ValueInvestor INSIGHT
The Leading Authority on Value Investing
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Mind the Gap

"We never confuse fundamental value with market price," says Nick Tompras, which goes a long way in explaining his market-trouncing success.

INVESTOR INSIGHT

ACR Alpine Capital Research
(*l to r*) Tim Piechowski, Nick Tompras and Willem Schilpzand

Investment Focus: Seek predictable, profitable and low-leverage companies facing issues the market incorrectly deems to be more chronic than temporary.

Struggling to find anything worth owning in the large-cap portfolio he then ran for a St. Louis bank, Nick Tompras in late 1999 had another idea. "Value was a four-letter word, but there were many high-quality, smaller-cap companies in boring sectors that were absolutely cheap," he says. "I thought it was the perfect time to start my own firm and buy them."

Tompras's timing and judgment proved impeccable then, and have continued to pay significant dividends for his ACR Alpine Capital Research investors. His flagship strategy has earned a net annualized 11.9% since April 2000, vs. 3.6% for the S&P 500.

Finding bargains generally scarce, he sees select opportunity today is such areas as food distribution, insurance, wireless services and banking.

You describe your strategy as determining a company's fundamental worth and owning it when the market price is much lower. Isn't that what everyone does?

Nick Tompras: As Warren Buffett says, value investing is really a redundancy given that all investing should be value investing. What's remarkable is how the introduction of market price seems to throw so many investors off. The focus on short-term results that is so prevalent is far more about market price than fundamental value. If you look at how many stocks people hold and how they worry about tracking error versus an index, that tells you they're paying attention to price more than they are intrinsic value.

We're traditional in the sense that we define intrinsic value as the present value of the future cash flows generated by an investment. That's the only reference point for what an investment is actually worth and for whether or not the market price is fair, high, or low.

What have you found most often creates the gap between value and price?

NT: Typically there are company-specific issues causing underperformance. We then evaluate whether a particular issue is a secular one that permanently lowers growth or margins, or something that might last only a year or two or three. When we conclude the issue is more temporary, that can result in an attractive gap between our estimate of value and the market price.

Sysco [SYY] would be a good example. It's the largest U.S. food distributor, with an excellent record of growth,

What It Takes

Ask Nick Tompras what it takes to be a successful investor and he doesn't offer a few quick sound bites – he's actually thought about it deeply and identified the professional and personal qualities he considers most essential. Here in his own words are the five personal qualities he believes foster investment success:

» "First is what I call a value ethic, a basic desire to create value over and above enriching yourself personally. There's nothing wrong with wanting to get rich, but I think the motivation has to be more about putting the client first and generating great results for them, not just you."

» "Second is a deep level of curiosity, which translates into a relentless pursuit and acquisition of knowledge."

» "Third is the ability to think independently, going after the truth despite others' opinions. This also means the ability and the willingness to change course when you're wrong."

» "Fourth is what I call people and business savvy. So much of what we do involves assessing businesses that will and won't be successful over time, and assessing human behavior, whether management, customers or competitors. While some of that savvy can be learned, I think there's an innate component to it as well."

» "Last is just raw intellect. You have to go through a lot of information and have a decent head on your shoulders. I would add, though, that if this was something where only raw intelligence wins, I'd clearly be in the wrong game. It's much more about the other factors."

profitability and capital stewardship. The market tends to price in that such success goes on forever and it never does. In Sysco's case you've seen weakness in the restaurant business and some new competition pressure gross margins, while it has also been spending heavily for years on a new management-information and IT overhaul. In our view, however, the economics of the wholesale food-distribution business have not materially changed and Sysco will continue to benefit from a strong competitive position going forward. We first started buying the stock in 2011 at a lower price than today, but we still believe the market is missing the remaining long-term potential the company has for value creation.

Willem Schilpzand: Many of our opportunities have been related to negative sentiment hitting a specific sector. A few years ago concern about defense-spending cuts gave us an opportunity to invest in Lockheed Martin [LMT]. We concluded after digging into the specifics that the most likely cuts would have little impact on the company, and that the "cuts" elsewhere were actually just slower increases in spending. Another example would be in late 2012, when share prices of managed-care companies most exposed to government programs came under pressure due to fears that the Affordable Care Act would make private insurance plans much less profitable. That gave us an opportunity to buy Humana [HUM], which we thought had a lower risk of being disintermediated because of its competitive positioning and the fact that its Medicare Advantage plans provided clear value-add to both its customers and the government. We've taken some profits in Lockheed Martin, but still own it and Humana today.

