

Mining MVPs

Contrary to Finance 101 orthodoxy, value investors want to generate excess returns by taking on less risk, not more. Here's how C.T. Fitzpatrick does just that.

INVESTOR INSIGHT



C.T. Fitzpatrick
Vulcan Value Partners

Investment Focus: Seeks high-quality, stable companies on the rare occasions when their estimated intrinsic values exceed values ascribed by the market.

It's surprising more money managers don't have the same rule, but at C.T. Fitzpatrick's Vulcan Value Partners no employee can own any public equity outside of the firm's portfolios. "We believe it's the right thing for our clients," says Fitzpatrick, "and I know it's critical to our culture. It's a very powerful motivator."

It has also been a smart investment. The firm today manages \$15.7 billion, and its large-cap strategy since inception in 2007 has earned a net annualized 10.1%, vs. 8.3% for the S&P 500. Its small-cap strategy over the same period has beaten the Russell 2000 by 300 basis points per year.

Finding more value in big companies than small, Fitzpatrick today sees upside in such areas as Internet services, healthcare, airplanes and real estate.

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VULCAN
VALUE
PARTNERS

	Inception Date	YTD as of 12/31/17	Annualized Since Inception	Peer Rank ¹ Since Inception
Large Cap Composite (Gross)	3/31/2007	18.2%	10.9%	2%
Large Cap Composite (Net)		17.5%	10.1%	
Russell 1000 Value Index		13.7%	6.4%	
S&P 500 Index		21.8%	8.3%	
Focus Composite (Gross)	11/30/2007	22.7%	11.7%	1%
Focus Composite (Net)		21.7%	10.4%	
Russell 1000 Value Index		13.7%	6.9%	
S&P 500 Index		21.8%	8.3%	
Focus Plus Composite (Gross)	3/31/2007	22.8%	10.5%	4%
Focus Plus Composite (Net)		22.0%	9.3%	
Russell 1000 Value Index		13.7%	6.4%	
S&P 500 Index		21.8%	8.3%	
Small Cap Composite (Gross)	3/31/2007	13.4%	11.8%	2%
Small Cap Composite (Net)		12.4%	10.7%	
Russell 2000 Value Index		7.8%	6.4%	
Russell 2000 Index		14.6%	7.7%	

Investor Insight: C.T. Fitzpatrick

Vulcan Value Partners' C.T. Fitzpatrick describes the characteristics of his "MVP List" of target companies, why in rare instances those companies go on sale, why he's recently moved on from some long-held media winners, the key lessons drawn from a big mistake, and why he sees mispriced value in CVS Health, Airbus, Alphabet and Jones Lang LaSalle.

You put primary emphasis in your company research on the "stability" of value. Explain what you mean by that and why you consider it so important.

C.T. Fitzpatrick: We are value investors because we want to generate excess returns by taking on less risk, not more. That's not what you learn in business school, but it's what Warren Buffett has been talking about for his entire career. We believe the only way you can do that is to make sure you have not just a margin of safety, but one that is also sustainable. If you buy a business that is statistically cheap but the value isn't stable, you might be correct in your analysis but still lose money. If you care first and foremost about managing risk, you have to limit yourself to businesses you believe have a sustainable margin of safety over a long period of time.

The characteristics of such businesses are pretty familiar, even if in combination they're fairly rare. Stable-value businesses have strong balance sheets, identifiable and sustainable competitive advantages and consistent production of free cash flow. They have deep moats and we want those moats to be getting deeper and wider. You also must have confidence in management, that they are ethical and trustworthy, that they put shareholders first, and that they're equally good at operating the business and allocating capital.

You spend much time and effort maintaining an "MVP List" of companies that meet your quality standards. How important is that to executing your strategy?

CTF: Most businesses that we qualify for investment in terms of value stability are overpriced most of the time. We invest the time to follow them anyway so that on the rare occasions when they do become discounted we can move very quickly. That's possible because we know the company,

we think we understand the business, and we've been carefully observing for some time what they've actually done relative to what they said they were going to do.

