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Selected Session Highlights from Wide-Moat Investing Summit 2020

The following snapshots have been provided by the respective instructors or compiled by MOI Global using information provided by the instructors. The following is provided for educational purposes only and does not constitute a recommendation to buy or sell any security.

Benjamin Beneche, Senior Investment Manager, Pictet Asset Management

FANUC (Japan: 6954) specializes in automation. Since becoming independent in 1972, the business has grown to become a market leader in three important robotics verticals: numerical controllers (29% sales), industrial robots (37%), and machine tools (16%). Within each of these businesses, FANUC has best-in-class contribution margins, enabled by a combination of technological, cultural, and cost-based competitive advantages.

The favorable underlying economics have been masked by significant investment in new capacity and R&D, which has contributed to EBIT margins declining from 40.8% in 2015 to 17.4% last year. As capex begins to normalize and plant utilization improves from the current sub-30% level (estimated), the business appears poised for significant improvement in both sales and margins, with steady-state ROCE of 25.2%.

R&D spending has largely focused on an edge-based software stack called FIELD, which offers tools such as predictive maintenance and zero-downtime applications to clients. Although still in the early stages, the ROI offered to clients appears high, with a bull case scenario of FIELD stand-alone potentially worth 140% of the company's recent market cap. Even assuming no value here, the shares recently traded at 17x Ben's normalized FCF estimate, a reasonable margin of safety for a business of this quality.

Rodrigo Lopez Buenrostro, Investment Principal, KUE Capital

OTIS (US: OTIS) manufacturers, installs, and services the most critical component of any building -- the elevator. As a spin-out from UTC in April 2020, OTIS offers an opportunity to invest in a market leader with a great business model. The company has "the best of both worlds": it services a large installed base of elevators in Europe and the US and benefits from growth in emerging markets, particularly China, through the installation of new equipment.

OTIS is more profitable than its peers, with ROIC of 21% (vs 16%), for a simple reason: It boasts the highest market share of the service business, with 19%, which provides recurring revenue, long-term client contracts, sticky relationships (93% retention rates), and attractive EBIT margins of 20-22%.

As the segment leader, OTIS also generates market-leading FCF, which allows the company to pay down debt (investment-grade rating), pay a dividend, invest in technology R&D, and consolidate the fragmented services business in order to increase network scale and density.

Management is well-aligned with investors to maximize EBIT and FCF. Although the peers recently traded at an average estimated FCF yield of 3.7% and EV/EBITDA of 17x, and a close German peer (Krupp) was recently taken private by a private equity group at 19x EBITDA, the market recently appeared to undervalue OTIS, with an FCF yield of 5.5%.

Stefan Ćulibrk, Managing Partner, Highway One Asset Management

Interactive Brokers (US: IBKR) is a low-cost, high margin, electronic brokerage business. IBKR's clients are individuals, financial advisors, introducing brokers, hedge funds, and proprietary trading firms. IBKR offers attractive rates on margin loans, deposits, and low commissions to its global client base. Most of the company's revenue comes from interest income collected on client assets. Thomas Peterffy owns 73% of the company he founded in the late 1970s. The company is conservatively financed, carrying billions more than the regulator is asking for, and multiples more than peers.

Stefan expects IBKR to double the number of accounts, client equity, and earnings power over the next five years. A normalization of interest rates should turn earnings power into cash flow.

Robert Deaton, Managing Principal, Fat Pitch Capital

Liberty Sirius XM (US: LSXMK): Sirius XM provides satellite radio services, primarily in audio systems in cars and trucks. 80% of new cars sold in America are enabled to deliver satellite radio. New car buyers are typically given a trial period. 40% of trial subscribers become self-pay subscribers. Sirius is a well-established company with 34.8 million subscriptions. Liberty Sirius

XM owns over 70% of Sirius XM. By buying shares of Liberty Sirius XM, an investor can get exposure to Sirius XM at a sizable discount.

Alex Gates, Research Analyst, Clayton Partners

Clean Energy Fuels Corp. (US: CLNE) owns and operates the largest footprint of natural gas fueling stations in the US. The growth of renewable fuels has transformed the company into a profitable, cash-rich business focused on reducing carbon emissions in the trucking industry.

Clean Energy distributes 50+% of all renewable natural gas (RNG) in the US through 550 stations, which Alex estimates would take more than ten years and $2+ billion to replicate. Clean Energy's stations are the only scalable pathway to monetize highly valuable federal and California state environmental credits from RNG usage.

The company will end the year with ~15% of the recent market cap in cash and no debt. Alex expects 2020 EBITDA of $45 million to triple in three years as the growth of RNG continues at the current pace. By 2025 the company will distribute 100% renewable fuel, potentially garnering attention from ESG investors.

