Omega Advisors, Inc.

At the end of 1991, following 25 years of service, Lee retired from his positions as a General Partner of Goldman, Sachs & Co. and as Chairman and Chief Executive Officer of Goldman Sachs Asset Management to organize and launch an investment management business, Omega Advisors, Inc.

At Goldman Sachs, Lee spent 15 years as a Partner and one year (1990-1991) as of-counsel to the Management Committee. In 1989, he became Chairman and Chief Executive Officer of Goldman Sachs Asset Management and Chief Investment Officer of the firm’s equity product line, managing the GS Capital Growth Fund, an open-end mutual fund, for one-and-a-half years. Prior to

Ruane, Cunniff & Goldfarb

David Poppe joined Ruane, Cunniff & Goldfarb in 1999 after a 12-year career in journalism. Mr. Poppe graduated with a BA from Columbia University in 1986.

John Harris joined Ruane, Cunniff & Goldfarb in August 2003. Prior to joining the firm, he spent two years as an analyst at Kohlberg, Kravis, Roberts & Co. (KKR), a private equity firm based in New York and San Francisco. Before joining KKR, he served as an analyst in the investment banking division at Goldman, Sachs & Co. Mr. Harris graduated with an AB from

Vulcan Value Partners

C.T. Fitzpatrick founded Vulcan Value Partners in 2007 to manage his personal capital. Since inception, all four strategies have peer rankings in the top 4% of value managers in their respective

Oasis Management Company

Seth Fischer is the founder and Chief Investment Officer of Oasis Management Company, an international investment manager headquartered in Hong Kong. Oasis was founded by Mr. Fischer in 2002 following a successful seven-year career at
Welcome to Graham & Doddsville

We are pleased to bring you the 32nd edition of Graham & Doddsville. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA). Since our Fall 2017 issue, the Heilbrunn Center hosted the 27th annual “Graham & Dodd Breakfast.”

In this issue, we were fortunate to conduct four interviews with investors who provide a variety of frameworks. From scuttlebutt research, tactical strategies, euphoria, and sustainable margin of safety, we discuss broader industry issues. Each investor has a strong passion for studying the history of markets and for continuous personal evolution.

Leon Cooperman, CFA ’67, the founder, Chairman, and CEO of Omega Advisers, Inc, discusses his battle with the SEC, passive management, and his relationships with other investment managers. He shares details about what is important to him outside of investing, personified by a song written about him from a charitable group he is passionate about.

We also have the privilege of speaking with David Poppe CC ’86 and John Harris of Ruane, Cunniff, & Goldfarb, heirs to the legacy of Bill Ruane—one of the superinvestors of Graham and Doddsville whom Warren Buffett touted in 1984. They describe their maturations as investors, discuss portfolio concentration, and pitch two of their favorite stock ideas.

C.T. Fitzpatrick, CFA of Vulcan Value Partners sits down with us, opining on his evolution from a strict value investor to his current emphasis on sustainable margin of safety. He talks about building partnerships with employees and investors. C.T., as he is known, keeps an MVP list of high-quality businesses that he would love to own and steps in when the time is right.

Seth Fischer, the founder and CIO of Hong Kong-based Oasis Capital Management, discusses his early education in global arbitrage as well as his recent forays into activism in Asian companies. He explains how he mixes tactical and fundamental approaches to investing, why frauds in China aren’t like frauds in the West, and why, for an activist, this time is different in Japan.

Finally, we continue to bring you pitches from current students at CBS. CSIMA’s Investment Ideas Club helps train CBS students, providing them the opportunity to practice crafting and delivering investment pitches.

In this issue, we feature finalists from the NYU Credit Pitch Competition, Columbia Business School’s CSIMA Stock Pitch Challenge, and the MBA Women in Investing (WIN) Conference organized by the Cornell SC Johnson College of Business.

The three finalist ideas from our classmates include: A.J. Denham ’19, Kevin Brenes ’19, and Gili Bergman ’19—Staples (SPLS) 8.5 2025 Long; Ishaan Bhatia ’19, Ryan Darrohn ’19, and Victoria Gu ’19—First Data (FDC) Long; and Aditi Bhatia ’19, Lisa Chen ’19, Victoria Gu ’19, and Aleksandrina Ivanova ’19—FleetCor Technologies (FLT) Long.

As always, we thank our interviewees for contributing their time and insights not only to us, but to the investment community as a whole, and we thank you for reading.

- G&Dsville Editors
Columbia Business School Events: 27th Annual Graham & Dodd Breakfast

The keynote topic was the future of value investing—heavy stuff for breakfast conversation.

CBS Professor and Co-Director of the Heilbrunn Center Bruce Greenwald, keynote speaker.

Attendees of the 27th Annual Graham and Dodd Breakfast.

Columbia Business School Dean Glenn Hubbard.

William von Mueffling ’95, President and Chief Investment Officer, Cantillon Capital Management, addresses the crowd.

A riveted crowd listens attentively to Professor Greenwald reassure them that value investing is here to stay.
those appointments, Lee spent 22 years in the Investment Research Department as Partner-in-charge, Co-Chairman of the Investment Policy Committee and Chairman of the Stock Selection Committee. For nine consecutive years, he was voted the #1 portfolio strategist in Institutional Investor Magazine’s annual “All-America Research Team” survey.

As a designated Chartered Financial Analyst, Lee is a senior member and past President of the New York Society of Security Analysts. He is Chairman Emeritus of the Saint Barnabas Development Foundation, a member of the Board of Overseers of the Columbia University Graduate School of Business, a member of the Board of Directors of the Damon Runyon Cancer Research Foundation, a member of the Investment Committee of the New Jersey Performing Arts Center, and Board Chairman of Green Spaces, a committee organized to rebuild 13 parks in Newark, NJ.

Lee received his MBA from Columbia Business School and his undergraduate degree from Hunter College. He is a recipient of Roger Williams University’s Honorary Doctor of Finance; a recipient of Hunter College’s Honorary Doctor of Humane Letters; an inductee into Hunter College’s Hall of Fame; and a recipient of the 2003 American Jewish Committee (AJC) Wall Street Human Relations Award, the 2006 Seton Hall Humanitarian of the Year Award, the 2009 Boys & Girls Clubs of Newark Award for Caring, and the 2009 UJA-Federation of New York’s Wall Street and Financial Services Division Lifetime Achievement Award. In 2013, Lee was inducted into Alpha Magazine’s Hedge Fund Hall of Fame and was honored by the AJC at their 50th anniversary with the Herbert H. Lehman Award for his professional achievements, philanthropic efforts, and longstanding support for AJC. In 2014, Columbia Business School awarded Lee its Distinguished Leadership in Business Award, and Bloomberg Markets named him to its fourth annual “50 Most Influential” list (one of only ten money managers globally to be so honored, selected “based on what they’re doing now, rather than past achievements”). He was inducted into the Horatio Alger Association in April 2015. Lee and his wife, Toby, have two sons and three grandchildren.

Graham & Doddsville (G&D): What is it about stock picking that excites you?

Leon Cooperman (LC): It’s a hunt. To be successful, you must love what you do. It is both my vocation and my avocation (as well as a means of supplementing my income).

G&D: The last time Graham & Doddsville spoke with you, it was the fall of 2011. What has surprised you the most since then?

LC: I would say at Omega we have been on the right side of the market. Our basic view is that every recession leads to the next economic recovery, and every recovery ultimately leads to the next recession. It was predictable to come out of the 2008 recession. I believe in the symmetry of cycles, so the length and duration of an upcycle probably bears some relation to the length and duration of the downcycle. We had the most severe recession, so having a longer—not necessarily stronger, but longer—recovery than average would probably make some sense to me.

But the growth of passive management is greater than I would have predicted six or seven years ago. I understand what’s behind it, but it’s something I would have thought would have passed by now. I look at it as being transitory. There’s a role for passive management, but I don’t think Warren Buffett got to where he is using an index fund. The same goes for Mario Gabelli, myself, and others who have been successful in money management. I’m committed to active management.

Some time ago, I went to a seminar entitled “Closing the Gap,” looking at income disparity and how to deal with it. A futurist who spoke at the conference said that in his opinion, the biggest problem facing the economy is that 45% of all jobs are going to be replaced by automation, with
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no alternative for those displaced workers. I thought about it, and perhaps our industry’s “automation” is passive management.

Passive turnover averages about 3% a year; active turnover, about 30%. If everything goes passive, that implies a huge reduction in liquidity and in the pool of available commissions. Passive management commands a five basis-point fee. So that’s a huge reduction in the pool of money available to active money managers.

But everything in the world is cyclical. I show people an article titled “Hard Times Come to Hedge Funds” and everybody thinks it’s contemporary. The article was written by one of the most distinguished writers of Fortune magazine, Carol Loomis, in 1970. At the time, the largest hedge fund was under $50 million. The second largest was A.W. Jones at $30 million. The entire industry was under a billion dollars.

Here we are in 2017 and the industry is $3 trillion. And there are many hedge funds that run tens of billions of dollars. The golden period for hedge funds was 2000 to 2007. Why? They were outperforming the indexes and conventional managers. CNBC brought them a tremendous amount of publicity. Money was pouring in, and they became cocktail-party talk. “I’m with Omega.” “I’m with Glenview.” “I’m with Third Point.” “I’m with Jana.” Then suddenly, the 2008 cycle hits, and even though hedge funds lived up to their expectations, people were dissatisfied. A lot of people who went into hedge funds had no idea what they were doing. In 2008, the S&P was down 35% or 36%. The average hedge fund was down 16%, but people said, “Hell. I didn’t know you could lose money. I thought it was a question of how much money I’m going to make. Well, give me back my money.” A lot of hedge fund managers either gated capital by not giving back the money on time, or retired because they didn’t want to work with a high-water mark.

“Look, all of us experience setbacks in life. How you handle the setbacks leads to future success.”

and only for a management fee.

In 2008, if I told you we were about to begin the longest, most impressive bull market in history, you’d probably have me locked up. People blamed the government. They blamed the insurance companies. They blamed the bankers. Nobody blames the individuals for not doing a good job managing their own financial affairs. It’s as if they have no responsibility.

In 2008, the people that stayed in hedge funds elected to be in an absolute-return, not relative-return, vehicle. If you’re running a hedge fund and you’re less than fully invested, then you’re shooting for absolute rather than relative returns, and you can’t keep up with a bull market.

People become dissatisfied and say, “Well, if I’m not going to beat the index, why do I want to pay you some variation of two-and-twenty? I want my money back.” Then they go into index products where they don’t have any idea what they’re buying.

It will take a bear market to end such behavior. Until there’s a bear market, my guess is this thing will play out. But you must be patient. It creates a challenge for the hedge fund industry because if you’re an absolute-return guy in a one-way market, you can underperform. Plus, you have an asset base that’s very transitory. It’s hard to be an investor if you have to constantly look over your shoulder at looming redemptions.

G&D: So we need a bear market to slow down the move to passive?

LC: That’s my view, but I could be wrong. Just like in 2008, hedge fund performance was below expectations—it was down less than half of the S&P, yet people were dissatisfied. Now they’re going into indexes because the indexes are outperforming active management. When they lose money, they’ll have the same attitude they had in 2008. They’ll want to get out. And believe me, there’s no liquidity in the market to absorb these ETFs. It’s going to be a blood bath. The S&P will be down more than 100 points in one day.

G&D: Your analogy suggests the move to passive is more cyclical than secular.

(Continued on page 6)
Omega Advisors, Inc.

**LC:** Everything is cyclical. It's just a question of when. In 1987, with portfolio insurance, investors thought they could insure their portfolio and get out. It was exposed as being bogus. In 1972, the new big thing was the Nifty Fifty. J.P. Morgan and U.S. Trust had this philosophy of not caring what they paid for a business so long as it grew at above-average rates. IBM, Merck, Xerox, Avon, and those kinds of companies traded at 70x earnings.

In 1973, OPEC increased the price of oil tenfold. We saw a huge escalation of inflation, and the market collapsed. It took stocks over a decade to recover. Some of them never recovered. Avon’s today a $3 stock; it used to be a $70 stock. My philosophy is: invest in any stock or bond at the right price. Their philosophy was: only the right stock at any price. To me, price is the key. I am willing to buy anything as long as management is not crooked. I am looking for above-average yield, above-average asset value, or mispriced growth. I think that over time, buying stocks at 50-60x earnings is not going to pan out.

**G&D:** Can you tell us more about your entanglement with the SEC?

**LC:** All I’ll say here is that we settled the case for a fraction of the government’s initial financial ask (less than $5 million), with no industry suspension or bar, no officer-and-director suspension or bar, and no admission of wrongdoing, on terms that permit me to continue running my business. Beyond that, under the terms of our settlement, I can’t comment on the specific facts of the case or on the merits or strength of our defenses. We settled because doing so saved us what were projected to be enormous legal costs, and a substantial diversion of time and attention over possibly years more of legal wrangling, had we gone to trial. I am still conflicted over that decision, but it’s water under the bridge.

I will say, however, that the entire experience has left me with a highly jaundiced view of our federal regulatory system, which I think is in desperate need of remediation. Given the vast resources of the federal government and the prospect of potentially ruinous legal costs (and collateral damage) that confront any defendant, it is little wonder that so many opt to throw in the towel and settle, rather than risk the vagaries and expense of extended litigation. On the positive side, at least my reputation remains intact. To many money managers, I’m something of a folk hero. Cold comfort!

**G&D:** What about some of your philanthropic activities?

**LC:** I’m busy changing the lives of kids. My signature initiative, Cooperman College Scholars, is in the process of sending 500 needy, deserving Essex County, New Jersey, kids to college. The average lifetime earnings of a college graduate are over $1 million more than those of a non-college graduate. We take 70 kids a year and we’re a few years into this, so I have 250 kids in the program right now. I give each of them up to $10,000 a year for up to six years to get a college degree. I give them the opportunity to do well. My objective is to help level the playing field by creating equality of opportunity; whether the outcomes are equal is up to the student, but I want to give them the chance to soar. Have you seen the movie Hidden Figures? I paid $10,000 to rent out a venue and invite all the kids in my program to come and see it.

The money doesn’t matter to me—I’ve given all my money away to charity. I’ve given away $200 million to the less fortunate in the last five years.

I give money to an organization called “Songs of Love,” which has roughly 10,000 volunteer songwriters who write customized songs for terminally or seriously ill children. They use uplifting songs to motivate the kids. The group learns about the kids’ parents, the names of their dogs, their favorite actors, their favorite singers—things that relate to the child, and then compose a song around those themes. About a year ago, I drove out to Queens, where the organization is based, and I was so impressed with what they were doing that, on the spot, I wrote a check for $1 million. They were so blown away that unbeknownst to me, they started doing their homework and wrote a song about me. Here, take a look [lyrics at the end of interview].

Not too long ago, I reached out to someone who was struggling. I like to do that—help those who are going through tough times. I said, “Look, all of us experience...”
setbacks in life. How you handle the setbacks determines future success.”

G&D: Can you talk about your idea-generation process?

LC: When I hire somebody on the investment side of my business, we agree upon the area that that analyst will cover. Every six months, I look at the opportunity that the analyst has presented and how he or she penetrated that opportunity. I also do a lot of reading on my own, and I have a lot of friends in the business and know who’s careful and does their homework. I may, for example, say to my financials analyst, XYZ Financial was recommended by this bright guy, so maybe we should look at it. If my financials guy likes it, we’ll buy it and I’ll share the position with him; if he doesn’t like it, we won’t buy it. It’s fundamentally a bottoms-up approach to stock-picking, with a top-down macroeconomic overlay.

