Value Investor INSIGHT

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The Leading Authority on Value Investing

# Tried and True

*"We as humans love to be with the herd," say Francisco García Paramés, who as an investor has quite successfully ignored that particular pull of our innate nature.*

**INVESTOR INSIGHT**

**Francisco García Paramés**
Cobas Asset Management

**Investment Focus:** Seeks to invest in easy-to-understand companies and is "willing to wait as long as necessary for the market to finally recognize true value."

It's rare that an investor at the top of his game decides to start over, but such was the case three years ago for Francisco García Paramés. After a brilliant run – his flagship Bestinver Internacional portfolio tripled the performance of its benchmarks with a better than 12% net annualized return from 1998 to 2014 – he parted ways with Bestinver and, following the lapse of a non-compete period, launched his own firm, Madrid-based Cobas Asset Management. The firm started investing in January and now manages nearly €2 billion.

While some business-side practices have evolved, "we're investing exactly as we did before," says García Paramés. Among the industries he's finding of specific interest today: shipping, auto manufacturing, fertilizer and bakery products.

**You commit to your investors that you will "keep faith with the value investing approach." What does that primarily mean to you?**

**Francisco García Paramés:** To us this means in-depth analysis, picking quality companies at attractive prices, and being patient for them to rise in value. Extremely patient, I would say.

In our analysis we're focused on understanding a company's competitive edge and therefore the quality and durability of its business, which allows us to credibly estimate intrinsic value. If our analysis is right and we have been selective in only buying at significant discounts to true value, time should work in our favor. We're prepared to wait for as long as necessary until the quoted market price finally recognizes that value.

What makes this so difficult to do is human nature. We as humans love to be with the herd, and it's very difficult to go against that. Even for us it isn't easy, but you can't be successful in this business without going against the grain.

**Describe situations you've found to be fertile ground for finding quality companies at reasonable prices.**

**FGP:** When you've been in the market for 25 years you do learn what to look for and the situations you like. Our portfolio today trades at around 8-9x earnings when the market is close to twice that, so obviously we are not buying companies where everything is perfect. I still look every day in the markets I follow closely at stocks hitting 52-week lows and that have declined the most that day.

One area where we're finding opportunity today is in U.K.-related consumer businesses that in some cases have seen their stocks come down 50% in the past couple of years, on top of the British pound depreciating another 20-25%. An example would be Dixons Carphone [London: DC], the electronics and appliance retailer with both Best Buy-type stores and also those focusing more specifically on the sale of mobile phones. There are a number of questions about Brexit's impact on the business and the threat of online competition, but as we assess the sustainability of the business against a valuation of less than 10x earnings, we believe the market is building far too much negativity into the share price.

Another area of focus for us over time has been family-controlled companies, which represent as much as one-quarter of the listed shares in Europe. They can be relatively overlooked because they manage their businesses over the very long term – which we much prefer, but which can frustrate many investors – and because they are often structured as holding companies with varied interests that can lack obvious coherence. We also like that family owners' interests are generally well-aligned with other shareholders, resulting in fewer errors in allocating capital, less reliance on debt, and a healthy emphasis on cost control.

A very successful investment for us over time has been Exor [Italy: EXO], the investment holding company of Italy's Agnelli family. When we last spoke [*VII*, October 31, 2012], if we just took the public market values of Exor's stakes at the time in industrial testing company SGS, in the Fiat Industrial truck and agricultural-equipment business, and in Fiat Auto, plus conservative value estimates

for smaller stakes in a number of diversified companies, we came to a share price estimate of roughly twice the then market price. If we adjusted those public holdings to what we considered fair values, that gave us an extra 25% upside. These types of things can happen in these types of companies and we believe the market eventually gets it right. It can take much longer than we'd like, but if we're right about the underlying businesses, we're protected on the downside while we wait because intrinsic value continues to grow. [*Note*: Around €16.90 five years ago, Exor shares closed recently at €54.10.]