The MVP List today has around 500 names. We've done initial valuation work on all of them and once we've done that, the assumptions we use are pretty stable

ON PICKING SPOTS:

Most businesses that we qualify for investment in terms of value stability are overpriced most of the time.

if it's the kind of business we think it is. Then in terms of basic maintenance of the list and of estimated intrinsic values, it's just a matter of updating financials as they report earnings.

Names come and go from the list. A company might fall off if there's a fundamental change for the worse in its competitive position or risk profile. Something might come on because it just went public, or new management took over that we think is far better than the old, or maybe it's a new company we found in a country where we hadn't done much work.

The difference between price and value drives where we spend most of our time. If a company, to use our vernacular, is at 110% of par, we start paying a lot of attention to it because it's coming our way. If it gets to par, we've already reconnected with management, we're fully up to speed on the business, and we're trying to understand what's going on that's making the stock cheaper relative to value. At that point, it's probably been front and center for months and we'll either have a high degree of confidence that temporary factors are driving the stock price down and

that the long-run fundamentals are intact, or we won't. If we do and it becomes discounted enough to displace something else in the portfolio, we buy it.

What's a company that qualifies in all respects except the discount to value?

CTF: There are a lot of them, but a representative example would be Zoetis [ZTS], which is a pure-play healthcare company focused on animal health. It meets all the tests: strong balance sheet, lots of free cash flow, scale advantages in manufacturing, distribution and sales, leading market shares in the areas in which they concentrate. People really care about their pets and there's loyalty to top brands. We also think it's a competitive advantage that animal health is all Zoetis does. Most of its competitors are divisions of larger companies and are sort of an afterthought when it comes to having resources to deploy when they should deploy them.

We value solid absolute returns on capital, but we really like to see higher marginal returns on capital. Zoetis's return on tangible assets is now in the mid-30s, up from the high-teens a few years ago. That tells you its marginal return on capital is outstanding. But, while that's all well and good, the current share price is far above our estimate of fair value.

What's something that either came on or went off the list fairly recently?

CTF: Moody's [MCO] and S&P Global [SPGI], best known for their global debt-ratings businesses, are companies we'd long followed, but they fell off our list when after the financial crisis they had certain legal exposures that, while the probability was low, if they lost, the value of each would materially decline. With that risk of value instability, they didn't qualify. We also would have been in a po-

sition of speculating on what a jury would do, which isn't investing.

By the beginning of last year the most-important suit to us was resolved in their favor and couldn't be re-litigated. They came back on the MVP List in the first quarter of last year and soon thereafter made it into the portfolio.

When asked last time [VII, September 28, 2012] about industries you avoid, your first answer was, "There's not an airline in the world we would own." Still true?

CTF: We generally like companies that control their own destiny, that aren't heavily regulated, and that operate in industries that aren't dependent on commodity prices for profitability and that support earning high returns on invested capital.

With airlines we've just never seen the competitive advantages and stability of value we want. That's still true, but the industry structure in the U.S. is evolving in a positive direction. It's still a highly capital-intensive business though, and it will be interesting to see in the next downturn whether the airlines actually behave rationally or not. The proof's not there yet.

Energy companies don't often meet your business-quality standards. Why does one of your top large-cap holdings, National Oilwell Varco [NOV], make the grade?

CTF: The sector is way underrepresented on our MVP List, which includes no exploration and production companies, shale producers or big integrated oil companies. Their economics are ultimately too driven by the price of the commodity.

National Oilwell Varco makes drilling rigs and equipment found on virtually every rig in the world. They are particularly dominant in the offshore market. Some parts of their business, to which we don't ascribe a lot of value, are more closely tied to the level of energy prices, but what really differentiates them is that their equipment wears out and if you're operating in a harsh environment you've got to replace it or you're going to have a big problem on your hands. At the same time, wells de-

plete, and just in order to replace production you've got to drill more. All of that is chewing up the equipment that NOV makes, independent of the price of oil.

The company is not capital intensive, has a strong balance sheet, and generates good free cash flow and returns on capital throughout the oil-price cycle. One other positive factor we see today is that as the inventory bulge that built a few years ago in the aftermath of the sharp fall in energy prices starts to wind down, incremental

LARGE CAP VS. SMALL CAP:

At the end of last year our large-cap portfolios were virtually fully invested; small cap was roughly 25% in cash.

demand for their products will increase. We expect NOV to have much improved results over the next several years regardless of the price of oil.