We also have at times taken advantage of balance sheet or accounting complexity. We no longer own DST Systems [DST], which basically provides a shared accounting platform for financial institutions, but we were attracted to it by a number of non-core real estate and private investments it held that we thought weren't adequately or clearly valued on its balance sheet. Much of this was difficult to see without digging deep, but as it became more widely recognized the discount to intrinsic value we originally saw started to go away. Lockheed is an example here as well. Because there is a lag between when it books pension expenses and when as a government contractor it is reimbursed for those expenses, earnings can look a lot worse than they really are. The sell side now adjusts for this discrepancy, but wasn't doing so when we first got interested in the stock.

ON A QUALITY FOCUS:

We want to ensure our companies can survive the worst bust scenario with their fundamental values unimpaired.

Describe your process for unearthing potential ideas.

NT: I've always believed in the principle that you search wide, so we start with a universe of all U.S. exchange-traded securities, including ADRs. Excluding those that barely trade, that comes to about 5,000 names.

While I don't believe in selecting companies by screen, I do believe in letting screens do some of your legwork for you. We initially eliminate companies that have too much leverage or are insufficiently profitable. We make a variety of adjustments to the numbers, but we're essentially looking for companies whose earnings before interest and taxes are at least four to five times their annual interest expense. In terms of profitability, we have both simple and more complicated screens, but the basic idea is to eliminate companies that have ever lost money on an EBIT basis over the past ten years. We do make an exception for companies that may have gone from a startup to more mature phase, but they have to have some record of solid profitability in place.

Just on those two quality screens, the universe shrinks to about 3,500 companies. That tells you there are a lot of weak companies out there. We don't dispute there may be values in those weak companies, but we don't pursue them.

Elaborate on that last point.

NT: One book that has had a profound influence on me was Charles Kindleberger's *Manias, Panics and Crashes*, which was published in 1978 and takes a narrative approach in explaining the political, social and business circumstances that have tended to accompany historical booms and busts. It gives particular focus to the theories of economist Hyman Minsky, whose financial instability theory says a lot about why booms and busts recur and, I believe, why they will continue to do so. My takeaway from all that is the importance of protecting the intrinsic value of the capital investors entrust to us. Prices will fluctuate, but as long as the intrinsic value is protected those price fluctuations are harmless. That's why we focus so much on quality, to ensure that our companies can survive the worst bust scenarios with their fundamental values unimpaired.

What's the next step with your set of 3,500 higher-quality companies?

NT: The next step is to distill that down to what we call our on-deck list, companies that we could imagine owning at the right price. To do that we're pulling in up to 20 years of financials and reviewing other publicly available information to assess the growth, profitability and sustainability of the business over time. Is it creating intrinsic value? Is it reliable in the sense that we can estimate what the business will look like in five or ten years with a reasonable degree of forecasting error? If yes, using the model I've used from the beginning, we can make key assumptions and calculate a preliminary estimate of intrinsic value.

To be clear, I view this as somewhere between a screen and initial due diligence. We're trying not to look at price at this point, just to create a working list of companies that if their prices did appear attractive, we'd take a much deeper dive to refine our estimate of intrinsic value. That on-deck list today has around 465 names. Every couple of days it's sorted and those companies with the lowest price to value are marked for additional work.

Are there industries or types of businesses to which you have typically gravitated over time?

NT: The biggest gating factor is the reliability with which we can estimate cash flows. That cuts across a lot of different industries, so it's probably more instructive to describe what we've tended to avoid. Most of our businesses are somehow tethered to GDP, but we've stayed away from sectors like energy because the key driver is often a commodity price that we're not comfortable trying to forecast. Except for recently – we now own Microsoft [MSFT] and Intel [INTC] – we've avoided most technology stocks due to the level of uncertainty we have in judging the future in more rapidly changing businesses.

Understanding what a business is going to look like in five to ten years is a very difficult thing, and getting that wrong is at the root of most of the mistakes we've made. Over time I've become more and more leery of companies operating in highly competitive environments. Today many retailers, for example, seem ostensibly cheap, but the competitive dynamics in their areas give us pause. That doesn't mean we won't buy a retailer, but any business where market share is so difficult to defend is tough for us to handicap.

