ValueInvestor INSIGHT
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The Leading Authority on Value Investing

It's High Time

Time-tested investors Yen Liow, C.T. Fitzpatrick, Christopher Smith, Dev Kantesaria and Andrew Brenton describe the opportunities and challenges they see in today's investing environment, how they stay prepared for adversity, and why they believe current holdings Five Below, Curtiss-Wright, Zoetis, Fair Isaac and Jen-Weld deserve particular mention.

INVESTOR INSIGHT

C.T. Fitzpatrick
Vulcan Value Partners

Editors Note: *Even if you'd seen with clear foresight the onset of the pandemic (and how many of us did that?), it's highly unlikely you would have with equally clear foresight judged the equity market's path since March of 2020: The steep decline, the rapid rebound, the rotation from growth to value and back again, and a calendar year 2021 that's almost over in which stocks have hit new highs with almost metronomic regularity.*

To help make sense of the investment environment today, we asked five market-beating portfolio managers to offer their views on the equity opportunity set at hand, where they're finding interesting things to do, and how they try to be prepared for whatever the market serves up next. If you're expecting a dour bunch sitting on their hands and bemoaning a dearth of actionable bargains, read on. That isn't the case at all.

One could imagine the "stable value" businesses you target – with strong balance sheets, identifiable and sustainable competitive advantages and consistent and growing free cash flow generation – would be richly valued in today's market. Are you finding that to be the case?

C.T. Fitzpatrick: It's actually kind of a weird market. We're constantly updating what we call our MVP list of companies, which to us qualify for investment for the reasons you mention. On the one hand, there are a number of moderately growing consumer-products and industrial companies on that list that we consider kind of dangerously overvalued, trading at 120 to 170 cents on the dollar by our math. Maybe there's still somewhat of a sugar-high from demand during or coming out of the pandemic, I don't know, but they're not at all interesting to us at the moment.

What we think people are not paying up for in a number of cases, however, are companies that were already great businesses that got better through the pandemic and still have incredible opportunities in front of them. Yes, stock prices have gone up, but the value growth in many of the businesses we've invested in is nothing short of spectacular. We're likely to end this year with the highest growth in the total intrinsic value of our portfolio companies that we've seen in our firm's history. A semiconductor company like Nvidia [NVDA], for example, may seem highly priced to some, but our estimate of value for it has continued to increase faster than the stock price.

Even the stock of a company like Mastercard [MA] we'd argue is trading at one of the biggest discounts to value we've seen in years. You might wonder how can that be? Its value was very stable through the pandemic crisis and we think its business model is stronger today than it was before Covid. But the stock is priced as if the company is not going to do as well post-pandemic as it did pre-pandemic. We think that's crazy.

In Mastercard's case could it be that the market is infatuated with all the new, putatively disruptive competitors in the payments' space?

CTF: We could be wrong, but for all our companies we're paranoid about disruption and potential risks to business models and we don't believe that's a material issue here. In our experience in this industry everyone who has tried to compete with Mastercard and Visa [V] has had their head handed to them. They figure out they're a lot better off working with Mastercard than against it. Think Apple Pay. Think Square. Don't get me wrong – new competition is not an idle concern here. But if that's what is weighing on Mastercard's stock price, we see that as a pretty attractive opportunity.

You've spoken about finding opportunity in companies that because of changing behaviors through the pandemic have gone from potential MVPs one day to MVPs today. Would Sweden's Evolution Gaming [EVO] – in which you established a position last quarter – fall in that category?

CTF: Evolution is an independent producer of online gambling content. This does fall in the category of a business where the secular growth that was happening anyway accelerated as the pandemic started to play out. Online gambling is taking share everywhere, but both traditional and online-only casinos have found it difficult to create in-house the best games that people want to play online. If you can create those – and Evolution has built a real franchise in doing just that – the power dynamic in the business shifts toward you. You've got pricing power, volume growth, expanding margins, good free-cash-flow generation, and it's likely to go on for a long time. It might not be an easy ride, but given the rate at which we see value compounding here, we think the price-to-value at today's share price [of around 1,000 Swedish kroner] is quite interesting.

When you have something to buy – either a new position or adding to an existing one – where does the cash to pay for it tend to come from?

CTF: We're usually fully invested, but we size our positions according to discount so we typically have liquidity when we need it. To give you an example, after years of it not qualifying for investment we not long before Covid hit added General Electric [GE] back to our MVP list. We thought under Larry Culp as CEO the company was doing all the right things and we were prepared to own it if the price was right. When Covid came, the price was right and we put it into the portfolio at a roughly 5% position.

Over the next 18 months or so the shares came back very strongly, and while value growth was fine, it didn't keep up with the stock-price appreciation. As the discount to value got smaller and smaller, the share position went from 5%, to 3%, to 2% and eventually it worked its way out of the portfolio. As that happens we've got money to reinvest where the discount to value is higher. That said, it is a challenge for us to figure out how to pay for all we'd like to buy at the moment. Some of our existing positions have had earnings volatility and their share prices have fallen 10-15%, but we haven't had much that we've been willing to sell in order to buy more of them.

Given your focus on value stability, you'd likely want to buy more of many of your current holdings if the market took them down 20-30% in an indiscriminate selloff. For the sake of illustration, what's one that you could imagine giving a particularly early look in that scenario?