Given the profile of companies you target, they would seem more likely to be large rather than small. Can you give an example of something you've found interesting recently on the small-cap side?

CTF: In the third quarter of last year we established a new position in Ibstock [London: IBST], which is a U.K.-based company that manufactures clay bricks and concrete products. It mostly serves customers in the U.K., but roughly 20% of the business is in the U.S. under the Glen-Gery brand.

In the U.K. its market share is around 45% and the top three brick makers control 90% of the market. Ibstock has plants located all over the country and because bricks are heavy, that wide network allows it to more economically get product to the right location than a competitor can whose plant is further away. The regulatory environment is also a plus. It's virtually impossible to get a new plant permitted. U.K. building regulations also either favor

or mandate brick, so substitution risk is low. Finally, because of strict zoning laws, there is a fundamental supply/demand imbalance for housing. If you've been there, you're in a city or village and then it just stops and you're in the country, without the sprawl we have in the U.S. from coast to coast. There is cyclical, but there's always pent-up demand for housing, which is a good thing for suppliers to that market and for the stability of their businesses.

On the general question of large cap versus small cap, it goes in cycles. In the late 1990s large caps were overvalued and there was more opportunity in small caps. Today it's really hard for us to find enough qualifying ideas in small caps, due to valuation. Not that it's easy in large caps, but at the end of the year our large-cap portfolios were virtually fully invested, while small cap was roughly 25% in cash.

You mentioned that most of your qualifying companies trade above your estimates of intrinsic value most of the time. What are common reasons for that to change?

CTF: Lots of things can happen. It could be a cyclical issue like with National Oilwell Varco, but that's rare given the types of companies we follow. It could be an industry issue. In the lead-up to the U.S. presidential election, for example, pharmaceutical companies were getting beaten up and they stopped raising prices. That caused the stock prices of a variety of companies whose business models reflected drug-price inflation to fall, like CVS Health [CVS]. In that case we thought the value was stable, so the price/value lines crossed and we added it to the portfolio. In general, the classic reason we have an opportunity comes down to missed earnings, when the short-term market reaction is negative and we don't believe the intrinsic value has changed. Another less-obvious type of opportunity is when a company's stock kind of flat-lines while it's grinding out growth, generating free cash flow and the value grows steadily. Maybe the business is out of fashion, or the energy in the market is just elsewhere. In those cases,

over time you can see a 120-cent dollar turn into a 75-cent dollar. That's why we track price and value.

Describe generally how you estimate intrinsic values.

CTF: It's very much discounted-cash-flow driven, using unleveraged, pre-tax, free operating cash flow. That's the amount of cash that if we owned the entire company we could distribute to ourselves after spending what's necessary to fund growth and remain competitively entrenched. We typically define that as operating cash flow or EBITDA, less all capital spending and less operational working-capital needs.

We discount those cash flows using qualitatively derived discount rates based on our assessment of the business quality – the higher the quality the lower the discount rate and vice versa. We talk a lot about this, but we still use equity discount rates of 10-12%, which might seem high in today's low-interest-rate, low-return world. We've decided not to ignore 100 years of market history, so we base those discount rates on the historical relationships between Treasuries and real rates of return and equity-risk premiums.

Do you use comps at all in valuation?

CTF: We do, but mostly as a reality check. If we end up way off the comps after finishing our analysis, that can tell us we're being too aggressive or too conservative in our assumptions. What typically happens is that we arrive at a reasonable value and the comps say we're being really conservative. If we can buy at a discount to our value in those cases, even better.

Explain how you size positions relative to your estimates of intrinsic value.

CTF: We size positions according to the discount to intrinsic value – the larger the discount, the larger the position. Our rule of thumb, which I'd emphasize is not hard and fast, is that we add a percentage point of weight in the portfolio for every 10 percentage points of price-to-value pickup.

That's coming in and going out. Anything at fair value we're not going to own because there's no margin of safety.