We're curious why Intel doesn't fall into that category?

WS: While it's difficult for us to look at Intel and understand exactly what the underlying technology is that they sell, we think we understand the competitive dynamics of the industry and its longer-term economics. The company's manufacturing advantages, the entrenchment of its chip architecture in specific areas and its scale give it a sustainable advantage well into the future. Combine these company-specific advantages with secular tailwinds from the proliferation of "smart" devices and society's ever expanding computational needs and we're quite comfortable owning Intel.

When you started ACR in 2000 you owned almost no large caps. Today you own only large caps. Explain that.

NT: There's an identifiable bubble today in domestic small-company stocks, which to us look egregiously overvalued as a group. So the simple answer to your question is that we own only large caps today because that's the only place we're finding sufficient value. I would add that even that is getting increasingly difficult to find. We have around 40% of our portfolios today in cash.

ON ABSOLUTE VALUES:

It strikes me as odd that if the market was up 2-3% and we made 4-5%, that somehow that would be good.

Which anticipates our next question, which is to describe the extent to which your valuation discipline is absolute rather than relative.

NT: It always struck me as odd that if the market was up 2-3% over a multiyear period and we made 4-5%, that somehow that would be good. If you're going to take equity risk, you should expect to get an equity-like return or you shouldn't take equity risk.

That absolute-return framework is built into our process by the discount rates we use in our discounted dividend or cash-flow models. Today we basically arrive at those rates by starting with a 2% risk-free rate, adding 3% for a baseline equity premium, adding 3% as an inflation plug, and then putting on an additional risk premium based on the individual company's risk profile. I'll use S&P scale even though we do our own credit-quality analysis, but today we use a nominal 8% discount rate for a AAA company, 9% for AA, 10% for A and 11-13% for BBB.

So in other words, for a AA company trading at our estimate of intrinsic value, we would expect it to return 9% per year. Of course we want to do better than that, so will only buy at a discount to our intrinsic-value estimate. We prefer the discount to be at least 30%, but for the highest-quality companies we're still willing to buy at discounts of 15% or so.

The weighted average discount rate in the portfolio right now is 9.2%, while the market, by our estimate, is discounting a nominal return of closer to 7%. When you have that kind of discrepancy on assets that have 20- to 30-year durations, you are going to get huge differences in present values. That's the primary reason we're having a tough time finding things to buy.

You usually own around 20 stocks at a time. Why that number?

NT: If you were perfect, you would only need to hold one company, and since you're perfect it would be a spectacular winner. Conversely, if you don't know anything about valuation, you should just hold the entire market. Our basic view is that if you're skilled at valuing companies, your 20 best ideas should perform better than your 20 next-best ideas. So for us 20 holdings is that gut-check number that gives us enough diversification to avoid one or two bad investments killing returns, while having enough concentration that we can add real value with our individual picks.

I would add that we closely monitor the business-risk factors in the portfolio. If we own property/casualty insurers, how exposed are we, say, to an earthquake in California or a hurricane in Florida? If we own Dell, Microsoft and Intel, we're probably not going to buy Hewlett-Packard because we have enough exposure to the global health of the PC market. These are relatively simple notions, but are extremely important for mitigating risk at a portfolio level.

Turning to some individual ideas, describe your investment case for wireless-services giant Vodafone [VOD].

WS: We first bought into Vodafone in early 2011 and the thesis was mostly around the monetization of the company's Verizon Wireless stake. That monetization has happened, with Verizon buying out Vodafone's 45% stake for $130 billion, much of which was distributed to shareholders and $30 billion of which was retained by the company.

Taking into consideration that inflow of money and assuming a reasonable net-debt-to-EBITDA ratio of 2x to 2.5x, we concluded the company had upwards of $60 billion available for M&A and organic investments. While we wouldn't usually be enthused by management having more or less of a blank check to spend freely, in this case we believe that firepower can be deployed to generate good returns going forward.

