario Brothers movie scheduled to come out next year. The latent value in all this intellectual property we think provides further downside protection to our thesis.

We also believe the company's approach to capital allocation is improving. Management has historically been quite conservative – as evidenced by the amount of cash and investments on the balance sheet – but they're becoming increasingly transparent in detailing plans for capital spending and have stepped up efforts to return excess capital. The company paid a special dividend in 2021. Over the past three quarters they've repurchased roughly 2.3% of the outstanding shares. We also like the new, recently announced restricted-stock compensation plan for directors and executives, which we think increases alignment between the company and shareholders.

Why wouldn't the market be sufficiently recognizing all of that?

SH: The overall market obviously hasn't been great, but more specific to Nintendo there's been disappointment over quarterly comps against some very big quarters early in the pandemic. Due to component supply issues, the company has been missing hardware production targets. There's also increased uncertainty, which tends to ebb and flow, over the next iteration of the Switch or even a new console. It's the nature of the business that companies generally don't want to give a lot of advance notice about new products, for fear that everyone stops buying the old one. Such things can preoccupy investors in the short term, but we think are masking fundamental improvements in the business long term.

How are you looking at valuation from today's U.S. ADR price of $54?

SH: Given the liquidity on hand, we believe the company could do a debt recap and buy back 25% of its shares. Assuming that and the resulting impact on the cost of capital and share count, in our balance sheet optimization we can expect 0% revenue growth and normalized operating margins well below current levels and still arrive at an intrinsic value estimate that is roughly twice the current stock price.

INVESTMENT SNAPSHOT

Nintendo
(US ADR: NTDOY)

Business: Global producer of videogame software – franchises include Mario, Pokémon, The Legend of Zelda and Animal Crossing – and videogame consoles such as the Switch.

Share Information (@6/29/22):

Price	**53.99**
52-Week Range	51.91 – 75.52
Dividend Yield	1.8%
Market Cap	$51.14 billion

Financials (TTM):

Revenue	¥1.70 trillion
Operating Profit Margin	35.0%
Net Profit Margin	28.2%

Valuation Metrics
(@6/29/22):

	NTDOY	S&P 500
P/E (TTM)	12.0	20.4
Forward P/E (Est.)	15.0	16.9

Largest Institutional Owners
(@3/31/22 or latest filing):

Company	% Owned
Public Investment Fund	5.0%
Daiwa Asset Mgmt	1.7%
Norges Bank Inv Mgmt	1.2%
Lindsell Train	1.1%
BlackRock	0.9%

Short Interest (as of 6/15/22):

Shares Short/Float	n/a

NTDOY PRICE HISTORY

THE BOTTOM LINE

Near-term supply shortages and unfavorable comparisons to pandemic-related surge demand have obscured the extent of the company's ongoing strategic and business-model transformation, says Sam Hutchings. Assuming the company optimized its balance sheet, he estimates its per-share intrinsic value at roughly twice the current stock price.

Sources: Company reports, other publicly available information

The stock today on our estimate of normal EBITDA trades at 10x EV/EBITDA. In comparison, Microsoft agreed to buy Activision at closer to 18x.

What do you think the market is missing in recent portfolio buy Starbucks [SBUX]?

SH: We've long been admirers of the company, but formally added it to our watchlist in 2018, around the time we purchased shares of Nestle. Nestle is heavily involved in coffee, including a significant joint venture in packaged coffees with Starbucks. As with everything on our watchlist, we were waiting for the right time to act and we saw that opportunity earlier this year.

There are two primary areas in which we think the market is being short-sighted. The first is around the unionization effort at a minority of Starbucks locations around the country, which people seem to worry will result in dramatic increases in labor costs that will squeeze margins. What that seems to miss is that if you look at studies of employee compensation in the retail sector – including a recent detailed one from Aon Hewitt – Starbucks already rates at the very top in terms of benefits and compensation for its store employees. Of the more than 15,000 U.S. stores, there are unionization votes in roughly 200. When we look at the long-term financial risk from all this, we think it's quite small.

The second big issue seemingly on the market's mind is China, where Covid shutdowns have had a significant impact on both same-stores sales and the pace of new-store openings. Given that China is such an important driver of the company's long-term growth, if you're worried about quarter-to-quarter results, this might be an issue. Long term, we think the growth story in China is fully intact.

With uncertainty about China at a heightened level in general, talk more about the company's operations there.