**Is Exor still attractive today?**

**FGP:** We own a tiny position. Something we think is more overlooked would be Bolloré [Paris: BOL], the investment holding company controlled by Vincent Bolloré. He thinks for the long term and controls some very interesting assets, both publicly traded like the media business Vivendi [Paris: VIV], as well as ports and other infrastructure businesses mostly in Africa. Just applying the multiples at which port companies trade in emerging markets to Bolloré's assets would result in a much higher share price for the company than today's €4.10.

**How important for you is business cyclicality as a source of opportunity?**

**FGP:** We're not scared off by cyclicality and I'd say today we have a greater focus on companies in more cyclical and even commodity-oriented businesses. Economic cycles need to be tolerated with enormous patience, but if your analysis of the business is correct cycles naturally turn around with fairly predictable results, if not predictable timing. We also see more commodity-based businesses defending the portfolio effectively against the possible negative inflationary consequences of central-bank monetary manipulation.

Given the unpredictability of timing, we emphasize in this type of investment only companies with efficient, low-cost production and those with strong balance sheets. Without either of those we think we're taking on too much risk.

**What's a cyclical business that has caught your eye today?**

**FGP:** Our portfolio currently has the largest exposure I've ever had to shipping. The industry has suffered over the past two to three years as commodity prices have fallen and capital has fled the sector, resulting in share prices moving dramatically lower. Of particular interest to us is the transportation of liquefied natural gas [LNG], where we see generally favorable supply-demand dynamics and we like that the business runs largely on long-term contracts. We'll talk in more detail about it later, but one of our holdings, Teekay LNG Partners [TGP], is a leader in the space, with long-term contracts with major energy companies like Total, Royal Dutch Shell and British Petroleum that secure more than $11 billion in future revenues. We think there's very good visibility into future cash flows, but the stock trades at maybe 8x forward earnings.

**ON CYCLICALS:**

**We have the largest exposure we've ever had to shipping, particularly the transport of liquefied natural gas.**

Coming back to your question about where ideas come from, one idea very often leads to another. As we learned more about LNG carriers and Teekay, we came across a French company called Gaztransport et Technigaz [Paris: GTT], which makes the membranes used to actually store the liquefied gas in the ships. It has a dominant global market share and we believe can earn strong economic profits over time despite some regular cyclicality. All in all, starting with our interest in Teekay LNG, we have ended up buying into multiple companies variously tied to LNG around the world.

Francisco García Paramés

## Encore

Though he decided in late 2014 to leave Bestinver, his investing home for 25 years, Spanish investing superstar Francisco García Paramés wasn't at all ready to try something new. "There wasn't the slightest doubt I would come back," he says.

Back he is, having started Cobas Asset Management to pursue the same value-investing strategy he's always pursued, but with heightened sensitivity on the business side to keeping assets under management for the firm's strategies at what he considers more manageable levels.

Having to fulfill a two-year non-compete agreement, García Paramés spent his first year "off" doing essentially what he always does, following the news, following the markets and generally keeping up on companies and industries he already knows or wants to know better. The second year he spent mostly writing a book, *Invirtiendo A Largo Plazo* (*Investing for the Long-Term*), which was published in Spanish last year and will appear in English early next year.

"People asked me if I wanted to retire and relax," he says, "but why? The work is stimulating and varied, it fits my personality, I do it reasonably well and it's very satisfying. Why would I want to stop 'working' when that's the case?"

**You've had a heavy European tilt to your international portfolio. Is that still the case?**

**FGP:** We are roughly 50% invested in Europe, which is low for us. Many of our

long-term holdings, like Switzerland's Schindler Group, or Wolters Kluwer in the Netherlands, or Exor, have done extremely well over the past five years. That's pushed us to look elsewhere and we're struggling somewhat to find new companies in Europe of sufficient quality trading at attractive-enough prices.