Our goal is to lower risk by driving the weighted average price-to-value ratio of the portfolio as low as possible. If we can buy a 40-cent dollar, we might sell an 80-cent dollar to pay for it. That's what happened in the financial crisis, which was a lot of fun. Today if we can find a high-quality 80-cent dollar, we're probably go-

ON PORTFOLIO MAKEUP:

Our goal is to lower risk by driving the weighted average price-to-value ratio of the portfolio as low as possible.

ing to buy it at a 2% position. In small-cap, as I mentioned, we're not even able to find enough of those.

Where are your price-to-value ratios coming in today?

CTF: We had a good absolute year for compounding in 2017, but it's interesting that our price-to-value ratios were virtually unchanged from where the year began. The value growth was approximately the same as our returns, which is pretty remarkable in such a strong market. Driving that value growth was just very good production of free cash flow and the benefit coming from lower corporate tax rates.

In large cap, we ended the year with an average price-to-value ratio of around 70%. For small cap it was closer to 75%.

Let's talk more about specific stocks in which you're finding attractive discounts to value. You mentioned CVS Health, describe your interest in it.

CTF: CVS ticks all the boxes for us. It and Walgreens are by far the leading U.S. retail pharmacies, giving them a lot of buying power and leverage. It is also one of the three big U.S. pharmacy benefits manag-

ers, offering a combination of mail-order pharmacy, benefits-management and data-mining capabilities that can genuinely help their insurance-company customers improve medical outcomes and costs. The company generates great free cash flow, capital allocation has been very good over time and the balance sheet is strong.

In addition to the political cycle impacting the share price, there has been concern that Amazon might enter the business in a big way. We're always scared of Amazon and have spent a lot of time trying to figure out what would happen if it did enter the industry. We think it's hard to see how Amazon can offer a service that is better than what CVS already offers. We're not saying they can't do it as well, but it's hard to see how they're better. CVS is very good at what they do, has a unique set of assets in place, and has been doing it for a very long time. Our numbers are hopefully conservative both in how we account for drug-price inflation and in reflecting that Amazon actually does enter the industry.

How are you processing CVS's offer to buy Aetna?

CTF: We also own Aetna, which we consider a well-managed company with very stable value and a bright future independent of CVS. We agree with the logic of the merger and the potential they see to create an integrated healthcare provider with all this data that can potentially improve outcomes and lower costs by better directing patients to services, including steering them into pharmacies that could morph into health clinics. If you can improve healthcare outcomes and reduce costs just a little bit, that would have a tremendous impact on the profitability of both Aetna and of CVS. We'd argue it would also be a good outcome for society.

With CVS shares currently just \$80, how are you looking at valuation?

CTF: I can't tell you our specific estimate of intrinsic value, but if you look at where the stock has traded on most any metric – P/E, price to cash flow, EV/EBITDA, price

INVESTMENT SNAPSHOT

CVS Health
(NYSE: CVS)

Business: Integrated pharmacy services consisting primarily of pharmacy benefit management and the operation of a chain of retail pharmacy stores in the United States.

Share Information (@1/30/18):

Price	80.19
52-Week Range	66.45 – 84.00
Dividend Yield	2.4%
Market Cap	\$81.24 billion

Financials (TTM):

Revenue	\$182.35 billion
Operating Profit Margin	5.4%
Net Profit Margin	2.8%

Valuation Metrics

(@1/30/18):

	CVS	S&P 500
P/E (TTM)	16.5	23.3
Forward P/E (Est.)	12.5	18.7

Largest Institutional Owners

(@9/30/17):

Company	% Owned
Vanguard Group	7.5%
BlackRock	4.3%
State Street	4.2%
Fidelity Mgmt & Research	3.0%
Massachusetts Fin Serv	1.8%

Short Interest (as of 1/15/18):

Shares Short/Float	3.6%
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CVS PRICE HISTORY



THE BOTTOM LINE

The market isn't recognizing the extent to which the company's leading positions in retail pharmacy and pharmacy benefits management will allow it to defend against competitive incursion and promote health-system efficiency, says C.T. Fitzpatrick. The proposed Aetna acquisition, he says, "offers tremendous potential operating leverage and upside."

Sources: Company reports, other publicly available information

to sales – it's at the bottom of the range over the past five years. And I can tell you annual value growth over that time has been very good – in the double digits.