SH: Starbucks first entered China in 1999, but only started to ramp the store base about a decade ago. From fiscal 2011 through fiscal 2021, the number of stores there grew from 275 to 5,500, a 35% annual clip. We estimate the company operates roughly 40% of the chain coffee stores in Tier 1 and Tier 2 Chinese cities today. The payback period on new stores is only 18 months, and at maturity they earn around 35% cash operating margins and provide 70% ROIs, both higher than in the U.S.

What's particularly interesting about the growth prospects from here is that the coffee category in China is really only starting to emerge. Tea consumption in the country still dwarfs that of coffee, and it's really only in the biggest cities where coffee consumption has started to take hold – in no small part facilitated by Starbucks' presence. In looking at penetration rates for coffee in China versus markets like the U.S., Starbucks still has a massive growth opportunity in larger and smaller markets alike. Any time there's short-term earnings trouble people worry it could be a result of waning demand or diminished brand strength. We don't see any evidence of that here and think as the Covid-related restrictions eventually fall away, the growth opportunity in China is as promising as ever.

So if you believe the two big things weighing on the stock are not long-term

INVESTMENT SNAPSHOT

Starbucks
(Nasdaq: SBUX)

Business: Sources, markets and sells premium coffee and related food and beverage products through more than 34,000 company-owned and franchised stores worldwide.

Share Information (@6/29/22):

Price	**76.43**
52-Week Range	68.39 – 126.32
Dividend Yield	2.6%
Market Cap	$87.55 billion

Financials (TTM):

Revenue	$31.33 billion
Operating Profit Margin	15.6%
Net Profit Margin	14.1%

Valuation Metrics
(@6/29/22):

	SBUX	S&P 500
P/E (TTM)	20.5	20.4
Forward P/E (Est.)	21.8	16.9

Largest Institutional Owners
(@3/31/22 or latest filing):

Company	% Owned
Vanguard Group	8.4%
BlackRock	4.5%
Geode Capital	1.8%
State Street	1.7%
Wellington Mgmt	1.1%

Short Interest (as of 6/15/22):

Shares Short/Float	1.3%

SBUX PRICE HISTORY

THE BOTTOM LINE

Sam Hutchings believes current market concerns about store-unionization efforts in the U.S. and the health of the company's China business overstate the long-term risks. The stock today trades at a 25% discount to his estimate of intrinsic value, which he considers "quite attractive for a company we believe can grow intrinsic value at a 10%-plus rate."

Sources: Company reports, other publicly available information

problems, you're left with a business that arguably has a lot going for it. Coffee has proven to be a highly attractive space for market leaders, with still above-average secular growth. Starbucks has a leading 60% share of specialty coffee shops in the U.S., and earns high-teens operating margins overall, ROICs above 40%, and new-store ROIs of 55% in the U.S. and that even more eye-popping 70% in China. Growth outside the U.S. and China is steady if not spectacular, with very high margins as the company tends to pursue franchising in those markets rather than opening company-owned stores.

A specific asset I'd highlight would be Starbucks' loyalty programs, with 27 million members in the U.S. and 18 million in China, both of which are growing rapidly. In U.S. company-operated stores, loyalty members spend at 2-3x the rate of non-loyalty members and now account for roughly 50% of total sales. They are a receptive, targeted audience, and the company does an excellent job in tailoring marketing messages to them, saving considerably on other advertising and marketing spending. We think these programs provide a real competitive advantage, which should increase over time.

Are you happy with Howard Schultz so far in his latest go-round as CEO?

SH: We generally think it's a good thing when a founder like this comes back, as he or she is usually better able to take the bold and necessary steps the situation may require. Who better to address the labor issues than the person who created the company culture in the first place? We think he was right to stop share repurchases for now, and he's talking about the right things in terms of upgrading stores, enhancing the loyalty programs and improving digital capabilities. With respect to investing in stores, when the bulk of the current locations were built things like cold beverages and online ordering were not a big deal. Upgrades that better reflect what's being sold and how it's being sold should make it easier and more efficient for baristas to get drinks into customers' hands. Spending like that should have a high return.

Off 35% since the start of the year, at today's price of around $76.50 how discounted do you consider the shares?

SH: When we optimize the balance sheet, in the first step we think they could take on enough leverage to retire roughly 13% of the shares outstanding. Then in our DCF we assume normalized operating margins of 18% and free cash flow growth only in line with long-term inflation. On our resulting estimate of intrinsic value, the stock today trades at about a 25% discount. That's quite attractive for a company we believe can grow intrinsic value at a 10%-plus rate for some time to come.