On the M&A front, Vodafone last year bought Kabel Deutschland, the largest cable-television provider in Germany, for around $15 billion, and last month it agreed to pay roughly $10 billion for Ono, the owner of the largest next-generation broadband network in Spain. On the organic-investment front, it has earmarked an incremental $11-12 billion for capex investments, primarily to build out 4G wireless capacity in developed markets, 3G capacity in emerging ones and fixed-line infrastructure where it makes sense. That leaves the company with maybe $25 billion in dry powder to use for additional future investments.

INVESTMENT SNAPSHOT

Vodafone
(Nasdaq: VOD)

Business: Wireless telecommunications provider with operations in developed and developing markets primarily in Europe, Asia, the Middle East and Africa.

Share Information
(@4/29/14):

Price	**37.51**
52-Week Range	27.54 – 42.14
Dividend Yield	5.6%
Market Cap	$99.44 billion

Financials (TTM):

Revenue	$72.18 billion
Operating Profit Margin	11.4%
Net Profit Margin	45.3%

Valuation Metrics
(@4/29/14):

	VOD	S&P 500
P/E (TTM)	3.1	17.9
Forward P/E (Est.)	11.1	15.7
EV/EBITDA (TTM)	6.4	

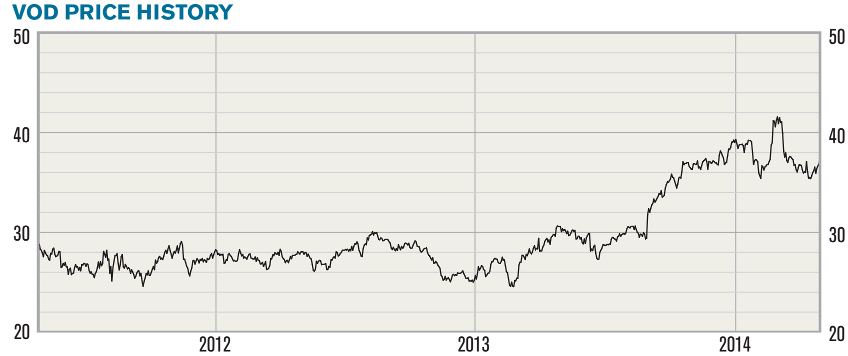
Large Institutional Owners
(@12/31/13):

Company	% Owned
Paulson & Co.	0.7%
Fidelity Mgmt & Research	0.6%
Invesco	0.6%
Institutional Capital	0.5%
Arrowstreet Capital	0.4%

Short Interest (as of 4/15/14):

Shares Short/Float	n/a

VOD PRICE HISTORY



THE BOTTOM LINE

While the next year or two might be "pretty ugly" due to investment spending on organic growth and acquisitions, Willem Schilpzand expects that money to be proven well spent and result in a 50% rise in company EBITDA over the next four to five years. His base-case valuation scenario envisions a 13-16% IRR on the stock over a multi-year period.

Sources: Company reports, other publicly available information

What gives you confidence this has and will be money well spent?

WS: Part of it is because we believe the European wireless market will continue to evolve in a way that favors the large incumbents like Vodafone, which has leading or near-leading share in Germany, Italy, Spain and the U.K. Regulators are recognizing that many individual markets have too many competitors, so they appear to be increasingly open to consolidation of both market share and control of wireless spectrum. That should ultimately make for more rational competitive environments and higher incremental returns on invested capital. At the same time, in these developed markets packages of voice, Internet and TV services are becoming more popular, again playing to the strengths of the largest players, like Vodafone, that can offer the most attractive bundles.

Vodafone is also very well positioned in many emerging markets, where increasing penetration of smartphones and an uptake in data services provide a nice tailwind to those with the technology infrastructure and brand strength to compete. Currently only 35% of Vodafone's overall profits are in emerging markets, while 65% of its customers are in those markets. That makes investment in these geographic areas attractive, and as the markets evolve, Vodafone's absolute and relative profitability in them should increase significantly.

I should also add that we have a lot of confidence in CEO Vittorio Colao, who took over in mid-2008. When he came on he said he wanted to basically clean up the company's far-flung portfolio and focus only on businesses firmly in its control. He got rid of passive ownership stakes in companies like Softbank and China Mobile. He exited the Verizon joint venture and others, including a JV with Vivendi in France. He's consistently delivered on what we believe is a rational plan, while also building a substantial personal stake of his own in the company.

How are you looking at valuation at today's share price of $37.50?