G&D: Is there a danger that getting ideas in this manner leads to groupthink?

LC: I look for merit and individual ideas. An analyst recommends a stock, and we try to separate the wheat from the chaff. To me, Wall Street is a distribution machine; I don’t rely upon Wall Street.

The most rewarding part of my career at Goldman was finding stocks that I thought made sense and having the market prove me right. But after Eliot Spitzer, all the firms prevented their analysts from buying stocks. They’re telling you to spend a lifetime building expertise in some area of the market, but you can’t use it. If you’re really a skilled money-maker, you don’t want to work at Goldman or Morgan Stanley. You want to work at a Third Point, a Glenview, an Omega, or a Pershing Square. If you’re a money-maker, you come to my firm.

G&D: To what extent does management figure into your decision-making process about a business?

LC: It’s a factor. Ben Graham in The Intelligent Investor said that you evaluate management teams twice, once through the numbers and once face-to-face. By the numbers, I mean looking at returns on capital, growth rate, market position, gross margins, and so on. When measuring the quality of management face-to-face, you make your own judgment on how they respond to questions and what their integrity is like.

G&D: When you’re getting close to management while researching companies, what are the dangers?

LC: Management might lie to you, or see things through rose-colored glasses, or you, as a major shareholder, might get too close, and become reluctant to disappoint management by selling.

G&D: How do you control all of that?

LC: You try to be dispassionate, but there are no formulas. There are going to be errors. A few years back, I got hooked on an oil company. I had three energy analysts in 2014; not one of them got it right. There were very few people in 2014 who foresaw the collapse in the price of oil.

G&D: Many esteemed investors have struggled lately. What’s going on?

LC: Speaking broadly, in the last five or six years, almost no one has been right about the stock market. We’ve had an unbelievable bull market. Carl Icahn returned money in 2008 because he didn’t like what he saw. Seth Klarman has now given back money. He’s been negative for three or four years.

Look at Pershing Square, for instance. As you know, every spring, the Friday night before Berkshire Hathaway’s annual meeting, Columbia Business School hosts a dinner. Three years or so ago, I was a guest speaker at that dinner. There were 200 people in the audience, including Ackman. I gave my presentation, and then someone in the audience asked about my thoughts on Herbalife. I said, “I’m not involved, but I have an opinion.” I knew that Ackman was in the audience, and I said, “I know Bill Ackman. He’s a very bright guy, he’s very generous, I have respect for him. But anybody who gets up in front of 500 people telling them he’s short 20% of the market cap of a company is allowing his arrogance to get in front of his intellect.” The danger is you can get squeezed on that short. Bob Wilson, a
very famous short-seller, famously said that nobody ever gets rich publicizing their shorts. You want to get rich quietly. I don’t go on CNBC trying to talk a stock up.

That’s why George Soros, myself, and a bunch of people went after Ackman on his latest activist idea, ADP. ADP is one of the greatest success stories in American industry. You don’t go after a company like that in a proxy fight. You meet with them and you tell them what your views are. Ackman is looking for visibility, and he’s dead wrong in his approach. Ackman tried to tell ADP—a company that’s gone from $10 million in market cap to $60 billion—that they didn’t know how to run their business. It’s preposterous. He should have sat down with them to explain his views, but he chose instead to go public and ask for board seats.

ADP went public in 1961, with a market cap of maybe $10 million. Take the market cap of ADP today and add in the market cap of CDK, the automobile dealership business they spun out, and the combined market value is about $60 billion. $10 million to $60 billion is a compound rate of return of 17% a year for 50 years. The company earns 40% return on equity against the S&P 500’s 16%, with a debt-free balance sheet versus the S&P’s 40% debt-to-capital. ADP is trading at a multiple of 27x-30x earnings. I’m not addressing the merits of a bargain here, I’m just talking about the business.

Ackman called me up, asking for assistance. He said that he had spent the last six months working on ADP, that they had serious issues and he wanted to meet with the board, but that the committee window closed in eight days and he wasn’t ready. He wanted an extension on the window. I told him there’s no way the company could or should give him an extension. His whole argument was spurious. He was looking at the margin differential versus Paychex. But they’re in a different business. Paychex competes in the down market, for small companies. ADP is a high-touch service, so they have a tremendous return on equity. Bill is a great guy and I’m friendly with him, but he obviously has a flaw.

G&D: Are you a shareholder of ADP or on the board?

LC: I was on the board for 20 years, and I chaired the audit committee for 18 years. When I retired from the board, I gave all my stock away to charity. What I said on CNBC was the stock should triple; I should donate cash and hold the stock. I’m not debating the merits of Bill’s arguments. What I’m saying is this company’s performance is so outstanding they deserve different treatment. The company is open to meet with their shareholders; they are open to constructive suggestions. I guess it didn’t serve his purpose to meet with management privately to present his views.

I meet with management teams all the time. For certain companies, activism is justified. They can overpay, they can perform poorly, or they can be slow to adjust to new conditions.

Activism, generally, is a late-cycle phenomenon. Hedge funds are having trouble making money so they’re going after governance. In some cases, they’re right; in other cases, they get it wrong.

G&D: Do you feel that your investment style has changed at all over the last 50 years?

LC: No. I’ve been managing my firm like I’d manage my own money. Let me explain the way I run the firm. I split our incentive fee in thirds. I give a third of it to the idea generator, I give a third to the non-revenue generating folks. They don’t make investing decisions but they’re important in running the business. Finally, I keep a third.

When an analyst makes a recommendation, it must be written up with a price target and the downside risk. If we buy the stock, it’s because we’ve accepted the upside-downside equation. If the stock falls to the downside level, the analyst becomes secondary to the decision. I have a committee that helps evaluate if we should hold on, double down, or sell it.

G&D: What led to the decision to create this committee?

LC: Analysts get paralyzed when their recommendations are down. They don’t want to see their stocks sold out of the portfolio. You need people that are long-term thinkers because short-term greed will jeopardize the firm, while the long-term guys will not.
Omega Advisors, Inc.

**G&D:** Do you find analysts get clouded when they are on fire?

**LC:** My technology guy looks like a genius because of FANG. I look like an idiot because I’ve bought most of the recommendations, but not as much as he wanted me to. My job is to figure out what’s going to work, and what’s not going to work. But I have a value orientation.

**G&D:** When you look at the market today, what stands out?

**LC:** There’s an expression on Wall Street: In bull markets, who needs analysts; in bear markets, who needs stocks? We first have to understand the market outlook. I believe the market is adequately priced. I think we’re heading to a normalization. We have been living through a very strange period.

A year or so ago, Switzerland raised 50-year money at negative interest rates. A guy who owns a home in Denmark will get a check every month because he has a negative interest rate on his mortgage. It’s crazy, right? It makes no sense.

I think we’re heading now to a normal level. What’s normalization? In the U.S., it’s about 50 bps of growth in the labor force and 150 bps of labor productivity. Let’s assume 2% inflation. That’s 4% nominal growth. The Fed funds rate will be around 2% and we’ll be there soon. The 10-year bond will be at about 4%, and will take three to four years to get there. In that world, a multiple of about 17x seems fair. It’s high relative to history but low relative to interest rates. Using 17x our S&P 500 earnings estimate for next year of $138, that’s about 2385. That doesn’t include any benefit from the tax package. The tax package could add as much as $10 to S&P 500 earnings.

As John Templeton said, bull markets are born in pessimism, grow in skepticism, mature in optimism, and end in euphoria. There are very few signs of euphoria in this market. Optimism is high. Everybody believes the market is higher in six months and in 12 months, but I don’t see euphoria.

**G&D:** What does euphoria mean? How would you know it if you saw it?

**LC:** Look at 1987. The 10-year bond was yielding 9% and the S&P trading at 27x earnings. You can see it in how stocks act—the character of leadership and valuation. There’s some euphoria in the market. Maybe Tesla or Amazon.

**G&D:** You’ve been known to take macro bets and invest in different areas of the capital structure. How do you think about your overall strategy?

**LC:** We try to make money at Omega in five ways. First is market direction. We keep in mind that stocks are high-risk assets and short-term bonds are low-risk assets. We spend a lot of time trying to determine where the market is going because that determines your exposure to the markets.

Second is asset allocation. Every study I’ve seen indicates being in the right asset class is more important than being in the right stock. We look at stocks versus bonds, and when we look at bonds, we look at government bonds, corporate bonds, high yield bonds, etc. We’re looking for what I call the straw hat in the winter. Nobody is buying straw hats in the winter when they’re cheap. We’re trying to find what is mispriced. I have eight or nine credit people. They’ve done extremely well over the last five years.

Third is undervalued stocks on the long side. Fourth is overvalued stocks on the short side. We’ve never been particularly productive at this at Omega for some reason.

Fifth and finally, macro bets. We will risk about 2% of our capital trying to make a 4% to 5% return. These are not necessarily correlated to equities, but they can be profitable. If the dollar-yen exchange rate goes from 108 to 120, you can make some money. We could buy or sell oil. It’s just another opportunity to make money or lose money.

**G&D:** How do you, schooled in the Graham and Dodd way of fundamental analysis, get comfortable with those macro bets?

**LC:** You’ve got to rely on the team. But sometimes you know nothing. My worst year was in 2014. I had three energy guys, we had no major position in energy. Not one of them said sell or go short. Energy prices collapsed. Macro is difficult because there’s no equity capital market line, so if you don’t know what you’re doing, you could be separated...
from your capital very quickly. That’s why I only allow us to risk 2% of our capital. My best year, 1993, I was up over 70%. I made 20% in equities, which was twice the S&P. I made 50% in bonds. You want to field as many plays as you can in the hope of finding opportunities that work for the fund.

But you raise a good point. It is very painful losing money in an area where you’re not the captain of the ship. It’s easier to lose money when you know exactly why you’re losing money. In equities, I know where I went wrong. It’s part of the delegation of responsibility. You just can’t celebrate the profits only. You’ve got to be willing to accept the risks.

Macro has had a rough few years because of low volatility and interest rates. A lot of the macro guys are losing assets big time. Money goes where money is treated best.

Everyone started off 2017 bulling up about the dollar versus the euro, and look what happened. When everyone is on one side of something, there’s probably something wrong. Bloomberg has an exhibit on next year’s outlook. Nobody’s bearish.

Over time, one change we’ve had to be conscious of is increasing the size of companies we look at, given our size. You don’t want to have hundreds of positions. If you start out with average position sizes of 3% and have $4 billion in assets, that’s $120 million in each name. If you multiply that by 20 because you don’t want to own more than 5% of a company, you’re looking at a minimum $2.5 billion market cap.

G&D: Do you have different strategies for the taxable and non-taxable portfolios?

LC: No, but I don’t buy anything in our long-term capital gains strategy that I don’t intend to hold for at least a year. If I get lucky and buy something that goes up quicker than I expected, I use options to hedge it out to age it to a one-year position.

G&D: Besides the trend to passive, what else do you make of the current environment for hedge funds?

LC: I saw an article recently that in the last decade, the number of publicly traded companies has gone down by 50%. In the same period, the number of hedge funds has quintupled. We have many more people looking at half the company universe. It’s a much more competitive situation.

If you had a choice between managing money at a mutual fund for a 1% management fee or working for some Master of the Universe for two-and-twenty, most people would rather be at the hedge fund because of the greater compensation. People see Julian Robertson, Ray Dalio, and George Soros on the covers of magazines; people want to emulate them. They want to go for the gold. It’s natural instinct.

It used to be that if you followed the most popular industry among the graduating Harvard Business School class, you’d find that the industry was in the process of peaking. Whether it was management consulting, investment banking, international trade, or hedge funds. Maybe venture capital will be peaking soon.

It is the worst time, in my opinion, for private equity because one of the big windfalls for the private equity guys was the exit multiple being so much higher than the entry multiple as interest rates declined. Who wants to bet on lower interest rates over the next five years? The odds are interest rates will be materially higher, which will suppress valuation.

Secondly, we’re nine years into a business recovery. Economic setback is overdue. The idea of buying something, levering up, and then having three or four years of economic growth to de-lever sounds like a suspect bet. Private equity is also a much more discovered phenomenon now.

G&D: Has this brutal competition in the hedge fund world changed what you do day-to-day?

LC: There are 10,000 hedge funds that are asking for some variation of two-and-twenty. Your client will pay a premium fee if you supply premium

G&D: Thank you so much for your time.

“Do What You Love, Love What You Do” - A Song for Leon Cooperman from the Songs of Love Foundation

You started out in the Bronx
Went to Hunter College
Met the lovely Toby
Both had a hunger for knowledge
Columbia, Goldman, and Omega
You did better than the best
Leon Cooperman, you’re like Superman
Let’s follow in your footsteps!
As you say…

Do what you love
Love what you do
Never retire
Stay inspired
Do what you love
Love what you do
Day and night
Keep feedin’ that fire
There’s one secret to success, it’s true
Gotta do what you love…
And love what you do

Words by Alex Forbes
Music and vocals by John Beltzer

In 1900, Andrew Carnegie said the most important thing is to surround yourself with people smarter than yourself and fairly share the loot. Some people feel threatened by strong colleagues. I say no; I’m benefiting from strong colleagues. This is what you should aim for.

I tell people, no matter how much money you have, the one luxury you cannot afford is arrogance. Be nice to people. I have seen guys play nice to people above them but be nasty towards people below them. It’s just uncalled for. Just be nice to everybody, and it’ll come back to benefit you. For example, when I retired from Goldman Sachs, I agreed to become a consultant to the firm to help with client retention, and they ended up being a big investor in my fund.

G&D: Any advice for students trying to make it in finance?

LC: First, do what you love to do. If you have a passion for it, you’ll be successful. When I’m looking to hire somebody, I look for a desire, in addition to talent.

max
To the arts and education
Leon Cooperman, hope you and Toby can
See the difference that you’re makin’
As you say…

Do what you love
Love what you do
Never retire
Stay inspired
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Words by Alex Forbes
Music and vocals by John Beltzer
Ruane, Cunniff & Goldfarb

Harvard College in 1999, Magna Cum Laude and Phi Beta Kappa.

Graham & Doddsville (G&D): Can you both tell us about your background and how you came to be at Ruane?

David Poppe (DP): I’ve been at Ruane for 18 years. I went to Columbia for college and went to work in the newspaper business afterwards and loved it. I was a financial journalist for 12 years, and as time went by, I really became convinced of the idea that you could have an informational advantage and could understand a company by understanding its people.

Ruane is a heavy due-diligence shop—we adopt a journalistic method of gathering “scuttlebutte” research, and we try to understand the culture of a company as well as its numbers. In 1999, they recruited me to join the firm. It was a perfect fit and I’ve been here ever since.

John Harris (JH): Investing is what I wanted to do ever since I can remember. It was the dinner-table conversation in our house growing up.

My grandfather and great-uncle had a consumer products business that made home permanents for women that they sold to Gillette in the 1940s. They were quirky entrepreneur types, and they didn’t like working for big companies, so they left Gillette.

At the time, if you were a Graham and Dodd-style investor, the thing to do was to find bankrupt railroad and utility company shells that traded publicly, of which there were many. In the Roaring 20s, those were the original roll-up vehicles, the 1920s version of 1960s conglomerates. A lot of them went bankrupt, and when they did, many of them had big capital losses inside of them. So if you were smart, you would buy one and then invest through it and use the capital losses to offset your taxes.