From coffee to financial technology, describe your investment case for Fidelity National Information Services [FIS].

SH: This is a relatively new purchase which we looked at more closely near the end of last year as the boom in SPACs brought a lot of financial-technology companies to market. People seemed to think these companies were going to significantly disrupt

INVESTMENT SNAPSHOT

Fidelity National Information Services
(NYSE: FIS)

Business: Provider of a range of financial technology systems and services, including merchant payment processing, bank core processing and capital-markets trading platforms.

Share Information (@6/29/22):

Price	**94.57**
52-Week Range	85.00 – 152.20
Dividend Yield	2.0%
Market Cap	$57.58 billion

Financials (TTM):

Revenue	$14.15 billion
Operating Profit Margin	10.0%
Net Profit Margin	6.4%

Valuation Metrics
(@6/29/22):

	FIS	S&P 500
P/E (TTM)	64.3	20.4
Forward P/E (Est.)	11.3	16.9

Largest Institutional Owners
(@3/31/22 or latest filing):

Company	% Owned
Vanguard Group	7.7%
Capital Research & Mgmt	5.5%
BlackRock	4.8%
State Street	4.4%
Wellington Mgmt	4.0%

Short Interest (as of 6/15/22):

Shares Short/Float	1.9%

THE BOTTOM LINE

Fears over more competition in the company's Merchant Solutions business – accounting for 30% of total revenues – appear overblown, says Sam Hutchings, resulting in a below-average valuation on its stock that he doesn't consider warranted. Based on his balance-sheet-optimization valuation, he estimates intrinsic value at closer to $130 per share.

Sources: Company reports, other publicly available information

the businesses of high-quality competitors in the payments space like Fidelity National, Fiserv [FISV] and Global Payments [GPN]. Those stocks were selling off, but in each case we were also seeing insider buying. That type of thing often gets our attention.

FIS operates in three primary businesses. Its Merchant Solutions business allows merchants to accept digital payments at the point of sale and online, with revenue tied to payment volume. Banking Solutions provides outsourced central-account processing and back-office technology to larger financial institutions. Switching costs here are high and clients typically sign long-term contracts. The third segment, Capital Markets Solutions, provides regulatory, risk management and trading software to buy-side and sell-side firms – also a recurring-revenue business with long-term client relationships. All of these are stable, high-quality franchises with scale, where scale is important. Overall company EBITDA margins are over 40% and have consistently improved over time.

The fintechs coming to market are typically in the merchant-acquiring space, which makes up roughly 30% of FIS's revenues. In addition to it not being that large a part of the overall business, we also think the negativity about new competition is overdone. Merchant Solutions at FIS grew its revenues nearly 20% last year. Customers typically aren't that quick to switch – FIS already serves 40% of the top 100 merchants in the U.S. – and attrition remains low. There very well could be new competition in various parts of the pond, but the pond is very large and expanding, particularly internationally.

We did a back of the envelope sum-of-the-parts valuation and think the merchant business is trading for no more than 5x EBITDA. That's far too low for a business we believe can still grow at a double-digit rate, is fairly recession-resistant, and fares well in inflationary environments.

FIS was in the market to sell all or part of its capital-markets business, but decided earlier this year to pull back from that. Were you supportive of that?

SH: That wasn't really a big issue to us one way or the other. We think capital-markets is a good business that generates a lot of cash, but if they found a buyer willing to pay an attractive price we wouldn't object. It shows that they have a set of assets that gives them optionality and flexibility.

There's no pressure to sell assets. The company has some debt – at the end of last year net debt to EBITDA was roughly 3x – but that's a reasonable level and management wants to increase capital return to shareholders in the years ahead. The dividend payout ratio is expected to increase from the current 25% of adjusted net income to 35%, which could result in the dividend increasing close to 20% annually for several years. They also believe the stock is undervalued and have committed to repurchasing $9 billion worth of shares over the next two years. At today's share price, hitting that would mean retiring 15% or so of the shares outstanding.

ON DIVIDENDS:

Going forward we believe dividends are likely to again become a more important component of total return.

How attractive do you consider the shares at today's $94.60 price?

SH: The stock is trading at roughly 12x EV/EBITDA, versus closer to 13.5x for the broader market – a discount we don't think is appropriate for a significantly better-than-average-quality business. In our balance sheet optimization valuation, we assume free cash flow growth basically in line with long-term inflation and that EBIT margins stay basically where they are. Our DCF arrives then at an intrinsic-value estimate of around $130 per share.