The equity would be valued at $3.50 per share assuming 8.5x 2022 EBITDA. However, if we value the company at a comparable gas station operator multiple of 12x, the equity could be worth $6 per share.

Hunter Hayes, Vice President and Portfolio Manager, Intrepid Capital Management

Take-Two Interactive Software (US: TTWO) is a popular video game publisher with a wide moat, substantial growth opportunities, and excellent management. The company owns or licenses the intellectual property behind some of the best-selling entertainment series of all time, including Grand Theft Auto, Red Dead Redemption, and NBA 2K.

During the COVID pandemic, engagement across the company's franchises has shattered previous records. TTWO is one of the "Big Three" video game publishers in the US, with the lowest operating margins (despite competitive gross margins) as the company has not yet scaled to the same extent as Electronic Arts (US: EA) and Activision Blizzard (US: ATVI).

The equity recently traded at ~$138 per share, which Hunter views as an attractive discount for a company with premium intellectual property, ROIC in excess of 20%, and the potential to generate annual FCF of $10 per share in the next few years.

Management owns a substantial amount of stock and the company's developers receive stock-based compensation, creating an aligned, shareholder-friendly incentive structure across the organization.

Charles Hoeveler, Managing Partner, Norwood Capital Partners

Rimini Street (Nasdaq: RMNI) is the leading independent support provider for enterprise software systems, a ~$16 billion industry. RMNI features a “coder culture” of software engineering expertise combined with a service orientation to deliver a compelling value proposition to customers. The industry is expected to triple over the next four years as global enterprises become aware that there is an alternative to the abusive pricing and poor service of SAP and Oracle.

RMNI has a long runway for growth, is ~10x larger than its next-largest independent competitor, ~99% recurring revenue, and valued at a fraction of business service and software peers.

Jonathan Isaac, President and Portfolio Manager, Quilt Investment Management

Exponent, Inc. (US: EXPO) is a multidisciplinary consulting firm providing scientific and technical services to organizations to address and prevent failures. Like Coca-Cola in the mid-to-late 1980s, Exponent has a dominant position in its core market—reacting to failures—while being able to grow organically within that market, and in new markets. Coke from that period and Exponent both exhibit how a highly profitable, relatively non-cyclical business with a sticky customer base can accelerate organic growth through boosting its instances of use throughout the average day of the customer. For Coke, this meant expanding the Coke Megabrand of soft drinks in order to take market share from water, and moving towards the adoption of fountain and vending channels internationally. For Exponent, this means flipping the script from helping firms react to failures, to helping them prevent potentially costly failures. In an increasingly complex technological world, Exponent’s expertise in battery consulting and the interactivity between humans and machines (what Exponent calls “Human Factors”), positions Exponent to further leverage its historic customer relationships to drive organic growth.

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Arvind Mallik, Co-Managing Partner, KMF Investments

ViacomCBS (Nasdaq: VIAC) is a “new” company resulting from the December 2019 an all-stock merger of Viacom and CBS. The company is controlled by the family of billionaire media mogul Sumner Redstone and has a dual-share structure: VIAC and VIACA. The stock has sold off post-merger and Covid-19 pandemic, trading at $25 per share recently, or an equity market cap of ~$15 billion. At a P/E multiple of only 5x, ViacomCBS is one of the most undervalued media giants. Merger savings of ~$750 million could add more than $1 to EPS.

The post-merger ViacomCBS has improved its scale and customer captivity moats in both the streaming and traditional businesses. The company plans to divest non-core assets (real estate, book publisher Simon and Schuster) where there is no significant moat or synergy. ViacomCBS’s vast content library surpasses even those of powerhouses like Netflix, Amazon, and Disney, allowing opportunistic “arms dealer” monetization. The global reach of the company provides a platform for growth and monetization of content.

While the company’s debt is significant, ViacomCBS maintains a manageable leverage ratio and healthy interest coverage. Even during Covid-19, the company successfully refinanced its near-term maturities and retained access to a $3.5 billion revolver, which remains undrawn.

Chairwoman Shari Redstone stated at the May 2020 annual meeting, “We totally believe the stock is dramatically undervalued. The market is looking for us to prove we can execute our strategy.” Redstone purchased $2 million of VIAC non-voting stock in February and March. Potential success in streaming could change investor perceptions of the company’s value.