We're neutral on the Aetna deal in our numbers. We think it's basically a value-neutral transaction and haven't given them any credit for executing their plan. If the deal happens and they're able to do things like lower Aetna's medical-cost ratio, there's tremendous potential operating leverage and upside. If the deal doesn't happen, the stock will probably go down and we'll probably buy some more.

You in the latter part of last year sold your position in Boeing [BA] and bought its arch rival, Airbus [AIR]. Explain the investment case for it.

CTF: Airbus is one of those ideas where the value was building at a greater rate than the share price and we ended up being able to buy it at an attractive discount.

Both Airbus and Boeing have been on our MVP List for a long time. They are essentially in a global duopoly for commercial aircraft, operating rationally in a market where the capital intensity creates

a high natural barrier and there are high regulatory hurdles. Underlying global passenger traffic growth has also been incredibly resilient over the last 50 years.

Airbus generates around 75% of its revenue from commercial aircraft, just under 20% from defense and the rest from helicopters. Our basic case is that it is in an eerily similar position to where Boeing was roughly two years ago. Then Boeing was ramping up production, particularly of the 787, and while you could see it coming, it hadn't really hit the bottom line yet. The idea was straightforward. If they were able to execute, going from producing x planes per month to 3x planes per month, on large fixed-cost base that would be a good thing for profitability and free cash flow. We thought the free cash flow growth was going to be higher than what was priced into the shares. As that played out more or less as we expected, the discount on Boeing's shares went away.

We see the same thing today in Airbus. It has a similar several-year production backlog to Boeing, but it's earlier in the production curve and is ramping up production of key aircraft like the A320neo and, as it works through some production bottlenecks, the A350. Again, if they execute – and we believe they will – you're going to see margins expand and free cash flow production that is already good become really good. We don't believe the shares today reflect that.

Given its ownership structure, do you have any corporate-governance concerns with Airbus?

CTF: The corporate governance and shareholder structure has improved quite a bit over the last few years. Now the governments of Germany, France and Spain own 26% of the stock, with the rest publicly held.

We very much respect the CEO, Tom Enders, and believe the company is run in the interest of all shareholders. He has said he's stepping down in 2019, so there's been some drama around the transition. We often find management transitions scary, but while his successor hasn't been

INVESTMENT SNAPSHOT

Airbus

(Paris: AIR)

Business: Designs, manufactures and sells commercial aircraft, civil and military helicopters and military combat and training aircraft; headquartered in Leiden, the Netherlands.

Share Information

(@1/30/18, Exchange Rate: \$1 = €0.805):

Price	€89.80
52-Week Range	€62.46 - €94.00
Dividend Yield	1.5%
Market Cap	€69.55 billion

Financials (TTM):

Revenue	€66.83 billion
Operating Profit Margin	(-0.1%)
Net Profit Margin	1.5%

Valuation Metrics

(@1/30/18):

	AIR	S&P 500
P/E (TTM)	67.1	23.3
Forward P/E (Est.)	20.4	18.7

Largest Institutional Owners

(@9/30/17 or latest filing):

Company	% Owned
Capital Research & Mgmt	7.6%
Primecap Mgmt	2.3%
Vanguard Group	1.8%
Lyxor Int'l Asset Mgmt	1.6%
OppenheimerFunds	1.3%

Short Interest (as of 1/15/18):

Shares Short/Float	n/a
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AIR PRICE HISTORY



THE BOTTOM LINE

The company is in an "eerily similar" position to that of arch-rival Boeing roughly two years ago, says C.T. Fitzpatrick, in that it is about to ramp up aircraft production – in its case for the A350 and the A320neo – in a way that should translate into much-higher profitability and free cash flow production than the market currently seems to recognize.

Sources: Company reports, other publicly available information

identified, it's been a multi-year process and we're expecting it to go fairly smoothly. Tom Enders will be there through 2019, and this year and next are when much of the production ramp is going to happen. So if we're right, the benefits should show up in the numbers before he leaves. If Boeing proves to be a fair case study, that will hopefully take the shares to fair value and we'll have to sell in a couple of years.

You owned Alphabet [GOOG], then called Google, from 2007 to 2013. Why did you buy back in during last year's third quarter?