WS: The next year or two with this might be pretty ugly. They'll be spending a lot on capex ahead of expected returns. They'll be working through integrating acquisitions and the upheaval and uncertainty that entails. They'll be rolling out new products and services.

But given the capital deployments and the positive longer-term dynamics I've mentioned, we believe four to five years out that annual EBITDA can increase from the current $21.5 billion to something on the order of $31.5 billion. We estimate that will translate into around $10 billion, or $3.80 per share, in distributable cash flow, which in our DCF model we use as the level of terminal free cash per share. When we discount the combination of the annual dividends received in the interim and the terminal value based on the $3.80 per share in earnings power by our required return for Vodafone of 10%, we arrive at an intrinsic value today of around $43.

In other words, we believe we're paying a mid-teens discount for an asset we expect to generate an annualized 10% investment return. Our base-case scenario provides an expected IRR of approximately 13-16% over a multi-year period. We consider that a more than satisfactory return for the risk we believe we're taking.

What is the market missing in Prem Watsa's Fairfax Financial [FFH:CN]?

Tim Piechowski: Fairfax Financial's franchise has been built through acquiring underperforming or unwanted insurance businesses and then focusing on two straightforward levers of value, improving underwriting profitability and improving investment results by utilizing a value-investing philosophy.

On the underwriting side the company has been consistently profitable, writing at an average 96% combined ratio on approximately $44 billion of cumulative insurance written for the ten years ending in 2013. It has been shifting its policy mix from standard to specialty lines, which are typically less price-sensitive. It has a record of being conservative in setting loss reserves. One significant upside we see today is that Fairfax has been writing very little insurance relative to its capital base for several years. Last year it wrote net premiums of $6 billion on a $10 billion capital base, but we believe it could write at least $10 billion in premiums for a few years in a harder P&C pricing market. The resulting increase in float to invest would significantly increase earnings power.

Another area of potential upside on the insurance side is Asia, where Fairfax has over the past several years established footholds in Singapore, Hong Kong, Malaysia, India and Thailand. Despite growing nicely there, it hasn't come at the expense of combined ratios, which are running below 90%. We believe that says a lot about the franchises they've built and the competitive environments of the markets they're in, both of which bode well for the future.

As one could expect after a bull run in equities, Prem Watsa has been criticized for excess conservatism with Fairfax's investment portfolio. What's your take on that?

INVESTMENT SNAPSHOT

Fairfax Financial
(Toronto: FFH:CN)

Business: Insurance holding company founded by Prem Watsa and focused on property and casualty insurance and reinsurance in North America, Asia and Europe.

Share Information
(@4/29/14, Exchange Rate: $1 = C$1.095):

Price	**C$481.25**
52-Week Range	C$391.00 – C$487.99
Dividend Yield	2.3%
Market Cap	C$10.79 billion

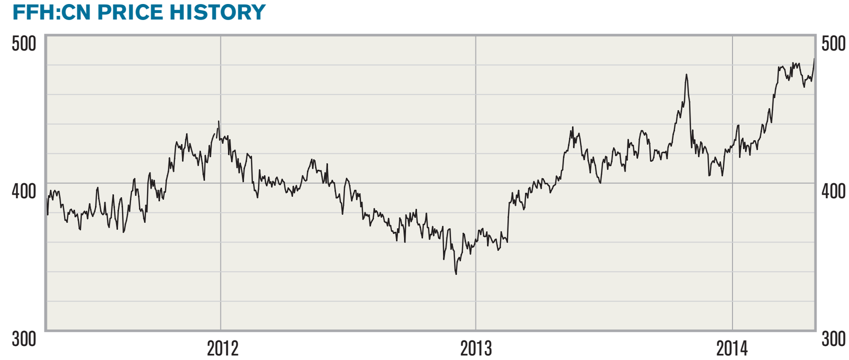
Financials (2013):

Revenue	$5.94 billion
Net Profit Margin	(9.5%)
Book Value/Share	C$360.10

Valuation Metrics
(Current Price vs. TTM):

	FFH:CN	S&P 500
P/E	n/a	17.9

FFH:CN PRICE HISTORY



THE BOTTOM LINE

Using a 9.5% discount rate and assuming earnings only from below-average investment returns, Tim Piechowski arrives at an intrinsic value for the company's shares of $520. Key areas of potential upside from there, he says, include harder property/casualty insurance pricing and matching past levels of underwriting profitability and investment returns.