We've been more active than has traditionally been the case in Asia, which represents 15-20% of the portfolio. Primarily in South Korea and Japan we're able to find companies trading extremely cheaply, especially in relation to the net cash on their balance sheets. To give two examples in the same industry in Japan, we own Daiwa Industries [Tokyo: 6459] and Fukushima Industries [Tokyo: 6420], which manufacture commercial refrigeration equipment for restaurants and retail stores. These are 50% return on capital businesses, but Daiwa currently trades at its level of net cash – making the operating business free – and Fukushima trades at 6-7x earnings. We don't believe those types of valuations make sense.

People talk about markets like Japan and South Korea as being permanently undervalued because corporate governance is often so bad. We are not naïve about that, but we've also seen plenty of examples in our careers where discounts related to governance can go away quickly. For a long time Exor, for example, had preference shares with no voting rights that traded at times at a 40% or so discount to the common shares with voting rights. We didn't think that was rational, especially in a company where we believed management was acting fully in our interest. Then one day the company decided to collapse all the shares into one share class with the same voting rights and the discount disappeared. Things change. We would have been fine if the discount had persisted, but it was clearly even better that it went away.

**How are you handicapping the current investing and political environment in your home country of Spain?**

**FGP:** It has been a painful process, but the restructuring of the economy following the financial crisis has generally resulted in an improved economic outlook for Spain. The public deficit relative to Gross Domestic Product is still far too high, but the competitiveness of the country has improved significantly and share prices have recovered fairly well from the lows five years ago.

**ON MODELING:**

**I have a calculator that adds, subtracts, multiplies and divides. I have no need for anything more sophisticated.**

The Catalonia situation is obviously not good. I don't have any unique insight into how it is resolved, but I'm optimistic that it's handled in a commonsense way that doesn't set the economy back. Most of the stocks quoted in the Spanish stock market are global companies, so the impact on share prices of the secession threat hasn't been that dramatic. I wouldn't say it's really provided a buying opportunity.

**Are there any themes of note behind what you are finding interesting in Spain?**

**FGP:** I wouldn't call it a big theme, but we are finding opportunities in the real estate sector, which I would say is in the very early innings of a recovery. Many of the excesses that built up prior to the financial crisis here involved real estate, so it has taken a very long time for those to work themselves out and for people to take on new projects with optimism about the future. We're investing mostly in small-cap companies focused on residential and commercial real estate development. One example would be Inmobiliaria del Sur [Madrid: ISUR], which is based in Seville and has a market cap of only around €180 million. There are a number of companies like it that we would expect to benefit from a return to normal in the real estate market.

**Describe how you approach valuation.**

**FGP:** I like to say that I have a calculator on my desk that adds, subtracts, multiplies and divides and that I have no need for anything more sophisticated. To me, analyzing companies is not an exercise in building complicated mathematical models with discounted cash flows, but is all about developing a complete understanding of a company's business and its capacity to generate cash earnings in the future. The goal is not to precisely forecast free cash flow each year, but rather to arrive at a level of normalized earnings upon which we can apply an appropriate multiple and arrive at our estimate of intrinsic value.

**Explain a bit more about how you normalize earnings.**

**FGP:** In normalizing earnings we first make sure the financial statements are an accurate reflection of the company's actual situation, looking at things like free-cash-flow conversion, the reasonableness of accounting policies with respect to income and expense recognition, and potential off-balance-sheet liabilities. We then try to determine what in the current situation might temporarily obscure the company's capacity to generate earnings. That could be a cycle – we want to look at earnings power based on stable market conditions, neither boom nor bust – or maybe there's a temporarily loss-making business that is likely to get better or will otherwise be sold off or closed. In all cases we're also estimating any organic improvement we see in the business over the next two to three years.

Finally, to arrive at an estimate of intrinsic value we apply a multiple to the normalized earnings that depends on the quality of the business. We generally use the stock market average P/E for the last 200 years of 15x, which is equivalent to an earnings yield of 6.6%, in line with the long-term real return on equities. For an outstanding business we might use 17-18x, and for a mediocre one we may use 12-13x. For most businesses we look at, though, 15x is reasonable.