They bought the Pittsburgh Railroad, and turned it into a publicly traded investment company called Pittway. The way they thought about investing was the way we think about investing. They tried to find good businesses run by good people, pay reasonable prices for them, and work with them for a long time.

My dad ran the family business after my grandfather, so investing was all I heard about growing up—and it fascinated me. I knew this was what I wanted to do, but back in those days it was not very easy to get a job at a firm like ours right out of college, so I worked on Wall Street for a few years.

When I came to Ruane for an interview, I spent about four hours with Bob Goldfarb. I got a sense for the place pretty quickly, and the minute I got a feel for this place, I was hooked. If you like doing what we do – if you’re curious about businesses, understanding businesses and trying to unpack the unsolvable puzzle that is the stock market – this is paradise.

G&D: David, how have you ended up marrying your journalism background with investing?

DP: I really felt that you could have an informational advantage around understanding the culture of a business and the way that people make decisions. If you can align yourself with management teams who make good decisions, you’re going to have a better result over time. On top of that, you just have to be a bit of a cheapskate.

G&D: Was there a moment in your journalism career when you realized how an investment analyst could get that information edge?

DP: I came to appreciate investing partly by watching short sellers as a reporter for the Miami Herald in Florida. I saw that you could really identify bad actors and make good decisions if you just weeded those actors out from your pool of potential investment ideas.

And as you start to weed out the bad actors, you also realize who the good actors are. I have found it true over 30 years that if you align yourself with people who consistently make good decisions, you would do well. As Warren Buffett says: If you had to leave a million dollars with somebody for five years, would you trust this person to be a fiduciary of your investment? That’s really the bigger question we are trying to answer in our diligence.

The numbers eventually play out from there. At Ruane, we’re trying to distinguish good people from really good people. A lot of times, capital allocation is the measuring stick. Are the decisions consistently good? And if they

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are, you’re generally going to, over time, end up with a good result.

**G&D:** When you conduct your due diligence, is there a way you quantify your findings? For instance, how would your assessment of management enable you to decide whether to pay 15x earnings for the business rather than 20x?

**JH:** The quantitative side of what we do is easy, to be honest with you. You don’t have to have much more than a sixth-grade mathematics education to spot a potentially interesting investment proposition. The real trick is, is it as good as it looks? That’s the hard part.

My experience is that the closer you look, the more risks come into focus. It’s very rare that the deeper you dig into a business, the better you like it. It’s usually the other way around. So I would say the qualitative side of what we do consumes 95% of our time because that’s the hard part.

Predicting the future is difficult. You have to look into this opaque haze and form a point of view about what’s going to happen. And I would say most of the mistakes that are made in our business are when people look at numbers and naively extrapolate the past into the future. Inflection points happen. If you aren’t able to peer around those corners every once in a while, typically you won’t bat at a high enough average to make it work in this business.

**G&D:** How do you think about multiples and discount rates?

**JH:** In the absolute simplest terms, over a long span of history, stocks in the U.S. have returned about 9% per year nominal, give or take. So that’s our cost of capital, and we want to beat it by a significant margin. We try to take a guess, and it’s nothing more than a guess. We don’t try to be precise about it and build eight-page models, because I think there’s a false precision in that. We just try to make a rough guess at what we think the cash flows of the business will be from now until Kingdom Come, and then discount that back to the present. We try to adjust for the fact that it’s an inherently uncertain exercise.

**G&D:** What are the heuristics that you’ve developed to help you predict the future?

**JH:** I think rules of thumb can be helpful when they help you allocate your time more efficiently and focus your thinking. But they can also be dangerous, so we try to avoid making judgments based on simple heuristics, because usually the world is more nuanced than that. It gets back to the same concept we were talking about before, where you can get in trouble just blindly assuming the future will look like the past.

**G&D:** A lot of these new Internet businesses are asset-light. Does that make a traditional value-investing heuristic such as return on invested capital less meaningful, because these asset-light businesses don’t require as much invested capital?

**JH:** I don’t think it’s one way or another. I think there are asset-light businesses that are tough to figure out, and there are asset-light businesses that are easier to figure out. All else equal, we would always rather own a business that doesn’t have to put any money in to get the money out. That’s a wonderful proposition.

But that’s not to say that the fewer the assets a business employs, the better it is. Sometimes it’s good to have to spend a lot to make a lot, because that means it’s hard to
Ruane, Cunniff & Goldfarb

copy. So, I don’t know that we necessarily prefer one or the other.

What we prefer is the wide moat over the narrow moat. Sometimes asset-light businesses have really wide moats and sometimes they don’t. Google, economically, is a far superior business to Amazon, just in terms of its economic efficiency. But that doesn’t mean the moat is any wider, because to recreate the infrastructure that Jeff Bezos has built over the last 15 years would require an astronomical sum of money. That’s a very hard business to copy. Google is also a very hard business to copy, not so much because it would cost you a lot, but for other reasons.

G&D: How have Ruane and the Sequoia Fund evolved over the years?

DP: First, I think philosophically the ideas underpinning the fund are the same as they were 40 years ago. I don’t think we’ve deviated far, but I think there’s been some evolution. The fund was smaller in the 1980s, and Bill Ruane was very comfortable with a 10-stock portfolio. Nowadays, we think a 20-stock portfolio is more realistic for us. But we still want to be concentrated in our best ideas. Insights are very hard to come by in our business, and when we have an actionable insight we want to own the stock in a big way. So we’re very comfortable with the top eight or 10 positions being 50 or 60% of our assets under management. I think that’s been consistent for almost 50 years now.

I think we have always been thought of as value investors, but if you go back and read our letters from previous decades, our analysts were always looking for companies that can grow. I think that’s the same today too. We are always looking for healthy businesses that are in an early stage of their lifespan and have good growth in front of them, because that’s really where you can make a big return.

I think a lot of value investors, not just us, have evolved over the last 50 years to a little bit more like Phil Fisher or Charlie Munger, who focus on the highest-quality businesses that you can buy for a reasonable price as opposed to strictly looking for cheap stocks. I think we’ve been consistent over time, but clearly there’s been a bit of an evolution. There was a time in the late 1990s when we were 30% Berkshire Hathaway, 20% Progressive, and probably 10 or 12% Fifth Third Bank. At our size today that level of concentration doesn’t make sense, but three stocks could be 30% of the portfolio.

G&D: As value investors who’ve made the transition to paying for quality or growth, how exactly do you define a “reasonable” price? Can you put a cap on how much you’re willing to pay?

DP: I’ll use a straightforward example, CarMax, which we bought in 2016. CarMax has a very unique business model. Four or five different quality companies have tried to copy this model of selling used cars with a more transparent buying experience, and they really haven’t been able to pull it off. So first off, it’s a model that seemed unique and interesting.

Second, it’s only halfway built out across the U.S., so there’s an opportunity to maybe double the store base over a period of time. Third, it appears that the stores are profitable in every market that they’re in. It is a replicable, scalable model. Fourth, when we bought in, CarMax was trading at 15 times earnings at a time when the U.S. market was trading at 17 or 18 times.

So the math isn’t that hard. You’ve got a chance to double the store base. You’ve got a business that’s growing—same store sales are growing at healthy rates—mostly with middle-class and upper-middle class good quality credit buyers. And no one else has been able to copy the model. And then you layer over that the incredible diligence that one of our analysts conducted, we ended up feeling very confident in the management team, very confident in their ability to harness technology in case the business does move to more of an Internet sales model. And so we hold that company at a 5% weight, which is a pretty good weight for an initial position at a fund the size of Sequoia.

JH: I also dislike the idea that there’s a fundamental distinction between value investing, growth investing, and growth-at-a-reasonable-price investing. It’s all the same mathematical equation, right? Every business is worth something. And ideally you’d like to buy for some discount to intrinsic value.
Ruane, Cunniff & Goldfarb

I think one reason you can make money with businesses that grow rapidly is that the future value of those businesses tends to be a little harder to estimate, because more of the value is far into the future than businesses with a small P/E that are earning a large percentage of their market cap in the here and now. And, I think for psychological reasons, the market typically tends to underestimate the rate and duration of growth for businesses that can grow rapidly.

So typically, the errors in estimating intrinsic value tend to be toward the downside in those cases. That is, you end up in situations where you thought you were buying it for half of what it was worth, but really you bought it for 10% of what it was worth. And that’s when you really do well.

The distribution of potential outcomes tends to be narrower for a more mature, slower-growing business where more of the cash flow is coming in now. That’s not to say that there’s anything wrong with owning those types of businesses, and we own them.

I think one of the unique features of our portfolios over time has been that they’re eclectic. One of our partners likes to say that we have two hands. We don’t just play with one hand. But I think the reason you can do better with businesses that grow is because the right side of the distribution is wider and more interesting.

G&D: The leadership at Ruane has changed. Can you talk about that?

DP: Well, we’ve made a lot of changes over the last two years. Our CEO Bob Goldfarb retired, and we were fortunate that we had a bench in place that was ready to take on more responsibility.

I’m biased, but I think over the past 20 years we have built maybe the deepest and the best research team around. We have a really strong bench. We had a bunch of people whom we hired in their mid-20s and now they’re 40 years old and absolutely ready for more responsibility.

We approached the leadership change as an opportunity to make Ruane more of a true partnership, with a structure that’s a little flatter, with a little bit more democracy around decision-making. And I realize people don’t like the word “committee,” but we really had a core of very strong analysts, very good decision-makers, and we don’t need to make that many decisions in a year. Having these people on our Investment Committee in the room when we make the final decision struck us as a very good idea.

G&D: What are some of your favorite stock ideas right now? John, you mentioned Google (GOOG) and its asset-light model earlier.

JH: We’ve owned Google since maybe 2010. And we recently bought more, and it’s now maybe 10% of Sequoia Fund.

That’s because we like to compare businesses we own with each other. And we owned a couple of other businesses that we sold this year that are relatively mature that grow organically in line with the economy and trade for maybe 23-24 times earnings in a market that seems to value stability, business quality and liquidity.

We felt that we could sell those businesses and buy Google instead—a better business growing at a much more rapid rate, with superior economics, for a P/E that probably isn’t all that different from the ones that we were selling.

Google is one of the best businesses the world has ever created. It’s a phenomenal franchise. It’s a little bit difficult with Google to peer into the future and have a great handle on what the rate of growth will be going forward. That’s partly because they don’t have total control over their pricing since at the end of the day, it’s an auction mechanism that prices the product. Also it’s difficult to have a handle on

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what the pattern of usage will be in the future. There are many variables that factor into that.

Right now, Google is growing 20% a year, and we have been surprised about the durability of the growth rate, especially at that size. It’s remarkable that not only is it growing that fast in absolute terms, but in a lot of cases, it’s accelerating even in relatively mature geographies where you wouldn’t expect it to. We don’t think that things will continue the way they’re going now. The nice thing is that the business could slow down dramatically and it would still grow over the next five years at a significantly faster rate than the companies we sold to fund the purchase.

**G&D:** How do you think about securing an informational advantage with a company as large and well-known as Google?

**JH:** Informational advantage can mean a lot of different things. Fifteen or 20 years ago, we were relatively unique in our commitment to “scuttlebut” research. And I do think there were cases where we just knew more about a business than other people did. There were other people that did the kind of work we did – that sort of “feet on the street” research – but not anywhere near as many as there are now. And as you guys know, there are lots of independent services that have grown up over the last decade that will allow you to outsource that function. With something like Google, and I would say most of the companies in the portfolio, we don’t necessarily know any more than the next guy.

But that doesn’t mean there’s not an advantage in doing your own work and doing incredibly intensive primary research. There is an advantage to gathering your own information and making decisions based on facts that you have gathered yourself. Investing is more of an emotional than intellectual exercise, and it becomes very hard to stay on an even keel and to make rational, unbiased judgements if you’re making them based on someone else’s information.

So if my buddy at hedge fund XYZ tells me that such and such company is a great investment, or if you go to any of these conferences where someone really smart comes up and makes a bold case on whatever company, it may seem compelling at first. So you think, “Maybe I’ll go out and buy it.” Then the stock goes down 40% and you get nervous. How much time did that really smart guy who made the original pitch spend thinking about this issue that is pressuring the stock? You don’t know, because you didn’t do your own work.

When you’re lost in the fog, you tend to make bad decisions because you’re scared. That’s why to me, you don’t necessarily have to know more than the next guy to have an informational advantage. But you are most certainly at an informational disadvantage if you haven’t made the effort to gather enough information to make an informed decision.

**G&D:** Do you think Google could be the Standard Oil of the 21st century? Its size and reach are already inviting lots of regulatory scrutiny.

**JH:** Yes, that’s probably the biggest risk that you face as a Google investor. Standard Oil, AT&T, take your pick for the analogy. AT&T was one of the world’s great companies, and there are obvious similarities between the AT&T of a few generations ago and Google today.

**DP:** AT&T was a great company, because it charged me a dollar a minute to call my parents when I was in college. Thirty years ago, it was crushing the consumer.

**G&D:** That’s an ominous parallel. Like AT&T’s forced breakup, what if 10 years later Congress decrees YouTube has to be a separate company from the search engine, and so on?

**JH:** There are different layers to the risk here. One is monetary penalties. We don’t worry so much about that, because Google is an incredibly well-funded company. I think they can afford to pay penalties. I think behavioral remedies are the bigger concern here. And the one that we watch the closest is how the Android OS comes pre-installed with Google products, or the gateways to those products. If that link were to break, it wouldn’t be a good thing. Although, it’s possible that Google has achieved escape velocity at this point and become so popular that even if it was forced to change its

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behavior, the change might have less impact today than it would have had a few years ago.

Microsoft reached a similar point when they attracted legal and regulatory attention, and were forced to unbundle some of their products. However, if you look back, Internet Explorer—which was at the center of that scrutiny—has lost a lot of market share in the browser market not because Microsoft was forced to change its practices but because, I think, competitors just came up with a better version of that product.

G&D: In that vein, how do you think about competition from, say, Facebook or Amazon? Eric Schmidt has said that, after Google, Amazon is the next biggest search engine U.S. consumers use.

JH: Amazon is already there. It is a huge advertising and product discovery platform, and it wasn’t started yesterday. Facebook is already a gigantic advertising medium that attracts eyeballs for huge periods of time every day. And they weren’t created yesterday. Google is already living with this competition and still growing at remarkable rates.

Also, by no means is our position predicated on the idea that Google is going to continue growing 20% a year for the next five years. I certainly would not want to take the over on that bet. Our guess is that the business is going to grow in the future, but the point is that we didn’t want to be forced to have an opinion about the rate of growth in the future, other than that we do think this is a business that ought to grow faster than the economy for a long period of time. So we paid a price that only assumes that Google grows at a GDP-type growth rate, maybe a little more. I think we paid a price that doesn’t require you to make bold predictions about the future of the business, just modest ones.

DP: The easiest way to figure out if something is really good and really works is whether its competitors can copy it. We owned an industrial distributor called Fastenal for 17 years—people tried to copy it and couldn’t. I think Google has similarly proven itself in the marketplace, precisely because there have been other search engines that haven’t stuck.

The Google search engine works better. It’s better for the consumer. And at this point, it’s so powerful and so widely used globally, it would be very, very hard for somebody to disrupt it in a major way.

G&D: Any other favorite ideas in the portfolio?

DP: Credit Acceptance Corp. (CACC) is a classic Ruane kind of stock. It’s a quirky business, and not especially well understood. This company is the lender of last resort for people who want to buy cars but are having real difficulty with their credit. So a lot of the loans are going to be made on the buy-here-pay-here type of car lots—where the car dealer is also the financier—and not a typical dealership. The customer has a credit problem, and is buying a $6,000 or $8,000 car that they need to get to work, and they can’t otherwise get a loan.