CTF: At the time we first bought Google, if you stripped out the cash and the non-earning assets it was trading at 12x free cash flow and maybe 14x earnings. It was also growing north of 20% per year and people couldn't understand how something growing like that could also be cheap. Well, sometimes things that grow can be cheap too.

When we first bought in, we loved the core business. There was concern about something better coming along in search, but our view was that the brand was so strong – nobody says, "I think I'll Bing that," or "Just Yahoo it" – that we thought

even if they flubbed the technology they'd have time to get it right because people were so habituated to using Google search that usage would be slow to change.

That turned out to be more or less right and the company's value grew a lot while we owned it. The share price rose to reflect the value we saw and we ended up selling at something like 24x free cash flow. It was a homerun investment for us, but we turned out to be way too conservative in our estimation of value. Over the next few years as the company did things like extend its dominance in search from the desktop to mobile, add functionality to search that made it more useful, and turn YouTube into a real business, the bottom line grew twice as fast as we were assuming in our valuation at the time we sold.

The short answer to your original question is that while the stock went up a lot since we sold it, the company has become more dominant and competitively entrenched, value has grown even faster, and it made sense for us to get back in. Of course, in hindsight we never should have sold, but that's no reason to make the same mistake twice.

Are the key drivers of the company's value still the same?

CTF: Search advertising obviously continues to be very important to the company, and it will continue to benefit from the ongoing analog to digital shift in ad spending. The ubiquity of the Android operating system is extremely valuable and positions the company well to grow its search and other businesses in developing markets. YouTube is starting to be monetized and is likely to be a major driver of future profits.

There's also a lot of upside optionality in businesses that we aren't valuing at the moment. Things like the nascent cloud-services business and the Waymo autonomous-driving business have a lot of potential, but we're not building in credit for anything like that.

Are the shares at a recent \$1,165 as inexpensive in your eyes as they were in 2007?

CTF: The stock isn't as cheap as it was, but today if you strip out the cash and the non-earning assets, the shares are still only trading at something like 15.5x forward free cash flow. And that's for a company we think can grow free cash flow at a mid-teens rate for the next several years – again, assuming nothing from the investment businesses and making what we consider very conservative assumptions about YouTube. We think the combination of price and value is very attractive.

Why would something this well-known and respected be mispriced?

CTF: That's a good question. I think there are concerns that the level of competition could increase from a company like Amazon, which is certainly a possibility. I think people are also scared by the fact that revenue per click in the advertising business is going down as much as it is. That hasn't materially impacted sales and profit growth because they've been able to increase the number of clicks so rapidly, but it could eventually call into question revenue growth in search. On this issue, while we're not modeling it, we think it's possible that with added capabilities built into mobile search that revenues per click

there could actually go up. If that happens, the stock would likely go up a lot.

In both of these cases we're not ignoring the concerns, but are comfortable that we've incorporated them appropriately in our outlook.

How are you thinking about regulatory or antitrust risk?

CTF: In a list of pros and cons, that's certainly one of the biggest negatives for Google. But we don't see it as an unacceptable threat to the business. When this type of thing is the worst you can say about a company, that usually means it's a pretty good business.

Why are you high on the prospects for global real estate services firm Jones Lang LaSalle [JLL]?

CTF: You can trace the history of this company and it's actually older than the United States. Today it's one of only two firms – we also own the other, CBRE [CBG] – that can offer a full range of real estate services to the 1000 largest firms in the world. There are a number of smaller firms that compete regionally, but if you're Ford Motor and want a competitively priced, one-stop shop for expertise on buying and selling industrial properties, leasing commercial space, operating distribution centers and doing it all across languages, geographies and legal systems, Jones Lang and CBRE are going to be on almost every request for proposal. JLL will win some, CBRE will win some, and there's plenty to go around for both.

The business has traditionally been considered cyclical, due to the mix weighting heavily toward sale and leasing brokerage, but that's evolving as the outsourced-services part of the business is growing. There's a lot of complexity in managing real estate and big companies are increasingly concluding that handling much of it in-house isn't a core competency and that they're better off paying a JLL to help them remove all the pain points. Because JLL has the global scale and expertise, it can provide the services at rea-

INVESTMENT SNAPSHOT

Alphabet

(Nasdaq: GOOG)

Business: Dominant global competitor in Internet search and related advertising, with key other business lines including YouTube, Android, Chrome, Nest and Google Capital.