Over time we have usually in our global portfolios held 40 to 50 stocks, with position sizes based on both the discount to intrinsic value and our conviction in the idea. In our global funds we've almost always been fully invested, with more good ideas than we have room in the portfolio. That's the case today as well.

**Explain the potential you see in fertilizer and specialty-chemicals company Israel Chemicals [ICL].**

**FGP:** The company has two main divisions. The first produces potash, phosphate and other specialty fertilizers used to improve crop production. These are generally commodity businesses in which the company is a price taker, and profitability depends greatly on the level of the commodity price. The second division produces specialty chemicals and advanced additives that are used in a variety of industrial and food-processing applications. This is a higher-value-add business with pricing power and generally high profitability.

**Do you have a particular view on where we find ourselves at the moment in the global fertilizer cycle?**

**FGP:** Here's generally how we think about the cycle: The potash price has been more than cut in half to less than $300 per ton, and at the current price level it's very difficult to justify building new capacity. At the same time, the world's population continues to increase and grow wealthier, increasing the demand for food, particularly protein, while the amount of arable land to grow crops is stagnant or slowly decreasing. So one primary way to meet rising global food demand will be to increase crop yield, which benefits from the application of fertilizer.

Given these dynamics we are expecting potash prices to increase at some point in order to bring the market into better supply/demand balance. A similar argument can be made with respect to phosphates, where producers are also making minimal profits right now.

**ICL benefits from a unique resource base in the Dead Sea. Is there any risk the company loses that in the future?**

**FGP:** The Dead Sea, which is 400 meters below sea level, provides the company with a practically inexhaustible source of low-cost potash, magnesium and bromine. That's an important competitive advantage, especially with respect to the bromine-based chemicals it sells. The production facilities ICL owns are also close to international ports, providing efficient access to both developed and emerging-market shipping lanes. We actually visited the facilities in June, which are state-of-the-art. I'd also point out that we were among a very small number of analysts and shareholders who showed up at the company event, reflecting how underfollowed ICL is.

The company does need to renew its concession with the Israeli government in 2030, but we don't think that's at risk. The government owns a special "state share" in ICL and receives significant taxes and royalties from it. In addition, ICL owns the Dead Sea production facilities, which would be extremely costly for another potential player to replicate. It appears to be

**INVESTMENT SNAPSHOT**

**Israel Chemicals**
(NYSE: ICL)

**Business**: Manufacture and sale of potash- and phosphate-based fertilizers and a variety of specialty chemicals used in industrial, food and other end-market applications.

**Share Information** (@10/30/17):

| | |
|---|---|
| **Price** | **4.15** |
| 52-Week Range | 3.52 – 4.95 |
| Dividend Yield | 3.5% |
| Market Cap | $5.02 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $5.3 billion |
| Operating Profit Margin | (-0.1%) |
| Net Profit Margin | (-3.4%) |

**Valuation Metrics**
(@10/30/17):

| | ICL | S&P 500 |
|---|---|---|
| P/E (TTM) | n/a | 24.2 |
| Forward P/E (Est.) | 16.0 | 19.5 |

**Largest Institutional Owners**
(@6/30/17):

| Company | % Owned |
|---|---|
| Israel Corp | 46.0% |
| Potash Corp | 13.8% |
| First Eagle Inv Mgmt | 2.0% |
| Cobas Asset Mgmt | 1.3% |
| Vanguard Group | 0.9% |

**Short Interest** (as of 10/13/17):

| | |
|---|---|
| Shares Short/Float | 1.8% |

**ICL PRICE HISTORY**

**THE BOTTOM LINE**

That the company operates in both commodity and higher-value-add businesses contributes to it being misunderstood by the market, says Francisco García Paramés. If he assumes continued strong performance in its specialty-chemicals businesses and a normalization in fertilizers, he arrives at a fair-value estimate for the stock of $9.80 per share.