Credit Acceptance has a program where it will advance the dealer a portion of the sales price of the car—but not the whole—and then the dealer and CACC are both on the hook. So it’s a model based on alignment with the dealer. Both the dealer and CACC are very incentivized to collect the full balance of the loan, and to sell the car at the proper price where you have a chance to collect the loan instead of exploiting a customer who is poor.

Meanwhile, consumers who couldn’t get a loan anywhere else get a chance to rebuild their credit record if they’re able to pay the loan off, even if they’re paying rich terms to access that credit. Around 60% of people end up paying the loan off. I think it is a benefit to the consumer. And for the 40% or so that ultimately end up defaulting on the loan,

“I also dislike the idea that there’s a fundamental distinction between value investing [and] growth investing....

Every business is worth something. And ideally you’d like to buy for some discount to intrinsic value.”
Ruane, Cunniff & Goldfarb

Credit Acceptance is very effective at repossessing the car and then reselling it.

It’s a niche product that you need for a particular consumer. On a buy-here-pay-here car lot, Credit Acceptance will account for 5% to 10% of the loans. And because CACC doesn’t advance the full price of the car, it doesn’t have the same leverage as a typical subprime lender who is advancing the full price of the car, and it doesn’t have the same risk profile. Over time, the returns on capital have been very high compared to any other subprime lenders, because the capital at risk is lower.

It’s a terrific model. Four or five other reputable, smart companies have tried to copy it over time and haven’t been able to do it. On top of that, I still think Credit Acceptance has got a relatively low market share, even among the subprime or sub-subprime customer base.

We also like that the management team is heavily invested in the company and owns a chunk of the stock. The CEO has been in place for 16 years and is only 51 years old. And the founder still owns a lot of the stock.

CACC gets lumped in with the stocks of other subprime lenders, which have been beaten up recently for good reason as the value of used cars decline and as those lenders’ experience with loans worsens. But Credit Acceptance is actually a little bit counter-cyclical to the rest of the subprime industry. It does poorly when there’s a lot of capital flooding into the space. And it will do better in the next couple of years if money exits subprime and more people struggle to find credit.

Thanks to some of these misunderstandings, CACC was very cheap. We bought it at 10 times earnings, with a management team that’s very good and very aligned with the shareholders. It feels like a great investment to us.

G&D: Can you explain why the other five competitors who tried to replicate CACC’s model weren’t able to? It seems all you have to do is make sure the dealer has some skin in the game.

DP: How much you advance to the dealer is important. One thing that’s really neat about Credit Acceptance is they have a ton of discipline. If they can’t get the right terms they’ll do only two loans to the dealer a year. They will walk away from business. Credit Acceptance over time has been very disciplined about what it will pay and about adhering to its economic model. In contrast, I think everybody else who gets into the business runs into problems. To get market share, they advance too much against the car, they take on more risk.

Secondly, Credit Acceptance is very good at repossessing the car to get the collateral back. And other people haven’t been as good at that either.

JH: Loaning money is hard. Loaning money in a leveraged way is harder. Loaning money to people in economically challenged circumstances is even harder.

And collecting money from CACC’s borrowers is very hard, because car loans are not really a secured lending business. There is collateral there, but repossession is not a major feature of the business model.

So CACC is a collections business. Collections businesses are tough. The more history and the more data you have on the borrower, the better. Lending against this office building is a relatively easy lending business. You’re lending to people who in a lot of cases don’t need the money, and you have a fantastic piece of collateral that’s readily saleable.

And it’s easy to get your hands on this building. It’s not on wheels.

G&D: Why are dealers willing to work with CACC? They’d ideally prefer no skin in the game, no?

DP: Because the dealer can then service a broader customer base and do more business. So instead of turning a sub-prime customer down, he can sell another car with the help of CACC. And dealers are in the business of selling more cars. And if the dealer does it right, he can make more money.

And as John just said it perfectly, CACC has a tough business. You have to do things sometimes that are adversarial with customers. Yet one of the things that was so impressive to me is that this

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company has been on the 100 best places to work list for years. It has a good culture. It has a good employee environment.

It’s easy to be in one of the 100 best places to work in America when you’re Google, and you’ve got an amazing business with smart people and a tremendous model. It’s not as easy to be one of the 100 best places to work in America when you’re dealing with people who are in distressed situations. I think they’ve built a really good culture in a really hard business.

G&D: A quick glance at the financials shows that CACC now makes 30% ROE, but before the Great Recession they were usually making 20% ROE. Is it possible they’ve over-earned the last few years because of the Fed’s easy money, which has kept down their cost of capital and also boosted their loan volume?

DP: That’s a good observation. I think after the Great Recession, a lot of lenders fell out of subprime, and there was a period of probably two or three years where they had much less competition. So their returns boomed.

Now, over the last couple of years, a lot of money has flooded back into subprime. So CACC has actually cut back on the amount of loans they do per dealer—because there’s much more capital available for these dealers—and they’ve tried to grow instead by being involved with more dealers. So I’m not sure we’re in an artificially inflated environment at this point.

G&D: Is there still a sizeable addressable market of new dealers they can be involved with, and hence grow?

DP: There are parts of the country, such as suburban Detroit and generally the Midwest, where they’ve got very good penetration. But there are other parts of the country where they’re not nearly as big as they could be—California, some of the Sun Belt states. I think there’s a lot of opportunity to grow.

“Credit Acceptance has a program where it will advance the dealer a portion of the sales price of the car...and then the dealer and CACC are both on the hook. So it’s a model based on alignment with the dealer.”

JH: More generally, I don’t think we wanted to have a point of view on what exactly the sustainable ROE of this business is. We felt that the price we paid for it assumed that the business never grew again.

DP: At 10 times earnings, certainly. It’s not as if we paid a stretch multiple.

G&D: Hasn’t the chairman-founder sold down his stake?

DP: He has sold down his stake. The founder owns a large percentage of the company and sold some stock last year, interestingly not at a great price. He sold a big chunk last year, and that’s around the time we bought CACC actually.

The founder selling gave us a little bit of pause, because we have great respect for him. But he had an overwhelming portion of his net worth in the business, had owned it for many years, and is no longer involved in the day-to-day management. He made the decision to hold a little bit less.

The CEO who is there now is in his early 50s, also owns a lot of stock, and I think has an incentive plan that rewards him based on stock performance over 10 years, which is the kind of thing that aligns with us very well. So I still feel that we’ve got heavy ownership by the management. The board of directors also owns a lot of stock. There are a couple of good investors on the board.

G&D: What about the politics of subprime auto lending? The Obama administration was particularly aggressive against such lenders.

DP: There is regulatory risk there, and we’ve thought about it a lot. Government does tend to look at high interest-rate loans and the way subprime consumers are treated. The good news is CACC has a very serious compliance culture—and as I mentioned, it is often listed as one of the 100 best places to work.
Ruane, Cunniff & Goldfarb

Keep in mind that this consumer would not have access to an automobile if not for a business like CACC. They perform a role in society. If they weren’t there, think of the number of consumers who wouldn’t be able to drive a car.

G&D: You assume that government will be rational.

DP: Yes. You assume the government will be rational and realize that this is a high-risk customer, therefore you need to have a high ROE model to serve that customer. And if CACC is not there, who would be there? In the case of Credit Acceptance, you could make an argument that 60% or so of the consumers do pay off the loans and rebuild their credit record. So there’s a benefit to a person who wouldn’t otherwise be able to drive a car.

G&D: What’s the interest rate on these loans?

DP: I’m sure that they’re pushing whatever state limits are on the interest rate. Perhaps 20% to 24%.

G&D: You’re referring to the usury limits states set. Though couldn’t a lender always get around the usury limits by inflating the price of the car?

DP: Again, I think they have a compliance-conscious culture. Part of the deal that they make with the dealers is that the dealer needs to have some alignment and some incentive to do the right thing. I think they do a good job obeying the law and caring about compliance.

G&D: That was fascinating.

JH: This is a learning business. Try to work with people who are good teachers in an environment where you can learn a lot. The fanciest name on the door is not always the right answer to that question.

It’s the same in your career as it is with college. I talk to young people and they seem to constantly think that if they don’t go to any one of these five colleges, life is over. That they must get this credential or all the doors will be closed to them. The truth is that’s just not how the world works. You have the motor inside of you that you’ve got. It’s up to you to put the fuel into it and get the most out of it.

Where you go to college, the name of the first firm you work at is not going to determine where you end up. You determine it. You determine how much you get out of whatever God gave you—and the way to get the most out of it is to work really hard and do what you love, because it’s hard to work really hard if you don’t do what you love. And then work with really good people in an environment where you can learn, that will help you get the most out of what you’ve got.

DP: The best advice I think I’ve ever heard anybody give is Charlie Munger’s bit about aligning yourself with people who are better than you are. Marry someone who’s better than you are. Work for somebody who you really respect and admire. If the day comes, hire people who are smarter and better than you. If you do that, your life is going to be so much more successful.

And if you’re trying to break into stock-picking, the other cliché that’s true is the stock market can stay irrational longer than you can stay solvent. So you’ve got to be humble. It’s not an easy business. You can be right at everything you do, and the stock can still go 20% the other way. Humility takes you a long way.

G&D: Thank you for your time.
A.J. is a first-year MBA student at CBS. Previously, A.J. worked in private equity at the Florida Mezzanine Fund then as a Manager in Strategic Planning at Verizon in the U.S.

Kevin is a first-year MBA student at CBS. Previously, Kevin worked at Banco General as an analyst in Panama City, Panama. He covered Latin American corporate bonds and Panamanian equities.

Gili is a first-year MBA student at CBS. Previously, Gili worked at Harel Insurance & Finance as a buy-side analyst in Tel Aviv, Israel. He covered both equity and fixed income global markets.

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**Staples 8.5 2025 (CUSIP: 03939PAA2) - Long**

1st Place - 2017 NYU Credit Pitch Competition

A.J. Denham, CPA [ADenham19@gsb.columbia.edu](mailto:ADenham19@gsb.columbia.edu)

Kevin Brenes [KBrenes19@gsb.columbia.edu](mailto:KBrenes19@gsb.columbia.edu)

Gili Bergman [GBergman19@gsb.columbia.edu](mailto:GBergman19@gsb.columbia.edu)

**Recommendation**

We are long Staples 8.5 2025 Senior Unsecured notes which are trading at 91.7 with a YTM of 10.3%. The market has overreacted to the announcement of Amazon Business Prime on October 24th, dropping the newly issued bonds from 96 to a low of 85 in a two week period. We believe the bonds offer a compelling investment due to 1) extremely stable cash flows with 70% of revenue on 3-5 years contract basis with 92-97% customer retention rates, 2) strong barriers to entry against Amazon, and 3) market overreaction to Amazon Business Prime.

**Business Description**

Staples is a B2B distributor of office products. The company is the 5th largest e-commerce merchant in the U.S. Staples was acquired by private equity firm Sycamore Partners on September 12, 2017, and issued $1.0bn in 8.5% Sr. Unsecured Notes maturing 2025 to finance the transaction alongside a Sr. Secured $2.9bn Term Loan and $1.6bn in new Equity. The issuer is Staples North American Delivery (NAD), a B2B office supply distributor. Staples NAD operates three business segments: Staples Business Advantage, which targets enterprise customers on a 3-5 year contract basis (70% of revenue), Quill.com, and Staples.com, which targets small businesses and individuals (collectively 30% of revenue). Sycamore spun off the retail store operations into a separate entity with its own separately financed capital structure with no cross obligations.

**Investment Thesis**

1) **Sticky customer base with extremely stable cash flows**

Staples has extremely stable cash flows with a high fixed charge coverage ratio. 3-year customer retention rates are 97% for enterprise customers and 92% for middle market customers. These customers comprise 70% of sales, creating strong revenue protection for the entire company.

Staples Business Advantage revenues are extremely sticky. We have modeled a downside scenario with assumptions of contracts renewing every 3 years and retention rates declining by 3% per year for the next 5 years. These inputs only produce a ~2% revenue decline per year. Because of its stable revenue and approximately 10% projected EBITDA margins, Staples generates strong free cash flow that covers its fixed charges by over 2.0x. Bringing the FCCR to parity would require assumptions of 50% customer retention rates, a 5% gross margin contraction, and a 17% revenue decline – unrealistic given Staples’ history and barriers to entry in the industry.

2) **Strong barriers to entry and protection against Amazon**

The B2B office supply business has strong barriers to entry, protecting it from new entrants like Amazon. The market is used to thinking of Amazon as a nimble competitor disrupting old industries. However, in this case Amazon is the company faced with legacy issues prohibiting it from adapting quickly. In the legal opinion from the antitrust proceedings blocking the merger of Staples and Office Depot in May 2016, the Federal Trade Commission provides 8 reasons as to why Amazon is not a viable B2B office supply competitor. Customer calls with corporate sourcing personnel confirm the FTC’s story. We highlight what we believe are the major

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**Bond Information**

<table>
<thead>
<tr>
<th>Bond Category</th>
<th>Outstanding</th>
<th>Current Price</th>
<th>YTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sr. Unsecured</td>
<td>1.0B</td>
<td>91.7</td>
<td></td>
</tr>
</tbody>
</table>

**Churn**

- 2016: 10.3%
- 2017: 9.8%
- 2018: 9.6%
- 2019: 9.2%
- 2020: 8.7%
- 2021: 8.3%

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A.J. Denham, CPA '19

Kevin Brenes '19

Gili Bergman '19

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A.J. Denham, CPA

Kevin Brenes

Gili Bergman
Staples 8.5 2025 (CUSIP: 03939PAA2) - Long (Continued from previous page)

- Desktop Delivery: Staples has a dedicated sales team and delivery fleet that work with office managers on delivery times and placement. Staples consolidates orders, delivers, stocks, and installs merchandise at specific times in specific locations within a building – for example, directly walking into a customer’s office and installing ink in the printer. By contrast, Amazon sends separate packages for each order (85% of Amazon Business deliveries are not consolidated by address) and delivers only to customer’s door or mail room. Corporate clients confirmed the high demand Staples’ approach to enhanced customer service without which it becomes much more difficult to win request for proposals (RFP).

- Customer Service: Staples assigns each enterprise customer a dedicated sales representative to provide support for personalized orders and logistics. Staples currently employs 3,500 sales representatives and is planning to add 1,000 more. Amazon does not have a dedicated office supply sales force and has no experience with the RFP process. This is a critical support factor; individual corporate sourcing agents have little to no experience planning corporate-wide office supply needs.

- Fixed Pricing: Enterprise customers require fixed pricing on a contract basis. Amazon is unable to provide fixed pricing because over 50% of its office supplies are sourced from third-party vendors over which Amazon has no control. Amazon’s existing business model conflicts with current business practices in the B2B office supply industry, and it will be tough for Amazon to change this core competency.

- Switching Costs: Switching costs such as process integration and retraining personnel are a real consideration for corporate customers. Office supplies are also such a small part of the overall corporate cost structure that there isn’t as much pressure to cut costs, and any gains are unlikely to outweigh the pain from switching vendors. Corporate inertia will delay any effort Amazon makes to enter the enterprise market.