SG: To go briefly back to what Sam said about capital return, we expect dividends generally to increase over the next few years. Many companies have been hoarding cash, and payouts have been low. Companies can more easily get away with holding excess capital when markets are up 20% per year. But in a more normalized market environment going forward, we believe that dynamic reverses.

Describe more broadly the potential you see today in Air Products & Chemicals.

SH: I mentioned earlier the company's massive order backlog, which highlights demand for its gasification, carbon-capture and hydrogen-related technologies. With focus on energy independence and national security at the forefront, Air Products' gasification technologies allow countries to better utilize their resources, reducing the need to import fuel and chemicals. Gasification is a partial oxidation process that converts hydrocarbon-rich natural resources like coal and natural gas into syngas, which is then used to produce power as well as other value-added fuels and chemicals in a more environmentally friendly way than by combusting the input resources.

Air Products' second major business is the manufacture and distribution of atmospheric gases such as oxygen and nitrogen, and process gases such as hydrogen, helium, carbon dioxide and carbon monoxide. These are used in a wide range of industrial applications, and following a period of industry consolidation Air Products, Air Liquide [Paris: AI] and Linde [LIN] now control roughly two-thirds of the global market, leading to generally rational pricing and competition. Roughly 50% of the business is considered on-site, where customers sign 15- to 20-year take-or-pay contracts with inflation passthroughs. That's resulted in mid-teens returns on invested capital and cash flows tend to be predictable and resilient through the cycle.

Of note on the gases side of the business, APD is the largest global producer of hydrogen, which many are betting is an important energy source of the future for power plants, trucks and maybe even a broader range of vehicles. Europe's efforts to lessen reliance on Russian natural

INVESTMENT SNAPSHOT

Air Products & Chemicals
(NYSE: APD)

Business: Manufactures large gasification and carbon-capture projects and sells atmospheric, process and specialty gases and related equipment to industrial users worldwide.

Share Information (@6/29/22):

Price	**243.13**
52-Week Range	216.24 – 316.39
Dividend Yield	2.7%
Market Cap	$53.78 billion

Financials (TTM):

Revenue	$11.39 billion
Operating Profit Margin	20.6%
Net Profit Margin	19.6%

Valuation Metrics
(@6/29/22):

	APD	S&P 500
P/E (TTM)	24.9	20.4
Forward P/E (Est.)	21.0	16.9

Largest Institutional Owners
(@3/31/22 or latest filing):

Company	% Owned
Vanguard Group	8.6%
State Farm Inv Mgmt	5.8%
State Street	4.7%
BlackRock	4.4%
Franklin Adv	2.1%

Short Interest (as of 6/15/22):

Shares Short/Float	1.2%

THE BOTTOM LINE
The company's gasification, carbon-capture and hydrogen-related technologies should remain in high demand as countries look to improve both their energy independence and the environmental impact of their use of resources, says Sam Hutchings. On his balance-sheet-optimization valuation, he estimates per-share intrinsic value at $310 to $330.

Sources: Company reports, other publicly available information

gas, for example, call heavily on hydrogen. The U.S. government has also called for the infrastructure to export natural gas to be capable of shipping hydrogen as well.

We're particularly high here on CEO Seifi Ghasemi, who became chairman and CEO in 2014. He has a great track record of creating shareholder value at previous companies and he's done an excellent job here in positioning the company strategically and in running operations. They're disciplined about the required return on all new business. Since he came to APD, EBITDA margins have improved by approximately 950 basis points.

How would you characterize the company's balance sheet?

SH: This is a good candidate for balance sheet optimization, with net debt now less than 1x EBITDA. If it were to optimize the capital structure, we estimate the company could raise debt by $9 billion at 4% interest in order to buy back up to 17% of shares. There's plenty of money to fund operations – the business currently generates about $3 billion in annual operating cash flow, $1.2 billion of which goes to dividends and the rest toward maintenance and growth capital spending.

At a recent price of around $243, how inexpensive do you consider the stock?

SH: In this case we don't really expect them to repurchase the amount of shares they could, given the backlog of what they consider high-return projects. But if we assume they did and conservatively model both free cash flow growth in line with long-term inflation and normalized EBIT margins of 29%, we estimate current intrinsic value at $310 to $330 per share.