Sources: Company reports, other publicly available information

a mutually beneficial agreement that both sides would likely want to renew.

**At a recent $4.15, how cheap do you consider the shares?**

**FGP:** We think ICL is generally misunderstood by the investor community, in part because it tends to be followed by commodity-fertilizer analysts rather than people knowledgeable about specialty chemicals.

The company should earn around $500 million in free cash flow this year, thanks to the specialty-chemicals business. Assuming the potash and phosphate cycles normalize, we believe the company can earn closer to $840 million in free cash flow by 2020. Applying a 15x multiple, our fair-value estimate is around $9.80 per share.

This is an example of the type of family-controlled business we like. The Offer family owns a 46% stake through another company they control, Israel Corp. [Tel Aviv: ILCO], and we believe they manage the company for the long term and in the interest of all shareholders.

One final thing I'd mention: Potash Corp. of Saskatchewan [POT], which owns 14% of ICL, has announced that it is going to sell its ICL stake in order to meet regulatory requirements around its merger with Agrium. That might be an overhang on the stock today, but it should only be a temporary one.

**From specialty chemicals to bakery products, describe your investment case for Aryzta [ARYN]?**

**FGP:** Another situation I didn't mention earlier that can lead to mispricing is when a company's main business is in a different geography from where it's based or where its stock trades. In this case, Aryzta is an Irish company that trades in Switzerland and half of the business is in the U.S. That's certainly not the only issue here, but it may be part of the reason why we're finding it mispriced.

The company is the largest specialty baker in the world, operating in nearly 30 countries. It manufactures the dough, freezes it and sends it to company-owned bakeries that then bake the finished products and deliver them to customers such as McDonald's, Starbucks and Subway. Globally it's quite a highly fragmented business – Aryzta is by far the largest player with about an 11% market share – with economies of scale at a regional level providing competitive advantage from more efficient manufacturing and distribution. Aryzta is typically well integrated into its customers supply chains and is one of the few companies in each regional market capable of delivering the product quantity, variety, quality and consistency that its customers require.

After a number of missteps, including ill-advised non-core acquisitions and the loss of substantial business volume from key customers such as Subway and Hostess, the company within the past year has replaced its entire senior management team. Gary McGann, who we know and respect from his previous position as CEO of packaging company Smurfit Kappa, was appointed chairman of the board. The new CEO, Kevin Toland, recently joined the company from airport operator DAA and, prior to that, food company Glanbia.

### INVESTMENT SNAPSHOT

**Aryzta**
(Switzerland: ARYN)

**Business**: Provider of bakery products such as breads, pastries, tarts and pies that are sold through various retail and restaurant channels in nearly 30 countries worldwide.

**Share Information**
(@10/30/17, Exchange Rate: $1 = CHF 1.00):

| | |
|---|---|
| **Price** | **CHF 31.52** |
| 52-Week Range | CHF 26.14 – CHF 45.87 |
| Dividend Yield | 1.8% |
| Market Cap | CHF 2.80 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | €3.80 billion |
| Operating Profit Margin | 2.7% |
| Net Profit Margin | (-23.9%) |

**Valuation Metrics**
(@10/30/17):

| | ARYN | S&P 500 |
|---|---|---|
| P/E (TTM) | n/a | 24.2 |
| Forward P/E (Est.) | 17.0 | 19.5 |

**Largest Institutional Owners**
(@6/30/17):

| Company | % Owned |
|---|---|
| Causeway Capital | 7.5% |
| Black Creek Inv Mgmt | 5.0% |
| Cobas Asset Mgmt | 4.5% |
| Norges Bank | 3.1% |
| OppenheimerFunds | 2.8% |

**Short Interest** (as of 10/13/17):

| | |
|---|---|
| Shares Short/Float | n/a |

**THE BOTTOM LINE**
While past strategic and operational blunders obscure the strength of the company's core business, they are now being addressed by competent new management, says Francisco García Paramés. At 17x his 2019 estimate of free cash flow, plus the value of non-core assets, he pegs the company's per-share fair value at around 60 Swiss francs.