3) Market overreaction to introduction of Prime membership for Amazon Business customers
On October 24, 2017, Amazon Business introduced Prime membership for its customers. Staples Sr. Unsecured notes fell 5% on the announcement. The announcement of Prime membership should not be confused with Amazon entering the marketplace. Amazon has been competing in the office supply industry for 15 years and has yet to make significant inroads into the B2B office supply business. The only new benefit of Prime membership is free two-day delivery. However, Staples already offers free next-day delivery covering 95% of the U.S., with 85% of orders already delivered next-day. Additionally, the FTC noted that Staples, inclusive of corporate discounts, actually has lower prices than Amazon. The market has overreacted to a non-event and has created a compelling opportunity.

Capital Structure
Staples debt consists of two issuances: a $2.7B Senior Secured Term Loan at L + 400bps due in 2024, and this $1B 8.5% 2025 Senior Unsecured. There are no near-term maturities and the Term Loan amortizes at 4% a year, reducing total debt over time. Staples also has access to a $1.2B undrawn revolver at L + 150bps for liquidity support if necessary. While rated B-, 3.6x EBITDA/fixed charge coverage and under 3.7x total leverage resemble a B+/BB- profile and will support a rating upgrade with continued strong financial performance.

<table>
<thead>
<tr>
<th>Rating</th>
<th>EBITA / / Average</th>
<th>FFO / Debt</th>
<th>Debt / EBITA</th>
<th>Debt / Book Capitalization</th>
<th>Yield</th>
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<tbody>
<tr>
<td>AAA</td>
<td>12.30%</td>
<td>11.5</td>
<td>12.7</td>
<td>41.5%</td>
<td>35.10%</td>
</tr>
<tr>
<td>AA</td>
<td>10.20%</td>
<td>13.9</td>
<td>15.2</td>
<td>43.4%</td>
<td>34.00%</td>
</tr>
<tr>
<td>A</td>
<td>10.00%</td>
<td>10.7</td>
<td>13.1</td>
<td>34.1%</td>
<td>34.70%</td>
</tr>
<tr>
<td>Baa</td>
<td>8.70%</td>
<td>6.3</td>
<td>8.1</td>
<td>29.1%</td>
<td>46.40%</td>
</tr>
<tr>
<td>Ba</td>
<td>8.50%</td>
<td>3.7</td>
<td>5.1</td>
<td>19.9%</td>
<td>55.70%</td>
</tr>
<tr>
<td>B</td>
<td>6.70%</td>
<td>1.9</td>
<td>2.9</td>
<td>11.7%</td>
<td>65.00%</td>
</tr>
<tr>
<td>Caa-C</td>
<td>4.10%</td>
<td>0.7</td>
<td>1.6</td>
<td>6.0%</td>
<td>89.30%</td>
</tr>
</tbody>
</table>

SPLS 2025 bonds have a credit profile comparable to B+ rated bonds

Key Risks and Mitigants
1) Amazon acquires Office Depot/OfficeMax: The most effective way for Amazon to enter the B2B office supply market is to acquire Office Depot and run it as a separate business unit, which could increase price competition. However, even in the event of an acquisition, it’s unlikely Amazon would drive prices too low or sell below cost for fear of antitrust action.

2) Sycamore sells assets and/or distributes cash: Sycamore has a poor reputation among creditors due to harmful actions in prior deals. In our model, we assume Sycamore will distribute any of the company’s excess cash and liquid assets in order to enhance its returns, which requires accepting the risk of further assets sales which might erode credit support. This risk is mitigated, however, by the over 2.0x fixed charge coverage ratio, stable cash flows, and $1.2 billion revolver. You are not buying these bonds for the balance sheet, you are buying them for the coverage.
**FleetCor Technologies (NYSE: FLT) - Long**  
1st Place - 2017 Women In Investing (WIN) Conference

Aditi Bhatia  
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Victoria Gu  
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Aleksandrina Ivanova  
Alivanova19@gsb.columbia.edu

**Recommendation**

We recommend a long on FleetCor Technologies (FLT) with an end of 2019 price target of $279.46, offering 80% upside from September 2017’s price of $155.00 and an IRR of 34% over a two-year holding period. We believe that FleetCor has 1) an attractive business model with strong network effects yielding an industry-leading ROIC, 2) the ability to grow revenue ~15% per annum over the next 5 years by capturing opportunities domestically and abroad, and 3) an attractive buy-in opportunity due to misplaced market pessimism.

**Business Description**

FleetCor is headquartered in Norcross, Georgia, and its products are used in 53 countries around the world, with its primary geographies in the US, Brazil and the UK. FLT provides workplace productivity enhancement products primarily related to fuel, lodging, and employee benefit payments, telematics services, and fleet maintenance management. Fleet card solutions (>60% of revenues) allow fleet owners to control employee spending, generate fuel savings and improve free cash flow. Further, by joining a fuel card network, gas stations benefit from increased vehicle traffic. The company’s core products are primarily sold to businesses, retailers, major oil companies and marketers and government entities.

**Investment Thesis**

1) **Attractive business model with strong network effects yields leading ROIC**  
The industry is characterized by high barriers to entry because the two interdependent factors for success include scale and network acceptance, which is challenging for a new entrant to build. The business model is characterized by highly recurring and diversified revenues with high customer retention, resulting from a strong value proposition to customers. FLT and its closest competitor operate in a duopoly market following significant consolidation, and there are no near-term threats from smaller players in the market. Between the two players, FLT has consistently had a higher ROIC, cleaner balance sheet, and a great execution track record.

2) **FLT can grow revenue ~15% per annum over the next 5 years by capturing opportunities domestically and abroad**  
We identify attractive market growth opportunities in its two key markets: fuel card market estimated to grow at 19% CAGR over the next 5 years driven by increasing market penetration, and corporate payments market estimated to grow at 8% p.a. Using a blended market growth rate across different business segments, we believe FLT can achieve a ~15% growth rate p.a. over the next 5 years.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$1,831,546</td>
<td>$2,350,381</td>
<td>$2,808,024</td>
<td>$3,275,885</td>
<td>$3,730,437</td>
</tr>
<tr>
<td>% growth</td>
<td>8%</td>
<td>28%</td>
<td>19%</td>
<td>17%</td>
<td>14%</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$1,055,852</td>
<td>$1,366,702</td>
<td>$1,646,853</td>
<td>$1,931,073</td>
<td>$2,210,214</td>
</tr>
<tr>
<td>% margin</td>
<td>59%</td>
<td>59%</td>
<td>59%</td>
<td>59%</td>
<td>59%</td>
</tr>
<tr>
<td>Net Income</td>
<td>$656,332</td>
<td>$831,042</td>
<td>$983,797</td>
<td>$1,174,765</td>
<td>$1,362,140</td>
</tr>
<tr>
<td>% margin</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>37%</td>
</tr>
<tr>
<td>EPS</td>
<td>$6.89</td>
<td>$8.86</td>
<td>$10.49</td>
<td>$12.53</td>
<td>$14.52</td>
</tr>
</tbody>
</table>

3) **Market pessimism is misplaced, creating a cheap and attractive buy-in opportunity**  
Citron published a short interest report in April 2017 accusing FLT of unsustainable fee practices from late fees and predatory billing practices that were driving away customers and large accounts (Chevron). The report was timed with FLT’s ComData IT conversion issue that caused billing inaccuracies and delayed customer service to 30K accounts, leading to a significant uptick in customer attrition and precluded new sales. Since then, the issue has been resolved and attrition has stabilized. Noise around billing practices has also quieted, with stock prices recovering since 2Q17. Upon inspection of FLT business practices, we see consistent above
FleetCor Technologies (FLT) - Long (Continued from previous page)

90% retention rates, lower than WEX revenue contribution from late fees, and historically low complaints, with the exception of a spike due to the IT conversion issue. We anticipate the NTM multiple to re-rate to historical levels after FLT proves consistent new customer wins and unaffected retention rates for the next few quarters.

Valuation
We are valuing the company assuming a two-year holding period. In our base case, we assume the multiple would re-rate to competitor WEX’s current level. In our bull case, we assume the multiple would re-rate to FLT’s level prior to the publishing of the Citron report and IT conversion issues. In our bear case, we assume the multiple would not re-rate. Taking into consideration all potential outcomes, we arrive at a FY19 target price of $279.46, which implies a 34% IRR. We also used a DCF as a sanity check to our valuation methods. Based on current market conditions and comparable beta to WEX, our DCF analysis yields similar price ranges to a multiple-based approach.

<table>
<thead>
<tr>
<th>Implied Return:</th>
<th>Base</th>
<th>Bull</th>
<th>Bear</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY20 NTM EPS</td>
<td>$14.02</td>
<td>$17.27</td>
<td>$10.57</td>
</tr>
<tr>
<td>NTM Multiple</td>
<td>20.0x</td>
<td>22.0x</td>
<td>16.5x</td>
</tr>
<tr>
<td>Implied share price</td>
<td>$281.04</td>
<td>$379.83</td>
<td>$174.35</td>
</tr>
<tr>
<td>Prem. / (Disc.) to current %</td>
<td>81%</td>
<td>145%</td>
<td>12%</td>
</tr>
<tr>
<td>IRR</td>
<td>35%</td>
<td>57%</td>
<td>6%</td>
</tr>
<tr>
<td>DCF implied share price</td>
<td>$293.06</td>
<td>$420.87</td>
<td>$166.85</td>
</tr>
</tbody>
</table>

Key Risks and Mitigants
1) Electric vehicle adoption in the truck industry: New vehicles have a long runway to prove economic viability. Furthermore, charging and production infrastructure needs to be improved.
2) Exposure to gas prices: FLT’s pricing model incorporates a natural hedge against a drop in fuel prices. Through actual diversification, the company only has 10% exposure to absolute fuel and 11% exposure to fuel spreads.
3) Shifts in fuel card outsourcing trends toward in-house solutions: ~60% of US gas stations are independently owned, making in-house solutions difficult. Furthermore, FLT’s consistent 90%+ retention rate proves strong value proposition to customers that will help continue increasing win rates.
4) Improved fuel efficiency: Economic growth along with a rise in the number of vehicles will offset the impact of improving fuel efficiency or new regulations.
5) Threat of consolidation of fleets and small gas stations: This would act as a tailwind, as the value proposition is stronger for larger-sized gas stations and fleets.

Catalysts
1) Analyst day in 2018 and a new Head of Investor Relations should provide for better management disclosure and correct the market’s misperceptions.
2) Proven strong customer retention in the coming quarters to counteract Citron’s allegations.

CBS first-year students Jade Hu ’19 (shu19@gsb.columbia.edu) and Ashley Allen ’19 (aallen19@gsb.columbia.edu) also participated in the presentation of the FLT idea at the WIN conference in November 2017.
First Data Corporation (NYSE: FDC) - Long
3rd Place - 2017 CSIMA Stock Pitch Challenge

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Ryan Darrohn
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Victoria Gu
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Recommendation
We recommend a long on First Data Corporation (FDC) with an end of 2020 price target of $39, implying a 128% absolute return and 30% IRR. We believe: 1) FDC is a winner in an oligopolistic market with industry leading margins and cash flow, 2) short-term fears are overblown and FDC can grow revenue at 6-8% due to secular recovery, and 3) strong FCF generation will lead to rapid deleveraging and a multiple re-rating to P/E.

Business Description
First Data Corporation is the largest merchant acquirer, merchant processor, issuer processor, and network services provider in the world, with a global footprint on four continents. FDC was taken private by KKR in 2007 and recently went public in 2015. It has three segments: 1) Global Business Solutions (GBS) - POS merchant acquiring and processing, 2) Global Financial Solutions (GFS) - credit/private label processing, and 3) Network & Security Solutions (NSS) - EFT network solution (STAR), stored value network solutions, and debit card processing. 79% of FDC’s revenues are from North America, 14% are from EMEA, and the remainder is split between Latin America and Asia.

Investment Thesis
1) Winner in an oligopolistic market with industry leading margins and cash flow
FDC’s scale and distribution network are protected by high barriers to entry. Its large network allows FDC to continuously reinvest cash flow into expansion, driving customer stickiness and cross-selling opportunities. At 1.5x the scale of the closest competitor in merchant processing volume, FDC enjoys the highest EBITDA margins (37%) and FCF conversion percentages (92%) in the industry.

2) Secular recovery and tailwinds spark growth
Cash-to-card conversion, which is forecasted to grow at a CAGR of 6% for debit cards and 9% for credit cards through 2020, will continue to drive FDC’s top line and represents a tremendous white space opportunity in key international markets where purchase penetration is low. Crucially for the GBS North America segment, lead flows suggest recovery in Joint Ventures while SMB attrition has started recovering, which will drive FDC’s recovery to continue to grow at 8-12% CAGR, while signature and PIN-less will grow in line with wider industry GBS. Meanwhile, VisionPLUS will continue to grow GFS at a projected 8-12% CAGR.
3) **Strong FCF generation leads to rapid de-leveraging and multiple re-rating**

We project FDC to have over $6B of cumulative FCF generation in the next four years (FY2019-FY2021), which will drive a Net Debt/EBITDA reduction to less than 4x by FY2020. As debt repayments are accelerated, FDC will be looked at on a P/E multiple, rather than an EV/EBITDA multiple, by the exit horizon.

![Net Debt/EBITDA reduction graph](image)

- FCF generation driven by EBITDA growth (>$200mm absolute growth/year) and interest expense reduction\(^1\)
- Accelerated debt repayments to create equity upside (no significant debt repayments till 2020)\(^2\)

**Currently viewed on EV/EBITDA multiple; FDC should be looked at P/E by exit horizon**

\(^1\) Interest cost reduction from 7.6% in FY15 to 4.7% going forward (FY17 onwards) due to refinancing of outstanding liabilities
\(^2\) Refers to debt maturity schedule in the appendix

**Valuation**

Our base case price target of $72 offers ~31% upside. In the base case, we assume:
- **Base Case**: one-year forward P/E multiple of 18.5x, driving non-GAAP EPS of $2.25/share in FY2021.
- **Bear Case**: one-year forward P/E multiple of 13x, driving non-GAAP EPS of $1.26/share in FY2021.
- **Bull Case**: one-year forward P/E multiple of 22.1x, driving non-GAAP EPS of $2.57/share in FY2021.

Using weights of 50% for the base and 25% for the bull and bear, our implied share price in FY2020 is $39.10, representing upside of 128% and an IRR of 30%.

<table>
<thead>
<tr>
<th>Weightage</th>
<th>P/E (1-yr. forward)</th>
<th>Non-GAAP EPS (FY2021)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Case</td>
<td>30%</td>
<td>18.5x</td>
</tr>
<tr>
<td>Bear Case</td>
<td>25%</td>
<td>13.0x</td>
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<tr>
<td>Bull Case</td>
<td>25%</td>
<td>22.1x</td>
</tr>
<tr>
<td>Implied Share Price (FY2020)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IRR (Exit in FY2020)</td>
<td></td>
<td></td>
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<tr>
<td>Current Share Price (11/03/2017)</td>
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<td></td>
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<tr>
<td>Upside (Absolute)</td>
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<td></td>
</tr>
</tbody>
</table>

**Key return drivers**

- **Earnings Growth**
  - Driven by increase in volume growth and reduction in interest expense
  - Margin expansion opportunity with scale leverage

- **Multiple Expansion**
  - De-leveraging will help FDC to re-rate at a P/E multiple (expansion opportunity)

- **De-leveraging**
  - Valuation in-line with peers at 1-yr forward P/E multiple
  - High FCF generated to be utilized to repay debt
  - Accelerated debt repayments leading to equity upside (ND/EBITDA reduction)

**Key Risks and Mitigants**

1) **Disintermediation**: International and domestic scale and network are critical to becoming the leading merchant acquirer and processor. For First Data, near to medium term disintermediation risk is extremely low. 2) **Pricing pressure**: High switching costs and a lengthy onboarding process should favor FDC’s scale. 3) **Leverage**: Superior FCF generation through top-line growth, margin improvement, and low CAPEX profile allows significant deleveraging. 4) **KKR controlling ownership**: KKR provides operational improvement opportunities such as business development through its portfolio.
categories. Prior to founding Vulcan Value Partners, C.T. worked as a principal and portfolio manager at Southeastern Asset Management. During his 17-year tenure, the team at Southeastern Asset Management achieved double digit returns well ahead of inflation and was ranked in top 5% of money managers over five, ten, and twenty year periods according to Callan and Associates.