Just a brief additional comment on the dividend. APD has increased dividends for 40 consecutive years, growing the payout in line with earnings. Dividends have risen at a 10% compound growth rate over the last ten years and continuing to increase the payout appears to be a clear focus.

When you sell a position for reasons beyond just valuation, what else tends to be going on?

SH: More often than not it would be because our assessment of the competitive situation has turned negative and/or we have increasing concerns around capital allocation. For example, we owned Intel [INTC] for a long time but in recent years we failed to fully understand the extent to which it was underinvesting in its business. Now under a new CEO they're planning to spend $25 billion-plus per year to invest in foundries. Given that free cash flow is now likely to be negative for a number of years and there's very low visibility into the ultimate payoff from all the spending, we sold our position. I mentioned earlier we're fine with heavy capital investment, but in this case our uncertainty about the outcome of the company's very ambitious program is just too high.

Another recent sale having a lot to do with capital allocation would be Franklin Resources [BEN]. The company has made a number of investment-firm acquisitions over the years, some of which we agreed with, but we thought more recent ones in the alternative-investment space were considerably overpriced. We would have much rather seen them buy back their own shares at 4-5x cash flow than spend

multiples of that on alternative investment managers when everyone seems to think that's the place to be.

SG: One interesting note here is that the founding family still owns a large stake in Franklin, which we've typically found helps mitigate capital-allocation risk. In this case, however, we were not enamored with the recent acquisitions.

On the subject of selling, I'd add that we rarely average down on holdings going sharply against us. When something has a 1% or more negative portfolio impact – say a 3% position is down 33% from our cost – we will formally reassess the investment case. We go into positions assuming there's a high margin of safety in our assumptions, but when a stock declines materially we have to consider there is risk we didn't factor in. More often than not, in reassessing we conclude we did miss something. We may not always sell after revaluing the business, but we rarely increase our position. We try to be sensitive about throwing good money after bad.

I generally believe that less turnover is better, especially for taxable accounts. A humbling exercise for any manager is to go back and look at what was bought and sold over the past five or ten years and look closely to see how trading impacted performance. This of course won't always be the case, but many times we find excessive trading has a negative impact.

With markets as they are, where would you say you are on the "It's an exciting time to be an investor" vs. "It's a scary time to be an investor" continuum?

SG: We're more in the former camp. When everyone is fearful, that's when you should be more active.

Valuations today are very reasonable for high-quality stocks relative to long-term interest rates. It's been distressing for quality value investors to live through a speculative decade where growth outperformed, but we believe downside protection, quality and fundamentals will matter again going forward, similar to the decade following the tech bubble bursting in 2000. VII

The London Company – Income Equity Strategy – Important Disclosures

Annualized Returns (since inception 12/31/1999)
As of 3/31/2022

	QTD	1Y	3Y	5Y	10Y	ITD
Income Equity (Gross)	-2.2%	15.5%	15.0%	13.1%	13.1%	9.9%
Income Equity (Net)	-2.3%	15.0%	14.5%	12.6%	12.6%	9.2%
Russell 1000 Value	-0.7%	11.7%	13.0%	10.3%	11.7%	7.5%
S&P 500	-4.6%	15.7%	18.9%	16.0%	14.6%	7.2%

The Income Equity product is typically compared to the Russell 1000 Value Index. Any comparison to the Russell 1000, S&P 500, or their corresponding ETFs, is for illustrative purposes only. Performance is preliminary. Subject to change. Performance results shown should, under no circumstances, be construed as an indication of future performance.

The London Company was founded in 1994 in Richmond, Virginia and provides equity portfolio management services to pension, profit-sharing, foundation, corporate, investment companies, and individual investors. The firm, which is majority employee-owned, is an independent, autonomous investment management organization. The London Company of Virginia is a registered investment advisor. Registration does not imply a certain level of skill or training. More information about the advisor, including its investment strategies, fees and objectives are more fully described in the firm's Form ADV Part 2, which is available upon request by calling 804.775.0317, or can be found by visiting www.TLCadvisory.com.

Past performance should not be taken as a guarantee of future results. The report is for informational purposes only. Data, while obtained from sources we believe to be reliable, cannot be guaranteed, and all statistics are subject to change. The statements contained herein are solely based upon the opinions of The London Company and the data available at the time of publication of this report, and there is no assurance that any predicted results will actually occur. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell any specific securities and should not be considered investment advice of any kind. In making an investment decision individuals should utilize other information sources and the advice of their investment advisor.