Sources: Company reports, other publicly available information

TP: The portfolio is certainly conservatively positioned, with 100% of its equity exposures hedged, a roughly 30% cash position, and a 15% fixed-income position in a wide swath of municipal bonds that are guaranteed by Berkshire Hathaway. They've also put a decent-sized bet – $550 million at cost – on deflation. Their position is in a derivative called an inflation floor, on which Fairfax would make approximately $800 million for each 1% drop in CPI below the derivatives' strike price. The contracts have around 7.5 years remaining and have been written down to just $130 million on Fairfax's books, so the potential upside relative to the downside is very good from here.

As for Fairfax's conservatism, the company isn't in the same position as Berkshire Hathaway, which has substantial earnings from operating businesses coming in every day. It couldn't sustain capital impairment in its investment portfolio the way Berkshire could. They only want to take risks in common stocks when they believe there is substantial underpricing. Given their long-term record and the market environment today, it's hard for us to argue with that.

The shares have done quite well so far in 2014. How do you arrive at an estimate of today's intrinsic value?

TP: We take a conservative and relatively straightforward approach. The company today has a bit less than $1,200 per share in total capital available for investments. We assume over time it can earn 4% on that after-tax per year – the number pre-tax since inception is 8.9% – which results in $47-48 per share in EPS. Using that as our normalized earnings and assuming a discount rate of 9.5%, we estimate intrinsic value at $520 per share. We retain optionality on the upside in a number of key areas, including the potential for underwriting profits – which we haven't included in our normalized EPS – an increase in insurance premiums in a hard market, and investment returns that come in closer to their long-term average than we've assumed.

Explain your ongoing interest in managed-care company Humana.

WS: Humana offers a range of insurance products and health and wellness services. Roughly 60% of its profit comes from Medicare Advantage, the private equivalent of government-sponsored Medicare, in which it is the #2 provider in the U.S. behind UnitedHealth. Another 20% of profits come from providing health and wellness services, including a Pharmacy Benefits Manager (PBM) business, with the remainder coming from individual and group insurance and investment income.

The cloud over the business has been that the government has been reducing funding for Medicare Advantage (MA) plans and will continue to do so through 2015. Our basic thesis is that Humana is well-suited to weather those cuts and has significant profit upside when they end.

Elaborate on the various sources of your optimism.

WS: The first is that we expect the company's MA product – and MA products in general – to continue to take share from original Medicare. MA plans now serve

INVESTMENT SNAPSHOT

Humana
(NYSE: HUM)

Business: U.S. health insurer with primary specialty in providing Medicare Advantage plans offered on an individual basis and through employer benefits programs.

Share Information
(@4/29/14):

Price	**109.05**
52-Week Range	72.13 – 119.93
Dividend Yield	1.0%
Market Cap	$16.80 billion

Financials (TTM):

Revenue	$41.31 billion
Operating Profit Margin	5.0%
Net Profit Margin	3.0%

Valuation Metrics
(@4/29/14):

	HUM	S&P 500
P/E (TTM)	14.1	17.9
Forward P/E (Est.)	12.6	15.7
Price/Book	1.8	

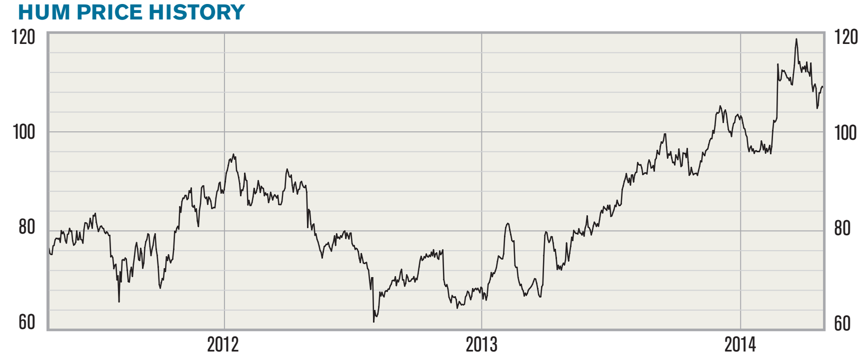
Largest Institutional Owners
(@12/31/13):

Company	% Owned
Capital World Inv	7.5%
JPMorgan Chase	6.2%
Capital Research Global Inv	6.2%
Vanguard Group	4.7%
Wellington Mgmt	4.4%

Short Interest (as of 3/31/14):

Shares Short/Float	3.9%

HUM PRICE HISTORY



THE BOTTOM LINE

The cloud over the company has been government funding cuts for the Medicare Advantage plans it offers, but Willem Schilpzand believes this competitively advantaged business will still thrive long-term. Assuming mid-to-high-single-digit revenue growth, normalized EPS of $8.20 and a 9.5% discount rate, he estimates intrinsic share value at $130.