CTF: I've been talking more about higher-growth companies, but one less-glamorous idea that comes particularly to mind if the market sold off broadly would be Curtiss-Wright [CW]. It makes a range of technological and industrial products that serve end markets across three operating segments, Aerospace and Industrial, Naval and Power, and Defense Electronics. The end-user mix is 60% or so commercial and 40% defense.

The company tends to sell niche-y products, where they have a leading position among a very concentrated set of competitors. One representative example is that they are the dominant supplier of pumps, valves, motors and generators used to power the U.S. Navy's nuclear-powered aircraft carriers. They make cool-

INVESTMENT SNAPSHOT

Curtiss-Wright
(NYSE: CW)

Business: Design, manufacture, sale and servicing of engineered products and systems sold primarily into aerospace, defense, power-generation and general-industrial end markets.

Share Information (@11/29/21):

Price	**129.15**
52-Week Range	103.55 – 136.97
Dividend Yield	0.6%
Market Cap	$5.04 billion

Financials (TTM):

Revenue	$2.51 billion
Operating Profit Margin	16.6%
Net Profit Margin	9.7%

Valuation Metrics
(@11/29/21):

	CW	S&P 500
P/E (TTM)	22.7	28.8
Forward P/E (Est.)	26.4	22.4

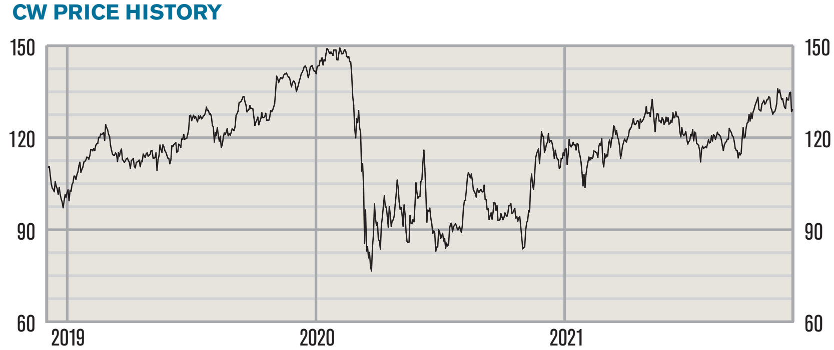
Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Vanguard Group	8.9%
BlackRock	8.1%
Boston Partners	5.2%
Fidelity Mgmt & Research	4.7%
Primecap Mgmt	4.3%

Short Interest (as of 11/15/21):

Shares Short/Float	1.7%

CW PRICE HISTORY



THE BOTTOM LINE

While not a sexy growth story, the company's niche, high-end positions in stable end markets can translate into low- to mid-teens annual value growth for it over at least the next few years, says C.T. Fitzpatrick. "This is a steady compounder that won't get too knocked around if something disrupts the market," he says. "That to us is pretty exciting."

Sources: Company reports, other publicly available information ant pumps for nuclear reactors. They make data systems for fighter jets. They make electronic throttle controls for on- and off-highway vehicles. These are typically not commoditized products, but rather those that have advanced technology, have to operate in sometimes very harsh conditions and cannot fail.

The end markets here don't grow particularly fast, but the company is a well-oiled machine that is constantly improving its products, has decent pricing power and grows at a steady, highly profitable rate. Management has been in place for a long time and just executes really well. Operating margins have increased by about 500 basis points over the past five years, and while those increases are not always in a straight line, we think there's still room to continue to grind out margin improvement of 25-50 basis points a year. We've followed this and it has been on our MVP list for a long time.

At today's $129 share price, how inexpensive do you consider the stock?

CTF: We think Curtiss-Wright can generate upper-single-digit annual revenue growth and double-digit compound growth in operating profits. Free cash flow conversion is excellent, so we see that translating into very solid value growth in the low- to mid-teens over at least the next few years.

As we want to see in every company we own, that value growth is quite stable. In 2019, EBIT as we adjust it for amortization and any sort of non-recurring noise in the financial statements was $469 million. In 2020 – think about what happened in 2020 – that number was $467 million. Free cash flow in 2020 came in at just under $215 million, 140% of net income.

Because they have slightly different growth rates and underlying economics, we value each of the three operating segments separately on a DCF basis. Without being overly specific, right before the pandemic the stock was trading at pretty much our estimate of fair value. When the shares tanked along with the market as the pandemic hit, because the value was so stable it gave us the opportunity to buy the stock at a very large discount, approximately 50 cents on the dollar. Today the shares trade just slightly below where they were pre-pandemic and our value estimate has compounded since then. So the shares still trade at a decent discount to our estimate of intrinsic value, which is a good place to start.

You never know exactly why the market might sell off, but if it did we would expect this type of company to hold its value quite well and provide an attractive opportunity like we were given last year with the pandemic. Again, it's maybe not as sexy a story as something like Evolution Gaming – which might be why the shares trade where they do – but we think Curtiss-Wright is a steady compounder that won't get too knocked around if something disrupts the market. That to us is pretty exciting.

On one final subject separate from what we might consider investing, do you have any thoughts on people's seemingly unquenchable appetite for things like cryptocurrencies?

CTF: Where do I start? I think it's insane and dangerous. People go from one bubble to another – it's human nature at its worst and a lot of financially unsophisticated people are going to be hurt badly. I don't know that there's anything to be done about it. I guess in the end experience will be a great teacher. VII