Sources: Company reports, other publicly available information

He had an excellent track record at both of those companies.

**Where is the new management team focusing its attention?**

**FGP:** The company has been developing a new strategic plan. Among the key initiatives, it's getting out of the direct-to-consumer business so as not to compete with core commercial clients. They're planning to focus only on the core frozen-bakery-products and prepared-meals businesses. They're looking to overhaul manufacturing and distribution systems to better optimize capacity utilization and reduce costs. Finally, they're looking to delever the balance sheet via asset sales and through the use of free cash flow. These are exactly the types of things they should be doing to better capitalize on what is still a solid and sustainable franchise.

**How do you see this translating into higher earnings and into upside from today's share price of 31.50 Swiss francs?**

**FGP:** As the new operational plan bears fruit, we expect EBIT margins to improve from 7% to around 10%, which is still below historical levels. Assuming 2-3% annual revenue growth, we believe the company by the end of its fiscal year in July 2019 can earn €250 million in free cash flow. Applying a 17x multiple on that free cash flow and adding in non-core assets, we arrive at a fair value estimate for the shares of 60 Swiss francs. There is some leverage in the business, but we think it's fully manageable given the level of free-cash-flow generation.

In general, we tend to emphasize the quality of the business much more than the quality of management in assessing investment opportunities. In this case, happily, we think we have both working in our favor from here.

**What do you think the market is missing in Renault [RNO]?**

**FGP:** Renault, headquartered in France, is today the 9th-largest automaker in the world, selling over three million passenger cars and light commercial vehicles annually. Just over half of its sales volume comes from Europe, with the rest coming primarily from emerging markets such as Brazil, Russia, Turkey, India, Iran and South Korea.

One unique aspect of the company is the strategic alliance it has with Japanese carmakers Nissan and Mitsubishi Motors, which has since been extended through additional partnerships with Germany's Daimler, Russia's AvtoVAZ and China's Dongfeng Motor. It has not been not an easy alliance to make work, but it does work and allows members like Renault to improve their speed to market and to benefit from significant manufacturing and research-and-development economies of scale that they would not have otherwise. The alliance companies, for example, are the leading manufacturers of plug-in electric vehicles in the world, with global sales since 2010 of some 425,000 units. By 2022, over 80% of Renault's vehicles will be based on common alliance vehicle platforms.

**Do you have a view on where we are in the auto-sales cycle?**

## INVESTMENT SNAPSHOT

**Renault**
(Paris: RNO)

**Business**: France-based global manufacturer of passenger cars and light commercial vehicles; operates in a strategic partnership with Japan's Nissan and Mitsubishi Motors.

**Share Information**
(@10/30/17, Exchange Rate: $1 = €0.86):

| | |
|---|---|
| **Price** | **€84.73** |
| 52-Week Range | €71.92 – €90.76 |
| Dividend Yield | 3.7% |
| Market Cap | €25.08 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | €55.59 billion |
| Operating Profit Margin | 6.3% |
| Net Profit Margin | 7.7% |

**Valuation Metrics**
(@10/30/17):

| | RNO | S&P 500 |
|---|---|---|
| P/E (TTM) | 5.4 | 24.2 |
| Forward P/E (Est.) | 5.5 | 19.5 |

**Largest Institutional Owners**
(@6/30/17):

| Company | % Owned |
|---|---|
| Norges Bank | 2.7% |
| BlackRock | 1.8% |
| Vanguard Group | 1.4% |
| Henderson Global Inv | 0.9% |
| Lyxor Asset Mgmt | 0.9% |

**Short Interest** (as of 10/13/17):
Shares Short/Float n/a

**THE BOTTOM LINE**
The company's global strategic alliances provide it with critical economies of scale and scope in manufacturing and new-product development, says Francisco García Paramés. Assuming revenue and profitability below company targets and applying an 11x multiple of normalized free cash flow, he believes the shares are worth closer to €130 per share.