Gary Mishuris, Chief Investment Officer, Silver Ring Value Partners

Covetrus (US: CVET) is a spinoff that combines two animal-health related businesses whose economics are still not fully understood and whose financials do not adequately reflect the earnings power of the company. The company’s legacy animal health distribution business operates in an oligopoly and is in the process of being turned around by a new CEO, with initial evidence of progress. The second business is the leading software-as-a-service (SaaS) platform for vet practices to fulfill orders online. It is growing 40+%, has a meaningful ramp for future growth, and has much higher incremental margins than the distribution business.

The historical financials are misleading due to spinoff accounting and because the SaaS business is not yet contributing significantly to earnings. The balance sheet has been strengthened with a recent preferred offering and, given the low cyclicality of both businesses, is in little danger regardless of the way that COVID or economic crises unfolds.

The shares recently traded at ~60% of Gary’s base-case value estimate, despite the meaningful recent run-up in the stock price. Catalysts include (1) continued turnaround progress at the distribution business, and (2) the high growth of the SaaS business starting to meaningfully flow through to net income.

Felix Narhi, Chief Investment Officer and Portfolio Manager, PenderFund Capital Management

Stitch Fix (US: SFIX) is an innovative online apparel retailer with attractive unit economics supported by durable competitive advantages, led by a mission-driven founder and available at a sensible price. The company combines data science and proprietary data with human judgment to deliver hyper personalization at scale, transcending traditional brick-and-mortar and most undifferentiated e-commerce retail experiences. The apparel market is massive. As online shopping continues to take share from offline, Stitch Fix should continue to outpace the market through increasing share of wallet, acquiring new clients, and expanding its addressable market.

The company has developed a proven, scaled financial model with headroom for growth. Stitch Fix is at the early stages of expanding beyond its successful “beachhead” clothing box model and into larger markets. Its new Direct Buy initiative provides existing and new clients a low-commitment and low-friction path to personalized shopping. This market is not only larger, but potentially has more attractive unit economics once at scale. It is an opportune time to launch stay-at-home services as e-commerce adoption is surging due to COVID19 while numerous bricks-and-mortar peers struggle to remain viable.

Stitch Fix hit management’s long-term operating margin targets first in FY15. Income from more mature segments is funding new, promising initiatives, thereby obscuring reported profitability. Trading at ~$24 per share, SFIX is a compounder available at a sensible multiple of about 10x “steady state” operating profit.

Ryan O’Connor, President and Portfolio Manager, Crossroads Capital Partners

Orchid Island Capital (NYSE: ORC) is an “agency mREIT” that invests solely in mortgage-backed securities (MBS) issued by government-sponsored agencies such as Fannie Mae, Freddie Mac, and Ginnie Mae.

While not all mREITs are created equal, they are the same in one respect: All are in essence simple spread businesses that use extreme leverage to borrow money short term in order to lend long term, augmenting returns as a result. These returns are then paid out as dividends to income-seeking investors stretching for yield. Simplistically, the difference between an mREIT’s “interest income” (i.e., mortgage rates) and “interest expense” (i.e., repurchase funding rates) equals “net interest income”. Subtract hedging costs and operating expense, and what’s left can be distributed to holders as dividends. (It can earn this spread because long-term rates are usually higher than short-term rates).

While mREITs take existential risks, typically blowing up once a cycle in times of severe distress, government agencies cannot default on agency MBS, insulating agency mREITs like ORC from credit risk. Predictably, recent turmoil in short-term funding markets caused panic selling during the COVID pandemic, indiscriminately crushing the share prices of mREITs and agency mREITs alike, creating a rare opportunity to buy shares of agency mREITs like ORC at steep discounts.

Soon after the crash, the Fed stepped in to get the market back on track, cutting short-term rates to zero and announcing it would buy essentially unlimited quantities of agency MBS -- two actions that directly benefit ORC's business, leading to wider net interest margins and higher earnings, while removing the possibility of reflexive negative feedback loops that get mREITs into trouble for at least the next 18 months.

ORC's Q1 2020 repo expense averaged 1.68% of AUM, but that cost will fall to 12.5 bips in the aftermath of a 0% Fed funds rate brought about by COVID-related distress. As a result, a simple back-of-the-envelope model (see slide 9 of Ryan's presentation) acts as a proxy for ORC's forward-looking earnings power: On a $3.4 billion investment portfolio earning a 341 basis point spread that is 9x levered, that is $116 million in normalized net interest income. After subtracting operating expenses, it should have $95 million available to distribute to shareholders, or roughly $1.64 per share on a stock that recently traded at $4.36 per share. Assuming ORC pays out 90% of net interest income going forward as required by the IRS, that puts its normalized annual dividend paying capacity at ~33% annually, or ~$0.12 per share per month.