C.T. earned his MBA in Finance from the Owen Graduate School of Management at Vanderbilt University. He also has a BS in Corporate Finance from the University of Alabama.

Graham & Doddsville (G&D): Could you tell us about how you got started in the industry?

C.T. Fitzpatrick (CTF): I was a weird kid. I was reading the Wall Street Journal when I was 14 years old. My father was my mentor. He was an entrepreneur and I was just curious about what he was doing. It became an intellectual curiosity. My dad was a value investor but he didn’t know it. He didn’t call himself a value investor. He did a lot of things in real estate and he would try to buy properties at a discount to replacement value. He’d be looking for things that had fat cap rates, things like that.

Since I knew I wanted to go into business, I did not have the patience to pursue liberal arts, so I went straight into corporate finance at the University of Alabama. I majored in finance and minored in English. As my coursework evolved and as I had exposure to more things, I discovered that I was passionate about investing.

While I was in school in the early 1980s, coursework emphasized efficient markets, CAPM, and all those things. Conceptually, a lot of it made sense but some of it didn’t. It was counter to how my dad actually did things in the real world. I started challenging my professors and I got pushback. It just didn’t feel right. Of course, you want to regurgitate it for the test, but then do you really agree with it?

I read Graham and Dodd’s Security Analysis just to try to understand, “Okay, what’s the other side of this?” It really appealed to me and struck a nerve. By the time I graduated, I wanted to be a value investor. It was the mid-80s and Wall Street was booming. I had some opportunities on the money management side, but I also had an opportunity to work here in New York in investment banking.

G&D: What was that job?

CTF: I worked at Merrill Lynch capital markets. I met my wife. She was a trader at what now is Credit Suisse First Boston, which was First Boston at the time. It was a great experience but I was only on the edge of what I wanted to do. I was an agent, not a principal.

I went back to graduate school at Vanderbilt’s Owen School of Management and had a great experience there. It was a lot of fun, but the main reason I went back to school was to transition my career. In 1990, I started with Southeastern Asset Management in Memphis, also known as Longleaf Partners. I was very fortunate there had been some changes in the senior management of that company. It left a hole, allowing some younger guys, including myself, to take on a lot of responsibility quickly. I became a partner in the company pretty early on.

I started as a generalist. We were finding things in the real estate area that were really cheap and interesting. We increasingly gravitated to it simply because there was more opportunity there. Long story short, we started a real estate effort, and I was very fortunate to be tapped to lead that effort. I went from being a generalist to a real estate expert. Then, in the early 2000s, we shut that program down because basically we rode cap rates down from 12% to 8% and thought the bargains had dried up. Obviously we got out too early. I became a generalist again. At that point, we had moved into international and global. That was really fun.

Then, in early 2007, I decided it was time for me to move on. I’d been there for 17 years. I think anyone who’s passionate about what they do, and strives to continuously improve, will keep their core principles but continue to refine them over time. I began to feel very strongly about some things that I wanted to do in my own personal evolution.
Vulcan Value Partners

I left Southeastern to start Vulcan Value Partners in order to put these principles into practice. I had a wonderful experience there and I'll be forever grateful for being part of Southeastern. I wouldn't be here today if I had not been there first.

G&D: Is there a particular philosophy or framework that they use?

CTF: When I was there my initial emphasis was just on valuation. The cheaper, the better. There were other parts to the analysis, of course, but the energy went to finding discounted companies. The bigger the discount, the more interesting, and that's the work you focused on.

As I evolved, I began to feel that it was even more important to focus on business quality, specifically value stability. This concept gets back to what attracted me to value investing in the first place: the idea that you could take on less risk and earn excess returns. That absolutely turns the Efficient Markets Hypothesis and CAPM on its head, but it is what Graham and Dodd were talking about, and what Warren Buffett and Charlie Munger continue to talk about.

For example, look at J.P. Morgan during the financial crisis. It was a really well-managed company but its balance sheet was so leveraged that it was impossible to figure out what its equity was worth with any accuracy. The company's assets are opaque and difficult to value with precision. Even if you were able to accurately value the assets, and the asset values dropped just a little bit, the equity value could evaporate because of the financial leverage on the balance sheet. You could buy J.P. Morgan at a discount to tangible book and believe you had a margin of safety, but the margin of safety would be ephemeral because the company's value is inherently unstable.

That is an example of a company that, in fact, the old C.T. would have said, “Oh, my gosh! I can buy J.P. Morgan at half of tangible book. You know, this is great!” or, “Maybe we should buy Bear Stearns too or maybe we should buy Lehman Brothers. We can buy them at a discount to book.” But, we didn't do any of that at Vulcan.

Instead, we were buying companies like MasterCard that were caught up in the taint of being a financial services-oriented company but it had net cash on its balance sheet. Unlike all the others that I mentioned, it generated a huge free cash flow coupon and had an inherently stable value. They all became discounted, but we bought the companies that had inherently stable values.

My evolution as an investor was that it's not enough to buy a company that is statistically cheap at a point in time. It has to have what we call at Vulcan Value Partners a sustainable margin of safety.

G&D: In addition to sustainable margin of safety, what other things are critical parts of your investment philosophy?

CTF: Time horizon is really important. It can be a huge competitive advantage if you're able and willing to use it. Our minimum time horizon is five years. Assume the equity markets are shut down or think about it like a private equity investor. If we would not be willing to have capital tied up for five years, it doesn't qualify for investment.

With that rule, we discard probably 90% of the companies that are publicly traded. A lot of them get cheap from time to time but we have no interest in them because they don't meet that test. If we're going to have a five-year time horizon and base our investment decisions on that time horizon, we have to invest in companies whose value is stable over that time horizon. Very few companies fit that criteria, but the ones that do, again, provide what we call sustainable margin of safety.

When I started, I was discount first and then the rest later. Today, at Vulcan, we are value stability first. We don't care if

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it’s discounted or not. Of course, we want to buy companies at a discount, but when we start, we don’t look for cheap stocks. We look for companies with inherently stable values. Those companies we follow. Most of them are overvalued most of the time but when they become discounted, we’ve already done the work. We’re up to speed on them. We follow them just like we own them.

Often there is an event: it could be a macro event, it could be something specific to the industry, or it could just be volatility. We haven’t had much of that lately but it does happen every now and then and you have a chance to buy these businesses at a discount.

You have a history of your values. You’ve updated them. When you watch that over and over again, it gives you a lot of confidence to buy a company. You might not have owned it for 10 years, but you might have been following it for 10 years and its value has compounded steadily. It gives you a lot of confidence because you’re not scrambling to get up to speed. If you’re trying to get up to speed at the last minute, the seller is going to know a lot more than you are as the buyer, but we’ve been following these companies forever.

We make mistakes but I think our dual emphasis on quality and discount is what really differentiates Vulcan. That is what we do differently than a lot of practitioners in the industry.

G&D: How do you motivate your analysts to look at things that aren’t cheap yet?

CTF: That’s a great question. It gets to how we’re wired. I’ve heard Mr. Buffett speak very eloquently about this. There are different types and different stripes of value investors. When he wrote the essay The Superinvestors of Graham-and-Doddsville, he mentioned there are different people who do it in different ways. There’s not, I think, one correct way to do it but there’s probably one way that’s correct for each of us to do it. It gets back to staying within our circle of competence.

G&D: You mentioned your shift towards value stability. Were there some investments that pushed you in that direction?

CTF: On average, our returns were really good but it bothered me more to lose money than I enjoyed making money. What attracted me to value investing in the first place is a margin of safety, taking on less risk.

Using a baseball analogy, you don’t improve your average by just hitting more home runs. If you can eliminate your strikeouts, you can really improve your results. It’s not so much about what you do; it’s what you don’t do.

G&D: When you’re thinking about the value stability, you seem to focus on free cash flow. Is that correct?

CTF: Yes. From a quantitative point of view, free cash flow is really important to value stability. That’s a quantitative metric. There are others: How high are your returns on capital? How stable are your margins? How strong is your balance sheet? We look at all of it, free cash flow being the most important.

We spend a lot of time qualitatively trying to understand what’s driving the numbers and the qualitative aspects of the business. Is the business getting better or worse? Our analysis is quantitative but I think our real value add is on the qualitative side. We spend an awful lot of time debating those qualitative issues.

G&D: In the past you’ve mentioned energy companies and commodity risk. Are there any other sectors that you’re saying, just by the dynamics of that business model and that sector, we’re not playing in that area?

CTF: Anybody who doesn’t control their own destiny, which is most people. You mentioned energy. There are less than a half a handful of companies in that area that provide value-added services that we like, but we don’t like most of the industry.

There are some really well-managed industrial companies. One we’ve owned for a long time that’s been really successful for us is Parker Hannifin. They’re a leader in motion control products and they have a substantial aerospace business as well, where they are in programs like the 787 which have a very long life. We like companies where the equity duration is long and the cash flow is very stable.
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Then there are other industrial companies that are just making commoditized products. They’re typically price takers and they are heavily leveraged. They’re in a very weak position. Anybody can do what they do. Those are just cigar butts. They get cheap, but we don’t care. We don’t want to waste our time with them, even if they are cheap, because they do not have inherently stable values.

G&D: Could you buy one of those cigar butts at such a discount that you are effectively agnostic to the commodity price risk?

CTF: Absolutely. You could, and I used to do things like that but don’t do them anymore. You have to be disciplined. We still like the discount. But liking a discount didn’t make it go away.

There are things we look at, we go, “Oh, my gosh. You know, this is just so tempting,” but don’t do it. We don’t.

G&D: You mentioned spending some time on the quantitative but a lot of time on the qualitative. How do you go about valuing those qualitative metrics for companies and kicking the tires before you invest?

CTF: We don’t screen. We’re looking for great businesses. There’s a lot of accumulated knowledge. A lot of businesses that we own currently, I have owned three or four times over the course of my career. That makes up what we call our MVP list: companies we follow that we would buy if they become discounted.

G&D: You have a couple hundred names on that list, right?

CTF: We have roughly 500. Our analysts are rewarded for finding new names to add to the MVP list, but they’re doubly rewarded for taking names off. No one is rewarded for how many names they follow in the portfolio. You just happen to be the person who is following the name at the moment it became discounted. These names on the MVP list have been updated by numerous analysts over many years. Nobody even remembers whose idea it was. It’s great because we’re now working objectively with a culture that reinforces our investment process. We’re not at odds with each other.

Most new businesses fail. You have a lot of things going against you but when you can set up initial conditions thoughtfully and create a foundation that can propel you forward, that is a one-time asset but it’s depleted over time. It’s gone. You only get it once. We spent a lot of time when we were setting up the company to make sure that we set up a culture and a compensation system that reinforces the execution of our investment philosophy.

G&D: How do you look for these new MVP companies?

CTF: We read a lot. We get a lot of ideas from following the companies we own. We spend a lot of time talking to the companies we own. I can’t give you all the secret sauce, but we’ve spent a lot of time talking to very accomplished people. We never ask about earnings. We talk about long-term issues impacting the business. We talk about what’s going on currently. We talk about the things that really matter. The companies we talk to really appreciate that.

G&D: You’ve owned Oracle for a while, and it’s your largest holding. Why?

CTF: We became believers in the shift from on-premise computing to cloud computing a long time ago. Go back a few years before the cloud grew rapidly. Oracle and SAP dominate the on-premise software markets, specifically the enterprise computing software market. SAP is stronger in applications and ERP and Oracle are stronger in databases, but Oracle has plenty of ERP products and SAP has its own database. SAP licenses the Oracle database for most of their stuff.

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It’s like Coke and Pepsi. Neither one of them is going to knock the other out. They fiercely compete with each other, but they respect each other. They bad mouth each other but at the end of the day, neither one of them is going away. It’s very logical. Both companies have pricing power and their products are really sticky. Renewal rates are north of 90%. They’re in a sweet spot if you look at where the economy is growing.

There’s more and more demand for their products. Everybody talks about the explosion of data, and that drives demand for their products. They both have had a wonderful business for a really long time. They’re both MVP companies.

Roughly five years ago, Oracle made an announcement that they were moving toward the cloud. SAP at the time said they were staying with on-premise and not really investing much in the cloud. Oracle spent a ton of money to make all of their on-premise products fully compatible in the cloud and integrated with the on-premise offerings.

When you say you’re in the cloud, what does that mean? Oracle is in the cloud in a much more integrated way than SAP is. Oracle invested aggressively to be able to offer the cloud across their entire product suite, a complete solution. With Oracle, you can be 100% in the cloud, you can remain 100% on-premise, or you can be hybrid and never know the difference. When you’re sitting at your desk and you pull up the database, you might be using one of the products in the cloud and one of the products on-premise. You’ll never know. That’s really easy to say and incredibly hard to do.

SAP kept focusing on on-premise. They’re more of a European company and more of their clients are based in Europe. The Europeans are generally more skeptical about cloud than the Americans. The adoption’s been a lot faster in the U.S. There are some business reasons for it, too, but Oracle is in a much stronger competitive position than they have ever been because of their investment in the cloud.

It cost them in terms of earnings. They’ve been converting their client base to cloud. It has impacted their revenue growth because you’ve had decelerating growth in on-premise. They have had heavy R&D investments and costs going up faster than revenues. Their earnings after growing steadily for decades starting dipping.

G&D: When was that? When did they start dipping?

CTF: They started dipping about two years ago, sort of flattening about two years ago and then just a slight decline. Part of it was FX, but I’m talking about down mid-single digits. Not a big deal at all.

At the same time, while the on-premise is slowing down, the cloud business is exploding. I’m a value investor. We have a really hard time modeling growth rates like this but this was 70-80% annual revenue growth with expanding margins. Earnings growing well over 100% in that part of the business.

The on-premise business is basically going from growing at a mid-single-digit rate to basically growing at zero. The cloud business is now at a $6 billion run rate. With that kind of run rate, it’s now growing around 40-50% instead of 70% or 80% on that much bigger base. You couldn’t see it in the GAAP numbers but we saw it in all of the new bookings. Growth was in line with the strategy that they explained to us. We weren’t the only ones who heard it, but you could see it in the figures that ultimately drive the GAAP numbers.

You can go read old sell-side reports that were negative on Oracle because its earnings growth had stalled. Now their earnings are beginning to accelerate and the reports are getting more favorable. Oracle’s stock price is beginning to go up but the growth was there two years ago if you looked at what’s under the hood and not at the GAAP numbers. The GAAP numbers are a lagging indicator to what’s actually happening in the business.