Sources: Company reports, other publicly available information

around 30% of the entire Medicare population, up from less than 20% six years ago. One reason for that is that prospective new members have increasing familiarity and comfort with managed care, but the bigger reason is the higher value-add that private plans like Humana's provide. By offering a narrower provider network, it can negotiate more-favorable rates and cost-sharing arrangements with in-network providers. Humana has also accumulated significant healthcare assets – including acute-care facilities, nursing-home diversion services and home-care services – that allow it to offer more cost-advantageous treatment options and to be more proactive in managing those treatments, which helps limit noncompliance and reduces expensive hospitalizations and readmissions. This integrated-care strategy is nearly impossible for the government to replicate and should be a sustainable advantage for Humana.

At the same time, we believe the company's scale and breadth of assets should allow it to take market share within the MA market. This is a very local business with clear advantages of scale as the bigger players can invest more in local clinical assets and leverage local selling, general and administrative costs to further improve benefits at lower incremental cost. If executed properly that results in further local market-share gains, creating a virtuous cycle for companies like Humana and a vicious one for smaller competitors.

One other positive, of course, is the aging of the U.S. population. Baby boomers aging into Medicare provide a secular tailwind of 2-3% annual membership growth.

At a recent $109, how inexpensive do you consider the shares?

WS: Our model assumes mid-to-high-single-digit revenue growth, normalized operating EPS of around $8.20, a discount rate of 9.5% and astute capital allocation. That results in a current intrinsic value estimate of around $130 per share.

Two things I'd mention from a margin-of-safety standpoint: We believe the company's balance sheet is under-levered and if it ran closer to the industry's 30% debt-to-capital ratio it could free up $1 billion that could be reinvested in the business or returned to shareholders. In addition, Humana's captive PBM business is the fifth largest in a consolidating U.S. industry, and we think monetizing it could unlock significant shareholder value.

What upside do you still see in food-distributor Sysco?

NT: There are clearly some issues that would help explain why we finally saw a price/value gap open up after this had been on our on-deck list for a long time. Revenue and profit growth has slowed and there's still a lot of stress in the restaurant business, which accounts for about 60% of Sysco's revenues. That's provided an opportunity for lower-cost, cash-and-carry competition from warehouse clubs and the like to take some share. At the same time, the company's business-transformation initiative centered around installing SAP systems throughout its network – meant to pull significant costs out of the business – has dragged on for years and has yet to produce tangible results.

INVESTMENT SNAPSHOT

Sysco
(NYSE: SYY)

Business: Largest U.S. distributor of food and non-food items to customers such as restaurants, institutional food-service providers and lodging establishments.

Share Information
(@4/29/14):

Price	**36.24**
52-Week Range	31.13 – 43.40
Dividend Yield	3.2%
Market Cap	$21.20 billion

Financials (TTM):

Revenue	$45.48 billion
Operating Profit Margin	4.3%
Net Profit Margin	2.2%

Valuation Metrics
(@4/29/14):

	SYY	S&P 500
P/E (TTM)	22.0	17.9
Forward P/E (Est.)	18.4	15.7
EV/EBITDA (TTM)	9.9	

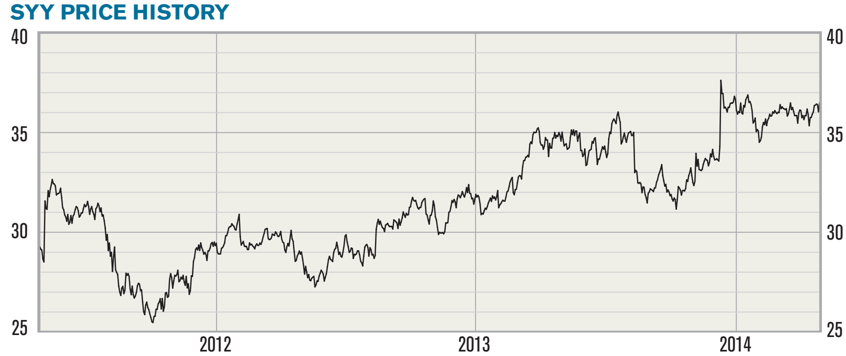
Largest Institutional Owners
(@12/31/13):