Danilo Santiago, Portfolio Manager, Rational Investment Methodology

Herman-Miller (US: MLHR) and **Steelcase** (US: SCS), the two most significant manufacturers of office furniture in the US (and worldwide), recently traded below Danilo's base-case fair-value estimate. The more undervalued of the two companies, MLHR, offers an estimated IRR of ~14% to the buy-and-hold investor. An investor achieving such a return would double her capital in less than six-and-a-half years.

Mr. Market appears to have focused on short-term EPS expectations variabilities. As it became clear that the COVID-19 crisis would bring normal life to a halt, the purchase of office furniture was put into pause. The occasional sale to a quick upgrade to home-offices was not sufficient to bring revenue expectations back from shallow levels. Manufacturers face inevitable operational deleveraging. Hence the short-term impact on EPS.

What should matter to the long-term investor are overall sales of office furniture to MLHR's core customer groups, along with the company's market share and ability to deliver margins not far from historical averages. Assuming no permanent *modus operandi* change by office workers, Herman-Miller should generate substantial cash flow to owners in the long run.

Dave Sather, President, Sather Financial Group

Unilever (US: UL, UN) is a 150 year-old food, beauty, and home care business that sells products to 2.5 billion people daily across 190+ countries. Despite its long history, interesting changes and catalysts have allowed this highly consistent and predictable business to grow EPS by 9-11% annually over the past decade. Despite Unilever's stability and above-average cash flow, the shares have recently been available at a fair price.

Elliot Turner, Managing Director, RGA Investment Advisors

Twitter (US: TWTR) is the world's most important information network. The user side of the network has never been stronger at Twitter, demonstrating accelerating growth for six straight quarters and registering its fastest quarterly growth ever in Q1 2020. These successes are lost amidst the slower evolution of the business side of the network and lackluster efforts to monetize the platform.

For the first time in its history, Twitter management is prioritizing revenue opportunities and has a revamped, engaged board with the experience and knowhow in order to guide the process. From the accelerated user growth and a modest normalization in the advertising environment by 2022, Twitter today could be trading at 8-9x EV/2022 EBITDA, with enhanced monetization offering meaningful upside to earnings from there.

Todd Wenning, Senior Investment Analyst, Ensemble Capital

Masimo (US: MASI) is a medical technology company best known for its highly accurate pulse oximetry sensors used in critical care settings. Masimo's mission is to improve patient outcomes while reducing system-wide costs, which is a rare strategy in the healthcare industry.

Most medical device companies are healthcare companies that use technology and are thus motivated to maintain the *status quo* of adding cost to the system. Masimo inverts this and is a technology company that focuses on healthcare. As such, Masimo starts with first principles when solving problems and creates solutions that are win-win-win for hospitals, medical professionals, and patients.

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Jim Zimmerman, Founder & Portfolio Manager, Lowell Capital Management

Transcontinental, Inc. (Canada: TCL-A) engages in the flexible packaging business in Canada, the U.S., Latin America, the U.K., Australia, and New Zealand. It operates through three segments: Packaging, Printing, and Other. The packaging segment engages in the extrusion, lamination, printing, and converting packaging solutions as well as manufacturing flexible plastic and paper products. The printing segment provides integrated services for retailers, such as pre-media services, flyer, and in-store marketing product printing.

TCL has ~87 million shares outstanding at C$14 per share, for a market cap of C$1.2 billion, and a net debt position of C$950 million as of April 2020, for an enterprise value of C$2.1 billion. TCL recently traded close to 4x adjusted EBITDA.

Jim believes the company can sustainably generate FCF of C$250+ million, which would result in an unlevered FCF yield of 12%. TCL has an improving balance sheet, with net debt reduced from C$1.4 billion after the Coveris acquisition in mid-2018 to about C$950 million as of April 2020. TCL could achieve adjusted EBITDA of C$500 million by 2022 and trade for 6x adjusted EBITDA or C$3 billion less C$800 million of net debt for a market cap of about C$2.2 billion or C$25 per share, as compared to a recent stock price of C$14 per share. TCL pays C$0.87 per share in annual dividends (7% yield), which appears sustainable based on strong cash flow.

TCL-A achieved a strong quarter for April 2020, with both the packaging and printing segments showing resilient performance amid COVID. The packaging segment expects organic growth in H2 2020, and the printing segment is recovering with a reopening of Canada's economy. The printing segment is a stronger business than the market is giving it credit for, as its flyers are an essential tool for major retailers to drive sales.

Jim believes TCL's recent market valuation misprices the resiliency of both the packaging and the printing segments. Packaging companies trade at much higher multiples, and as TCL's packaging segment grows, TCL's multiple should move up accordingly.