Share Information (@1/30/18):

Price	1,163.69
52-Week Range	790.52 – 1,186.89
Dividend Yield	0.0%
Market Cap	\$811.99 billion

Financials (TTM):

Revenue	\$104.60 billion
Operating Profit Margin	26.6%
Net Profit Margin	20.1%

Valuation Metrics

(@1/30/18):

	GOOG	S&P 500
P/E (TTM)	38.9	23.3
Forward P/E (Est.)	27.8	18.7

Largest Institutional Owners

(@9/30/17):

Company	% Owned
Vanguard Group	5.9%
BlackRock	3.7%
Fidelity Mgmt & Research	3.7%
State Street	3.4%
T. Rowe Price	2.7%

Short Interest (as of 1/15/18):

Shares Short/Float	1.2%
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GOOG PRICE HISTORY



THE BOTTOM LINE

The company is more dominant and competitively entrenched than ever, says C.T. Fitzpatrick, who believes it can increase free cash flow at a mid-teens rate for several years. Such performance, he argues, is not well reflected today in its stock, which trades, after stripping out cash and non-earnings assets, at only 15.5x forward free cash flow.

Sources: Company reports, other publicly available information

sonable prices while still earning attractive returns.

Another factor improving the stability of the company's business is that it is now so diversified by property type and geography that the cyclical nature going forward should be dampened compared to past cycles. So you're left with an increasingly stable business, which because the company is taking market share is growing revenues and free cash flow faster than the growth in the underlying market.

Assuming the cycle will still matter, what's your take on where we are in it today?

CTF: We are later rather than earlier in the real estate cycle overall, which is a factor to us, but not one that keeps us out of the stock. We assume there will be a down cycle and hopefully we've conservatively incorporated that into our estimate of intrinsic value.

After a rough patch, JLL's stock has been doing well and at nearly \$157 is up 50% in the past year. Is it still inexpensive?

CTF: It's not as cheap as it was when we were actively buying it in 2016, but on all the valuation metrics you can look at it

remains closer to the lower end of where it's traded over the past five years. [Note: As of the end of 2017, JLL was the largest holding in Vulcan's small-cap portfolio, representing a 5.5% position.]

You recently sold long-time media holdings Disney [DIS] and Discovery Communications [DISCA]. Why?

CTF: In general, when a company's competitive position begins to erode, all our alarm bells go off and we're trying to understand why and how permanent the impact will be. Sometimes those debates take a while and sometimes we can move pretty quickly.

Both Disney and Discovery were fabulous investments for us over a long period of time, but we came to believe that they were not as competitively entrenched in the digital world as they have been in the analog one. With Disney, for example, the risks to profitability at ESPN as it navigates a world of increased cord cutting just became unacceptable. When we built into our numbers an ESPN that might be less profitable and produce lower free cash flow, our estimate of value was impacted enough that the lines crossed relative to the market value and we no longer felt we had a margin of safety. The same type of thing happened with Discovery.

Describe the key lessons learned from a prominent recent mistake, in watch maker Fossil Group [FOSL].

CTF: We learned a lot of lessons here, but the big one was that when we recognize value instability and don't understand exactly what's going on, we should act fast and not stick around to find out. "I don't know" is not an acceptable answer.

In this particular case, Fossil in late 2015 bought a company called Misfit that made wearable devices to track things like fitness and sleep. The goal was to use Misfit's technology as a platform for Fossil to scale production of wearables and smart-watches. Before the acquisition, Fossil had net cash on the balance sheet and its margins were pretty stable. The acquisi-

INVESTMENT SNAPSHOT

Jones Lang LaSalle
(NYSE: JLL)

Business: Global provider of real estate-related services, including leasing brokerage, property management, capital markets advisory and investment management.