Oracle’s growing at double digit rates again. We think they’re going to grow at double-digit rates for a really long time. Ultimately, is it going to be a 10-year transition or a 20-year transition? If it’s 10 years, they’ll grow faster sooner, but if it’s 20 years, you’ll just have longer duration. They’ll grow slower but it’ll last longer. They will settle back down to a mid-single digit kind of revenue.
growth again but in the mean time they’re going to grow at an accelerated rate. SAP trades at a significant premium to Oracle because they have continued to enjoy their earnings growth over the shorter term. They haven’t made these investments, but that’s going to catch up with them.

Again, at the right price, we’d own SAP. SAP’s strategy is not flawed. It’s just a different strategy, but in terms of what’s going to happen, SAP’s growth is going to slow relative to Oracle’s and it trades at a premium. I think Oracle is an example of us exploiting our five-year time horizon. We look at that and say, “Okay, we’ve got two years of flat-ish earnings.” Meanwhile, they’re generating $13 billion of free cash flow, 80% of which has been put into share repurchases because they know their stock is cheap.

While we’re waiting for this transition to occur and earnings growth to accelerate again, our value is stable because of the robust free cash flow and stable margins. They quit growing for a while but we’re still getting a free cash flow coupon, and they are using that to repurchase shares at a discount.

Our view is that we were paid to wait while this transition occurred. We give Oracle’s management team points because they do what everybody says you’re supposed to do. They’re willing to sacrifice short-term results to strengthen the company over the long term. Now we’re in the payoff phase but we had to ride through the investment phase. Now we’re on the other side of it. As five-year investors, we’re happy to wait. Other investors are not. They want to see near-term earnings acceleration.

G&D: Can you talk a little bit about barriers for entering the cloud? Can’t others enter as well?

CTF: Oracle has made extensive investments not only to rewrite all of their code so that it can be deployed in the cloud, on-premise, or hybrid, but also in the infrastructure needed to deliver such services. We do recognize that cloud-only competitors exist in the application layer, such as Workday and Salesforce, and there are infrastructure-only competitors, such as AWS. However, no one competes effectively throughout the stack with Oracle in both on-premise and in the cloud.

G&D: Are there any other examples where your institutional knowledge from having followed these companies on the MVP list helped you spot a multi-year opportunity when others were focused more on near-term EPS?

CTF: It does happen from time to time. It’s really ironic because it’s what many say they want companies to do, but then the companies get in trouble for it. United Technologies is doing it right now with Pratt & Whitney. Honeywell did it a few years ago. FedEx did it a long time ago when they started building their international operations. Quaker Oats did it when they were investing heavily in Latin America. It can create great opportunities for long-term investors.

G&D: How do you evaluate management? Is that just going back and checking the track record of how they’ve performed as stewards of capital in the past or is it more by talking with them about the landscape they’re facing?

CTF: You have to do both. I think that studying somebody’s history is really, really important. We made an investment in Time Warner seven years ago. That was a company that was not on our MVP list because of mismanagement exemplified by the AOL-Time Warner merger. Because of that, there was finally a shakeup on the board. People that we didn’t like started to leave the board, and people we did like started to join the board. Jeffrey Bewkes became CEO, and we were paying attention.

The company was not on the MVP list because of this big, black mark on management but it could be a potential add. When Bewkes became CEO (Continued on page 33)
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and we saw this change in the board composition, we started watching more closely what he was doing. He started reversing all the crazy stuff they’d done. They started doing a lot of shareholder-friendly things like spinning out Time Warner Cable and started buying back the stock when it was cheap.

We kept listening to conference calls, and we kept watching, and we finally put it back on the MVP list. Luckily for us this happened right before the 2011 U.S. debt-ceiling debacle. First, we decided it met our quality criteria, including management. You can have a great business like Time Warner, but if you don’t have good management, it doesn’t work. That was the missing piece. It then became discounted, and we bought it. We just recently exited the position.

G&D: You mentioned the quality criteria for Time Warner. Can you define it?

CTF: Our definition of quality is value stability. How stable is your value? Things that lend themselves to value stability are production of free cash flow, stable margins, and strong balance sheets. You could argue that most of our companies have very inefficient balance sheets. Because of their free cash flow production, they could have a lot more financial leverage than they do. Most of our companies have net cash and their balance sheets can be used as a weapon.

You then go and say, “Okay, that’s great but that’s the past. What’s the future going to look like?” During the financial crisis, we had large investments in DirecTV and Comcast, and we ended up owning Time Warner Cable when it was spun out. Those businesses were great businesses when we owned them and their bottom-line financial results still looked fantastic when we sold them. But from a qualitative point of view, we had started to worry about cord cutting.

We started talking to the younger analysts that we had hired. All of a sudden, I’m hiring people and they’re saying, “I’ve never paid for cable or satellite in my life and I’m never going to.” The more work we did qualitatively, we said, “You know what? Power is shifting from the content distributors to the content owners.” About the time we bought Time Warner, we were getting out of DirecTV, Comcast and Time Warner Cable because we believed that the content owners were getting a stronger hand. We believed the distributors’ competitive position was beginning to erode, but you couldn’t see it in the numbers yet.

Now, look at today. Cord cutting’s rampant. We saw that six years ago from a qualitative point of view. The qualitative analysis is even more important than the quantitative analysis because quantitative is always a lagging indicator. By the time you see it in the numbers, it’s often too late.

G&D: So you recognize the qualitative thing that triggers you to think, “Okay, there’s a shift here that hasn’t turned up in the numbers yet.”

CTF: We’re not always right. Sometimes we sell something and the company remains competitively entrenched. Frankly, with the distributors, it’s come back full circle. The video business is not that important to them anymore compared to what it used to be, but every time you’re streaming Netflix or Amazon Prime, it’s going through their pipes. They win anyway. They have really become ISPs more so than video providers.

I’m not saying that they qualify again, but who knows? Five years from now, we might own Comcast again. I don’t know, but things evolve and they change. We don’t always know about the timing and how fast it’s going to happen.

As value investors, we don’t have to play. It’s all about managing risk. We might be wrong, but if we’re wrong and things continue to go well, we’ll just allocate capital somewhere else where we think things are also going to go well. We don’t have to take those risks.

G&D: Taking a long-term approach as opposed to more of an activist approach, I would imagine you definitely need buy in from your clients on this type of strategy. How do you communicate the type of investor you’re looking for and how do you best have that conversation?

CTF: That’s a great question. We truly view our clients as partners. We chose the word partners and put that in our name very deliberately. We view the companies that we invest in as partners. We want them to treat us as partners. If (Continued on page 34)
they don’t feel that way about us, that’s a big red flag. We look for the intersection, if you will, of a partnership between the management teams with whom we invest, ourselves, and our clients. One of the things I’m really proud about at Vulcan is everyone at Vulcan is required to invest in public equities exclusively through Vulcan. You can’t work at Vulcan and invest anywhere else.

I think that really aligns our interests with our clients. It doesn’t make us smarter than anyone else, but it does keep everybody focused and it weighs heavily when someone in a research meeting feels strongly about something. I know that their net worth is riding on it.

Our clients share our time horizon. They share our ability to differentiate between value and price. We have fantastic clients. We tell them that investing with us can be very uncomfortable. There are going to be periods of time when we’re doing things that are very uncomfortable in the short run. If you are not willing or able to go through that discomfort, don’t hire us. You’ll be unhappy with us. We want client partners that can provide stable capital for us.

There’ll be a time when we’re going to say, “Give us money. The opportunity set is rich.” I really think they will because we’ve told them it’s not a great opportunity set right now. If you have better places to allocate your capital, we encourage you to do that. If you have another manager who’s got some great things for another asset class, that’s great. Most of our clients are institutional. They invest in multiple asset classes, partner with multiple managers around the world, and have lots of options. We tell them to reduce their exposure to us and put their capital somewhere else where there

“With the [content] distributors, it’s come back full circle. The video business is not that important to them anymore compared to what it used to be, but every time you’re streaming Netflix or Amazon Prime, it’s going through their pipes. They win anyway.”

are better risk adjusted returns. We want the kind of client where we can have that dialogue. Then, there’ll be a day when we’ll say, “Now, the opportunity set is rich. I fully expect to get that money back and a whole lot more.” 2008 was a great example of that happening.

One of our competitive advantages is our group of clients. We closed to outside investors in 2015. Our clients provide us with very stable capital, and that is a huge advantage for us.

G&D: What advice would you have to students just as we think about careers in this industry long term?

CTF: I’m going to quote the interview you did in your Fall issue with Howard Marks. I thought his advice was outstanding. Do what you love. I’m the happiest guy in the world. Every day, I do what I love. I’m more blessed than I deserve to be. I have been happily married for many, many years. I have healthy kids, everything’s great. But during my working hours, I don’t think, “Okay, got to go and get through work so I can start enjoying my life.” I look forward to going to work. I get bored on vacations pretty quickly. It’s such a blessing to enjoy my work that much. My advice to everyone is to find something that you love. You’ll become so much more successful at something if you love doing it.

I’m sure you have all heard of Malcom Gladwell’s book Outliers, and maybe you have read it. It discusses the principle that if you do something you enjoy doing, you’re going to do more of it, and the repetition makes you better. That’s my biggest advice. In terms of value investing or anything else, you must be passionate.

G&D: Thank you, C.T. Thank you for sharing your thoughts and time with us.
to get coffee for the team—my first opportunity to showcase my work was an FX arbitrage opportunity in Venezuela. It was an onshore-offshore arb of converting ADRs.

Highbridge co-founder Henry Swieca ’83 was extraordinarily generous towards me. I was working with Alex Jackson ’91 at the time—and he suggested I present the Venezuela idea to Henry. I did, and Henry said, “Great. Here’s half a million dollars, why don’t you give it a try?”

That was still a lot of money back then, but we gave it a try and it worked. I stopped getting coffee and started looking for more opportunities. We then did some cash extraction trades in Italy, where interest rates were really high.

G&D: What’s a cash extraction trade?

SF: This may seem alien to current MBA students, but once upon a time the world had both high interest rates and opportunities for pure arbitrage. And cash extraction is literally buying a warrant, shorting the underlying stock and receiving interest on your short sale proceeds. At the time, rates in Italy were about 12%, so high that you could actually make money for free.

G&D: And this would be very hard to do in today’s near-zero environment?

SF: Yes, this is impossible to do at zero. Plus, the world is much more efficient and there's much more capital, so this opportunity would be arbitrated away in 30 seconds these days. But, at the time, there were more opportunities than there was hedge fund capital in places like Italy.

And then we got involved in the Japanese convertible bond market. That was then the largest CB market in the world, because Japanese companies were issuing so much CB paper. And this reflected a regulatory quirk of Japan. Insurance companies, who were among the biggest allocators of capital, had limits on how much equity in other corporations they could own. So corporations would issue what are essentially surrogate bonds as equity–securities that stood in the eyes of the regulators as bonds but that offered equity-like participation. And they issued them cheap. There was just so much supply of paper that it was shockingly cheap.

Then I started getting involved with everything else. There was a wide variety of arbitrage opportunities in Malaysia, Indonesia, and the Asian Tigers. Soon, the 1997-98 Asian crisis occurred, and I learned about risk management and how to deal with problems quickly.

G&D: You started off in the business finding arb opportunities, but Oasis is a lot more than arbitrage today. How would you characterize Oasis’s strategies?

SF: As I say to my traders, and to my investors, “We’re trying to make a buck, and not lose one.” And we have three idea buckets: We are trying to do it faster than everyone else, know it better than everyone
They are different types of muscles. And you’re paid for a different ability. I think acting faster in trading means you’re getting paid for mostly risk tolerance, and to some extent the ability to quickly source an idea or a block of securities when an event occurs. It may also mean you’ve thought about these events before—or have seen some version of this story—and can act quickly this time around.

“**We are trying to do it faster than everyone else, know it better than everyone else, or question the very premise of the story.**”

Then we also started questioning everything, in what is now our third bucket. On the long side, we started questioning Japanese gaming company Nintendo many years ago. Why doesn’t Nintendo use its IP for mobile? This became a big case of shareholder activism for us, where we kept nudging Nintendo into this direction.

That’s an example where the future doesn’t necessarily reflect the past, and where we have to think differently from the herd. In our Strategic business in general, the great returns come from being very different.

**G&D:** Is it possible for the same analyst to both “do it faster” and “know it better,” possess both trading instincts and the fundamental-analysis chops?

**SF:** I think you’re right that they are generally different muscles. They are fast versus slow muscles. That’s why we have four analysts in our Tactical team, and about eight in our Strategic Team.

They might work on something for three or six months and you decide to kill it.

I’ve made mistakes killing ideas that I shouldn’t have killed. And maybe we proceeded with ideas that I should have killed along the way. But it’s much nicer to make these decisions when you aren’t immediately pressured to put risk on, and generate some profit in the short term. We can slow down and do our Strategic work diligently.

Plus, our Tactical business gives us access to a lot of pieces of information that we would otherwise miss.

**G&D:** What kind of information?

**SF:** A lot of ideas in the Strategic bucket come from observations made from the Tactical side. For instance, why is a company continuously issuing capital? We learn a lot about a company or its promoter who is doing a lot of deals or trading a lot of securities. We also generally know of incoming supply or offerings in a market that may affect the price of a particular security, which does affect our timing for our investment.

Could we have figured that out without being in the Tactical business? In some cases, yes. But in other cases, we wouldn’t even be paying attention to that space if it weren’t for our Tactical work.

Thanks to the Tactical bucket, we end up making more connections, meeting more people. On any given day, there are three to seven companies coming through our

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Oasis Management Company

office. There’s a lot more idea sourcing. And we know more about the IPOs, secondary offerings and private placements in the region as a result.

We traded a stock recently where we remembered that somebody had been sitting on a related convertible bond for a very long period of time. The underlying stock has gone up in value a lot, so all of the sudden the CB looks cheap. So we said: Why don’t we just call this guy and see if we can source the stock block or buy the CB from him?

G&D: How would your Tactical prowess work in markets that are getting faster by the day and that rely increasingly on algorithms? Could no algorithm have gone through the CB holder list and convinced that guy to sell?

SF: No algorithm is yet making automated phone calls to holders and convincing them to sell. There is still value to getting on the phone. As they say in “Glengarry Glen Ross,” you should always be closing a sale. You have to convince the fund manager who holds a security that this is a good time to sell. At least for securities that aren’t that liquid, the business is still about relationships.

G&D: As for your other business line, what does it mean to you to know a business better than others in the market?

SF: In China, for instance, this may often mean being skeptical from the get-go—and not being complacent enough to think that Western rule of law or validity of contracts is the norm. In the West, we see sophisticated accounting frauds, but not as many physical frauds. In China, there are outright physical frauds—where the business just doesn’t exist. Despite the fact that you have all the financial statements, and auditors and lawyers have signed off, a substantial part of the business is just not there. That takes a lot of on-the-ground work to know better, but also a healthy degree of cynicism.

G&D: Can you elaborate on “In the West, we see sophisticated accounting frauds, but not as many physical frauds. In China, there are outright physical frauds—where the business just doesn’t exist.”

These physical frauds? It’s intriguing that this is something a sophisticated New York-based investor, used to Western norms, may miss when looking at Asia.

SF: Perhaps the easiest example to talk about is Sino-Forest Corporation, the Canada-listed Chinese timber company where the trees were simply not there. They didn’t own the trees. In the one property that they took investors to see, if you drove around, you’d see a massive forest. But if you hired a helicopter to fly over the forest, you’d see the inside was cut out.

Sino-Forest ended up being a fraud from so many points of view. That business model didn’t make any sense, because it seemed the customers were paying the company’s suppliers, and the company could say it was not touching any cash. That helped them manage the accounting part of the fraud—the auditors couldn’t see any cash going in or out. But tell me this: What business reports EBITDA margins around 60% and doesn’t touch cash?