Sources: Company reports, other publicly available information

**FGP:** It's possible that the U.S. and Europe are at or near the top of the sales cycle. However, emerging countries like China, Russia, Brazil and India still have decades of secular growth ahead of them. We expect emerging countries to pick up the slack from any cyclical issues in the U.S. and Europe and don't see overall sales declining. We'd also note that the number of vehicle miles driven per year is on a continuous upwards trajectory, even in developed markets, which bodes well for long-term vehicle demand.

**Do you think incumbents like Renault are more or less likely to come out ahead as technology disrupts the car business?**

**FGP:** The main vehicle manufacturers in the world today are mostly the same ones from 50 years ago, which shows how difficult it is to dislodge entrenched incumbents in this industry. Over the next five years the alliance will spend something like €50 billion on research and development, with an emphasis on self-driving cars and so-called transportation as a service. They have been aggressive in establishing partnerships with start-ups focused on new technologies. None of that guarantees they win as the industry evolves, but they are certainly doing the right things to put the odds in their favor.

**How are you valuing Renault's shares, now trading around €84.75?**

**FGP:** The company's latest five-year plan calls for €70 billion in revenues and 7% operating margins by 2022, based on selling more than five million cars a year. We hope they make those numbers but our estimates are more conservative.

Assuming annual revenue growth of around 3% and average operating margins of 4.7% through the cycle, our normalized estimate of annual free cash flow is roughly €1.4 billion. At an 11x multiple, that values the Renault business at around €15.5 billion. We add to that another €22 billion as our estimated value of the 43% stake Renault still owns in Nissan, which is also based on 11x normalized free cash flow. This gets us to a total estimated value for Renault of €129 per share.

A potential catalyst for the share price would be if the French government sold its nearly 20% minority stake in Renault. We think [CEO Carlos] Ghosn's eventual end game is to merge Renault and Nissan, which could also be a strong catalyst on the upside for Renault's stock.

**Describe in a bit more detail your thesis for Teekay LNG Partners.**

**FGP:** Teekay LNG owns and operates a fleet consisting primarily of 32 liquefied-natural-gas carriers and 25 liquefied-petroleum-gas carriers. It has another 18 LNG carriers on order, scheduled for delivery from 2017 to 2020.

There are two primary aspects to the thesis. One, because it's significantly cleaner and more environmentally friendly, natural gas is the fastest growing fossil fuel worldwide. That's driving demand for LNG, which allows global buyers to source supplies from markets where natural gas is plentiful and natural-gas prices are lower. China, for example, wants natural gas to account for 15% of its total energy consumption by 2030 – from around

### INVESTMENT SNAPSHOT

**Teekay LNG Partners**
(NYSE: TGP)

**Business**: Bermuda-based provider of global marine transportation services used primarily for the movement of liquefied natural gas, liquefied petroleum gas and crude oil.

**Share Information** (@10/30/17):

| | |
|---|---|
| **Price** | **17.40** |
| 52-Week Range | 13.05 – 19.90 |
| Dividend Yield | 3.3% |
| Market Cap | $1.39 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $403.5 million |
| Operating Profit Margin | 46.8% |
| Net Profit Margin | 35.9% |

**Valuation Metrics**
(@10/30/17):

| | TGP | S&P 500 |
|---|---|---|
| P/E (TTM) | 10.2 | 24.2 |
| Forward P/E (Est.) | 8.3 | 19.5 |

**Largest Institutional Owners**
(@6/30/17):

| Company | % Owned |
|---|---|
| Fidelity Mgmt & Research | 10.0% |
| OppenheimerFunds | 6.3% |
| Cobas Asset Mgmt | 5.0% |
| Morgan Stanley Inv Mgmt | 3.3% |
| Neuberger Berman | 2.8% |

**Short Interest** (as of 10/13/17):

| | |
|---|---|
| Shares Short/Float | 1.5% |

**TGP PRICE HISTORY**

**THE BOTTOM LINE**
Positive demand dynamics for natural gas make the company's business more attractive than the market appears to recognize, says Francisco García Paramés, and long-term contracts make it more predictable. Applying a 15x multiple to his 2019 estimate of free cash flow, he estimates per-share fair value at $33, nearly double the current price.