Share Information (@1/30/18):

Price	156.62
52-Week Range	99.80 - 158.82
Dividend Yield	0.5%
Market Cap	\$7.11 billion

Financials (TTM):

Revenue	\$7.56 billion
Operating Profit Margin	6.8%
Net Profit Margin	4.5%

Valuation Metrics

(@1/30/18):

	JLL	S&P 500
P/E (TTM)	21.0	23.3
Forward P/E (Est.)	16.9	18.7

Largest Institutional Owners

(@9/30/17):

Company	% Owned
Generation Inv Mgmt	9.6%
Vanguard Group	8.4%
BlackRock	8.1%
Harris Assoc	4.4%
Atlanta Capital Mgmt	3.2%

Short Interest (as of 1/15/18):

Shares Short/Float	2.9%
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JLL PRICE HISTORY



THE BOTTOM LINE

The changing composition of the company's business and its broader diversification has set it up to grow faster than its market and with less cyclical nature in its performance, says C.T. Fitzpatrick. While the stock isn't as cheap as it was when he was actively buying it in 2016, it's cheap enough to be his small-cap fund's top holding as of the end of 2017.

Sources: Company reports, other publicly available information

tion immediately put pressure on the balance sheet and on margins, fundamentally changing the company and the risk profile and we should have sold our shares that day. It might have worked out and the stock would have gone up and we would have overreacted, but we simply didn't need to take that risk. Going forward, we'll be much quicker to sell if an acquisition could cause financial instability if it doesn't work out.

I also think we were too slow because we had confidence in management, assuming they would be able to make the acquisition a success. It still surprises me given the circumstances and the people involved that the acquisition was as poorly done as it was. Our faith in management probably contributed to our not adequately quantifying the damage Misfit could do. That won't color our judgement again.

Has the rise of passive and algorithmic trading in any way changed the way you ply your trade?

CTF: I would argue that algorithmic trading, in particular, is creating incremental opportunities for us. We see very quick and deep reactions to companies that maybe miss earnings or fall short of expectations. Many times it's just a short-term reaction to short-term factors that have nothing to do with the long-term fundamentals of the business. That can give us good opportunity to trade around the margins of businesses we own. As long-term investors, the more others are trading with short-term superficial or non-existent analysis, the better.

In terms of passive, it will be interesting to see what happens in the next downturn. In 2008 ETFs were already big enough to matter, which I think opened up incremental opportunities to buy fabulous businesses when all a sector's stocks were dragged down as part of a broad sector move. A State Street custodial bank is a different animal from a Citigroup, but they're both in the financial ETF that's selling indiscriminately. Now that ETFs are so much

bigger, in the next downturn the opportunities stemming from that type of trading could be even more widespread.

Value investing hasn't fared well in the relative-performance game for some time now. Are you keeping the faith?

CTF: It's true that growth has outperformed value for one of the longest stretches ever. That's the main reason value investors are lagging. But if you believe in reversion to the mean, which as value investors you do, to us it's really a coiled spring. There's an awful lot of capital flowing into growth – I'm including in that most of the indexes – at the expense of value. That type of thing always ends badly. I'm not really concerned about value investing at all. **vii**

VII Editor and Publisher John Heins since August 2016 has also been the C.T. Fitzpatrick Professor of Value Investing at the University of Alabama.

Disclosure

- Note 1: Vulcan Value Partners Large Cap, Focus and Focus Plus Composites versus peer group of eVestment US Large Cap Value Equity for the period ending December 31, 2017 since inception as of January 18, 2018. Vulcan Value Partners Small Cap Composite versus peer group of eVestment US Small Cap Value Equity for the period ending December 31, 2017 since inception as of January 18, 2018. This information is supplemental information for the Large Cap Composite, Focus Composite, Focus Plus Composite, and Small Cap Composite.
- Vulcan Value Partners, LLC is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Vulcan focuses on long term capital appreciation; targeting securities purchases that we believe have a substantial margin of safety in terms of value over price and limiting our investments to companies that we believe have sustainable competitive advantages that will allow them to earn superior returns on capital. Value is our estimate of the price a willing buyer would pay, and a willing seller would accept, assuming neither was compelled to enter into a transaction.
- Vulcan Value Partners buys concentrated positions for our portfolios, averaging 5% in our model portfolios, which may make our performance more volatile than that of our benchmark indices and our performance may diverge from an index, positively or negatively, as a result. Our focus is on long term capital appreciation, so our clients should consider at least a five year time horizon for an investment with Vulcan. Past performance is no guarantee of future results and we may not achieve our return goal.
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