That was a case where you could ask big existential questions. You could work down the chain, and cover every part of the business. Who are the customers, who are the suppliers, do these people exist, where are these assets, do they actually own the forest?

There is a similar, more recent case—another physical fraud in this part of the world that involves sandalwood trees. There is misrepresentation on almost every single account.

If you are an alternative-asset manager or a family office who has bought into the idea of buying a forest or securities in companies linked to forest, be very careful. Yes, on one hand, it could be a great long-term, uncorrelated investment—because yes, the world still needs wood.

Yet the problem is that forestry is a 20-year or so investment, and it matters how the companies value these assets. In this case, the company misrepresented how fast its trees grow, how much...
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yield they get in sandalwood oil out of it, the survivability rate of the trees, the price that they sell it at, the size of the demand from customers.

**G&D:** Ha, so what were they not misrepresenting?

**SF:** The fact that they had trees? The larger picture is that these trees are very hard to grow. The company said that these trees had very high survivability—but we got the individual plantation numbers, and survivability was much lower than their claims. They tried to claim that they cut the trees earlier and had a better yield than ever before. All the claims were overstatements.

Most importantly, customers, who are often in China, were either made up or had stopped being customers—and the company failed to disclose that. The price these customers were paying has dropped by 50%. The company sold some plantations to the CEO, who borrowed the money from the company to buy those assets. Now, the CEO has defaulted in paying even the interest on the loan.

The company has finally turned around to sue him. A few months ago, this whole thing blows up. He resigns, says he’s going to try to buy the company, and whispers rumors that he’s going to do it with a big private-equity firm. Which is unlikely, because that PE firm owns another sandalwood oil plantation that they are trying to sell. And nothing has come of that “rumor.”

**G&D:** Wow. What does a Western investor need to know to steer clear of such physical frauds in Asia?

**SF:** Uncovering physical frauds requires real work, which means going to visit sites not on a company-sponsored trip. There are countless stories of people going to factories in China a day before the roadshow and seeing a different name on the door. When they show up on the roadshow, on the other hand, there’s a whole Potemkin village out there.

So first, go check it out. There are no repercussions for going to see the assets without telling the company you are going to see it. Second, visit the customers, without being pre-announced. Third, visit the suppliers. Fourth, in China, pull up the local-government filings (that are separate from what is filed to the stock exchange) and read the publicly disclosed taxes. Do those numbers make sense?

The point being, this stuff is hard if you are trying to look at a hundred different companies. So a lot of people outsource the work. This is harsh to say, but there are certain on-the-ground investigation firms that have a short time horizon and think they are doing you a favor because you are sitting in New York or Chicago and need their help. You are trying to get to a “Yes” on your investment. But they are trying to please you because you’re the customer. So they’ll do half or three-quarters of the work and still give you an OK.

So you either need to find people who are going to go the extra mile, or people who realize it’s really a long-term relationship with you.

**G&D:** To get around this principal-agent problem, does Oasis do all that work itself? Or do you rely on partners?

**SF:** Both. I have internal staff performing 80% of this diligence. Yes, it’s labor-intensive and time-consuming, and sometimes you are working on a project for three months and you’re wrong. But the good news is that it’s not physically difficult. You can send somebody who doesn’t have a PhD. Most anyone diligent can stand outside of a factory, count cars, and click pictures.

What you do need is that healthy degree of cynicism. And it’s very helpful if you have some business experience. If you’ve never gotten your hands dirty growing up, you might not know what a business looks like. And I don’t mean knowing what a business looks like on an annual report. I mean having a sense of when money changes hands, when a company pays taxes.

It’s important to also protect against our biases. For instance, on the short side, I don’t like our analysts meeting the management. While it’s very helpful sometimes to hear the company’s answer for what you don’t know, it’s human nature to believe people. Some of these companies may be frauds but, not surprisingly, they have good salespeople.

Even our most cynical internal analysts, when they meet management, end up believing management. We can have other people ask the company

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questions but I don’t want the primary analysts to meet the company in those situations.

G&D: You mentioned your activist stance with Nintendo. Can you tell us more about your activism?

SF: Our activism has a couple of different buckets, too. It could be a white-space opportunity—something the company is just not engaged in that we think it should be. We call that “a better business.” Nintendo is a phenomenal case from this bucket. It was a classic value investment, trading at just a 20% premium to its cash when we got in. That is, cash was roughly 80% of its market value.

Essentially, the pitch book Nintendo puts out at IR meetings today is the pitch book I gave them in 2013. My pitch was about going mobile and monetizing IP with new theme parks as well as media. Today, cash is at 15% to 20% of market cap, and as the company has taken steps in this direction, the stock is up 4x.

A current campaign we have in this bucket is called A Better Pasona (www.abetterpasona.com), where we’re involved with the Japanese staffing firm Pasona.

The second bucket is imagining that the future could be different from the past. In Japan, I got encouraged on this front by Prime Minister Shinzo Abe’s new corporate governance and stewardship codes about four years ago. This meant that the corporate abuse of minority shareholders that has gone on in Japan for decades doesn’t have to continue. We call that “protect”.

A campaign we have in that bucket right now is Protect Alpine (www.protectalpine.com).

Japanese stock valuations are extraordinarily low. If you think about valuations on EV/EBITDA as opposed to price/earnings, or if you think about them on a P/E ex-cash basis, Japan is very cheap. And that’s because Japan has much lower leverage, lower ROEs and lower profit margins.

“In the one property that they took investors to see, if you drove around, you’d see a massive forest.

But if you hired a helicopter to fly over the forest, you’d see the inside was cut out.”

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Over the last 30 years or so, Japan Inc. has gone to excess cash with no leverage. That situation is changing as the Bank of Japan’s monetary stimulus tries to bring leverage back into the equation. It’s prudent in a deflationary environment to have no leverage but if you are trying to have inflation, it’s actually prudent to be levered. On top of that, the government has pushed for shareholder payouts, independent directors on boards, unwinding cross-shareholdings, and a focus on return on equity.

In the case of PanaHome Corp., a listed subsidiary of Panasonic, we had a company with 89%+ of its market cap in cash with zero leverage. Ex-cash, the business was trading at one and a half times earnings. It was extraordinarily cheap but possessed good long-term revenue streams—and not in tobacco or a heavily regulated industry with systematic problems.

G&D: What does PanaHome do?

SF: It builds steel structured houses in Japan. It has a fair bit of Southeast Asian expansion potential, they have a land bank that they can use, and they have cash to use to buy additional land.

Now, they had never used that cash, because that cash happened to be parked with its parent Panasonic. Why? For cash-management purposes, they told us. Well, I’m also holding my five-year-old’s lemonade money—literally. But he’s five. When they’re 13 years of age, they want to hold their own money. This company has been listed as an entity for 40 years. I think it’s about time it grew up.

Why is its cash held by its parent? Because the parent gets to pay out only five basis points and hold all its subsidiaries’ cash and use it. So the market completely discounts PanaHome’s cash because it thinks the company is never going to get to see it. You can read all the sell-side reports and nobody uses the cash in their valuation.

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So I thought it was time to say to PanaHome, “You should get your cash back. You should not only get your cash back, you should use your cash for growth. Invest with a positive IRR.” I went to them in March 2016 and said so. They said, “Great, we’ll think about it.”

They never got back to me, so six months later, I wrote them a formal letter. Three weeks after I sent them the letter, they set up a committee to privatize the company—basically, to get rid of pesky guys like me.

Then they go ahead and privatize at a very small premium to the current stock price. And they bias every part of the valuation process. The comparable companies they list for market multiples are not really their competitors. The DCF suddenly has them using all that cash in the next three years. They show zero growth and negative cash flow in the DCF, so the imputed market value ends up very low.

They revised down earnings on November 1, 2016, which caused the stock to fall, then announced the privatization on December 20. And guess what they used to calculate the historical average stock price over which they would pay a premium? They used the three-month average, the 44-day average, and the 30-day average—so they massively weighted the exercise to the 44-day mark, right after the time they revised their earnings.

Then in April they revised up earnings, leaving no doubt that they had revised down in November just to bias the metrics for the takeover. I thought this was ridiculous, and I wasn’t going to stand for it. We bought more stock, and ended up owning 9.9% of the company. I set up a website called www.protectpanahome.com to spread the word—something that had been done before by activists in the U.S., but not in Japan.

The comparable companies they used were not their only true nationwide competitors, Sekisui House and Daiwa House. Instead, they chose small, money-losing and illiquid companies as comps to further depress the “fair” takeover price. Yet, we have tapes from more than 10 PanaHome sales agents referring to only Sekisui House and Daiwa House as their main competitors. Naturally, Sekisui House and Daiwa House trade at more than double the multiple of PanaHome.

I remember that we were protesting at the time because we were shareholders of those two listed subs. But I decided not to really take the fight to them at the time, because I didn’t think we would have enough shareholder support.

This time, it was different. The Japanese government was behind us, so we launched a full-scale battle. A few months later, PanaHome announced a revised tender offer, which was 20% higher. I still think the price is too low. We have sued for appraisal rights, a process in Japanese law where a shareholder can sell the shares back to the company, if he objects to a transaction, at a fair value that a court has to determine.

G&D: Activists have tried knocking on Japan Inc. doors before. Is this time different entirely because of the government push?

SF: Yes, this time is different because of the government. And press coverage is in our favor. During the PanaHome debate, the Nikkei—Japan’s largest business paper—had a cover story on justice for PanaHome’s minority shareholders.
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We are not coming to Japan saying, “This is the way it should be. Let me tell you how to do business.” We are using the Japanese government’s own initiatives. After all, this is Abe’s third arrow of structural reform.

There have been other changes in Japan too. The Tokyo Stock Exchange set up a new JPX 400 index, where ROE is the key metric for inclusion. And the Government Pension Investment Fund, which manages $1.3 trillion—trillion with a “t”—now invests trying to match the JPX 400. The whole government, including the alphabet soup of regulators and associations, is massively behind this corporate-governance initiative.

In particular, cross-shareholdings are getting much, much weaker. This was the problem when fund manager Warren Lichtenstein in the early 2000s was taking an activist approach in Japan: a company’s web of cross-shareholdings ensured that the management had enough friends on the register to vote in its favor. Now, minority shareholders have real voting power.

We put forth a proxy in another company in March. We lost. But note that abstentions went up dramatically during the proxy vote. The new trick for the other shareholders was not to vote against us but just to abstain. So management may have beaten us in the vote, but the numbers were a lot tighter. The people who abstained were people who typically would have voted for the management, but now couldn’t justify voting so.

Now, thanks to new developments in Japan’s corporate governance rules, companies in Japan have to reveal how each individual shareholder voted. So there is gradual progress. We’ll be back soon with the company. And they know it.

G&D: If the driving force is political, what happens if Abe loses an election?

SF: There is a risk. But we think Abe is stable and going to continue in power. And the two leading candidates of the Liberal Democratic Party—Abe’s party, which has been in power for the overwhelming majority of Japan’s postwar history—both embrace these ideas. What’s more, most people in Japan think the corporate-governance train has already left the station. The only question is about the speed of acceleration.

U.S. investors or international investors may get very excited about the recent corporate-governance initiatives, expecting quick change, but the reality of life is that such reform is slow. It’s slow everywhere. And Oasis is in it for the long haul.

One of the most recent initiatives out there is that Japanese companies now have to disclose their hidden advisors. These are often ex-CEOs of Japan Inc.—a 75-year-old, say, who’s still hanging around, who still goes to the office, still has a company car, and still gets paid 80% of his salary. The CEO he appointed as his official successor still unofficially answers to him.

One could say this is a cultural matter, and reflects Japan’s respect for its elders. But the problem is that the shareholders, the company’s employees and even some of the board members don’t know about this guy. They don’t know that he’s still pulling the strings.

G&D: The proxy never disclosed these advisors?

SF: No. But the good thing about Japan is its strong legal framework, so you have the power of the courts. We would sue to get this information and win eventually once we get the information, but that’s after six months to a year of fighting. Now, thankfully, it’s going to be a part of policy in Japan.

G&D: Oasis has recently taken an activist stake in Chinese industrial gas maker Yingde Gases. Are China or other parts of Asia new fronts for you?

SF: We are interested in the activism space in general, especially in line with improvements in corporate governance. It’s an increasing trend across Asia in general. Korea, for instance, is amazing—there was a whole election in 2017 based on change in corporate governance after the vice chairman of Samsung went to jail on bribery allegations. There are stewardship code changes coming to Hong Kong and Singapore as well. And it is occurring in some ways in mainland China, though China is a different beast entirely.

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We’re also involved with Premier Foods in London. That’s another place where cultural norms and shareholder activism are much more conservative than in the U.S.

Premier Foods had a takeover proposal rejected by the board—and we thought it was poorly rejected. The stock plunged and we established a sizeable position. We own 8.9% of the company today. We put a colleague of mine on the board. And hopefully we’ll get a transaction done.

The U.K. is an example of a place that has white-space opportunity because of the gentleman’s club way of doing business. There has been some activism, though not like the U.S., which has been picked over and where activists have been extraordinarily successful.

G&D: What advice would you give U.S. investors about approaching activism in Japan, compared to how they approach it in the West?

SF: There is a very different style. You have to remember that you’re not just appealing to pure economics.

There are great business-school studies on how bargaining is different in different cultures. In some cultures, it’s acceptable for bid-asks to be 50% wide. In other cultures, it’s only acceptable to go 5-10% wide. It’s a big collision when two people of different cultures bargain this way. One person asks for $10,000 when the bid is $1,000. But the other person thinks that asking for 20% more already means you are a crook. We are speaking in different languages.

In Japan, you want to appeal to what is right. The arguments one could make are that abusing the process is wrong. Child abuse, like Panasonic abusing its subsidiary PanaHome, is wrong. Not making Japan as productive as it can be is a poor choice. Misleading shareholders is bad.

“You have to learn about the bad actions of people. It’s important also to understand where countries rule by law, rather than under the law.”

Thinking about how to have a business that is taking risks and growing in a well-mannered way, without being too aggressive, is good. So this is all about what’s right and wrong. It’s about adhering to the Corporate Governance Code, or dismissing it.

G&D: Do you expect the traits that allow Oasis to be successful today in Asia will be materially different from whatever is required to be successful there 15 years later?

SF: Yes, remaining nimble and changing our strategies as the capital markets grow will continue to be a key to our success. The great news is that Asian markets are still developing. I imagine Asia will look a lot more like the West where there is a more established rule of law.

Japan will look more like the Western world if Shinzo Abe is successful in 15-20 years’ time. Companies’ balance sheets will look more like the West, and that should be an upside for markets.

Most prominently, there could be a massive development of capital markets in China. There, we have to get out of the current gambling mentality—trading volumes in mainland Chinese markets are unbelievably huge.

The key here is rule of law. Without legal enforcement, trading is easy but value investing is very hard.

G&D: Any advice to MBA students who are interested in the world of investment

To make an Asian investor invest in the U.S., perhaps you have to get rid of a lot of scar tissue that you built up in Asia of not trusting anything. Maybe you waste too much time because you just don’t want to trust anything. Or maybe it makes you a great investor because you so diligently check everything.

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SF: First, don’t only sit behind a desk. Second, just because something is the way it is doesn’t mean that’s the way it has to be. If the way of the future is simply the way of the past, then a computer can do it better than you. Think about what your brain does that an algorithm can’t.

G&D: That’s great advice.
Thank you.
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