Sources: Company reports, other publicly available information

6% now – and it doesn't have nearly the domestic capacity to reach that goal. Globally we expect 5-10% annual growth in natural gas consumption for the next several years.

Second, as I mentioned earlier, the company adds capacity only with long-term contracts in place, resulting in much higher visibility and stability for future cash flows than the market seems to recognize. They have been in business for 25 years and have rarely needed to renegotiate contracts, which today have an average 13-year remaining life.

**You mentioned the importance of balance-sheet strength when investing in cyclical businesses. How would you rate that here?**

**FGP:** The company does have a relatively large debt load, but again, we think it's manageable given the dynamics of the business. They've been able to finance investment projects with low-teens expected IRR's with debt costing around 3%.

**Investors clearly hated it when the company cut its dividend by 80% near the end of 2015. Is that move still weighing on the share price?**

**FGP:** As oil prices collapsed in 2014 and 2015, raising additional equity capital to fund the company's large capital-spending program became impossible, so management cut the quarterly dividend from 70 cents to 14 cents. We think that was the right long-term decision given the high prospective rates of return on the planned investments, but after the dividend cut the shares fell from something like $25 to around $10, which we considered a significant overreaction.

Management has said they will raise the dividend after two hurdles are met: First, that all financing for the new carriers is secured, which should happen some time this quarter. Second, when debt that matures next year is refinanced. We're expecting both of those hurdles to be successfully met and to see a large dividend increase sometime in 2018 or 2019. We could imagine investors would like that just as they didn't like it when the dividend was cut.

**What do you think the shares, now at $17.40, are worth on your estimate of normal free cash flow?**

**FGP:** Based largely on contracts in place, we expect the company to earn $175 million in free cash flow in 2018 and $200 million in 2019. Applying a 15x multiple to the 2019 number – implying a 6-7% FCF yield – gives us an estimated $33-per-share fair value. That's still 30% below where the shares traded in the spring of 2014, despite having the same business plan and having executed as expected.

**We see you own Teekay LNG's general partner, Teekay Corp. [TK], as well. Is the investment case basically the same?**

**FGP:** As the general partner, Teekay Corp. will directly benefit from Teekay LNG's success, and because it receives 50% of Teekay LNG's dividends above a certain threshold, it will benefit disproportionately if TPG's profits increase significantly.

There are other moving parts in Teekay Corp., including general-partnership interests in Teekay Offshore Partners [TOO] and TNK Tankers [TNK]. There have been problems with both of those, but the non-cyclical issues appear largely to have been resolved. Based on our sum-of-the-parts analysis, with the significant majority of the value coming from Teekay LNG, we estimate Teekay Corp.'s net asset value at more than two times the current $8.25 share price.

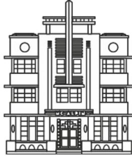
**There are always big-picture things to worry about in the world. Are any particular ones keeping you up at night?**

**FGP:** I'm always very interested in what's going on in the world and in individual countries, but I don't spend any time trying to predict what's going to happen with the big picture. What I can do is pay attention to when capital leaves a sector, creating potential opportunities for investors, and to when capital goes into a sector, creating potential risk for investors.

The best way for an investor to prepare for the future is to invest in real assets, and the best way to do that is to own equities. I have no clue what's going to happen with the markets in general. I only know that when overall markets are trading at 17x earnings we have a portfolio trading at half of that. If we can own publicly traded companies at low prices, we're happy. VII

c o b a s

asset management

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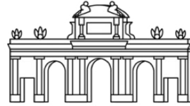

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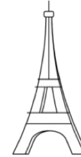

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