Company	% Owned
State Street	5.7%
Yacktman Asset Mgmt	5.5%
Vanguard Group	4.8%
Bank of NY Mellon	4.7%
First Eagle Inv	4.0%

Short Interest (as of 3/31/14):

Shares Short/Float	4.7%

SYY PRICE HISTORY



THE BOTTOM LINE

Nick Tompras expects the key concerns hanging over the company's stock – weakness in its end markets, a costly information-system upgrade and uncertainty over a large announced acquisition – to prove temporary. As the gap between his estimate of intrinsic value and the market price narrows, he's expecting an IRR from today's price of 14-15%.

Sources: Company reports, other publicly available information

There's also uncertainty around how Sysco's agreement near the end of last year to buy its next-largest competitor, US Foods, will play out. As I mentioned, our basic contention is that none of these issues is a permanent negative, and that Sysco's competitive position will continue to provide it with a sustainable advantage in an industry with solid long-term growth prospects.

The reality, of course, is that the company is going to have to pull out of its slump and perform better. One catalyst for that is the roll off in coming years of the huge cost of the SAP project while the savings from it kick in. We also see considerable upside from the US Foods deal, which is expected to close in the third quarter of this year. Sysco is paying $8.2 billion in cash, shares and assumed debt for a business with trailing 12-month EBITDA of around $825 million. That's not a bad price, but we're optimistic the company can create significant additional value by both cutting overlapping costs and improving margins on the acquired business.

What do you believe the shares, priced today at $36.25, are worth?

NT: This is a business we assume can grow at 4-5% per year, from organic growth, market-share gains and M&A. When we do the math on normalized operating margins, we come to 4.6% overall – 4.75% for legacy Sysco and 4.25% for legacy US Foods. On an after-tax basis, our normalized earnings number is around $2.70 per share. Assuming a discount rate of 9%, that gives us an estimated intrinsic value in the low-$40s.

Again, what that says is you're buying a 9% nominal-return business that's paying a better than 3% annual dividend at a 15% or so discount. On an IRR basis, our ultimate return depends on how quickly the gap between intrinsic value and market price narrows. In this case, if that took three years we'd be looking at an IRR of 14-15%. That's all overly precise for the nature of what we're doing, but we believe that's a sensible expectation.

You've called your next idea, JPMorgan Chase [JPM], "the world's best global banking franchise." Isn't that rather faint praise?

TP: We'd love to buy great banking franchises at or below book value during periods of robust economic growth, low credit losses and a benign government approach to regulation. The problem is that when those economic and regulatory environments prevail, financial stocks are typically priced as though the good times will last forever. In addition, perhaps contrary to common sense, it's those good times that actually foster a reduction in industry lending standards and competition starts to narrow credit spreads. So when we own something like JPMorgan – which we do consider a world-class franchise – everything is usually not firing on all cylinders.

There are a number of income-statement pressures on JPMorgan today, including tepid loan demand, legacy litigation settlements, subdued capital-markets activity and low interest rates causing depressed net interest margins. But even with all that it still has tremendous earnings power that we expect to improve significantly over time.

INVESTMENT SNAPSHOT

JPMorgan Chase
(NYSE: JPM)

Business: Broad-based financial holding company with significant exposure to investment, commercial and retail banking, asset management and credit cards.

Share Information
(@4/29/14):

Price	**56.10**
52-Week Range	46.98 – 61.48
Dividend Yield	2.9%
Market Cap	$212.46 billion

Financials (TTM):

Revenue	$94.02 billion
Operating Profit Margin	38.0%
Net Profit Margin	17.7%

Valuation Metrics
(@4/29/14):

	JPM	S&P 500
P/E (TTM)	13.9	17.9
Forward P/E (Est.)	9.2	15.7
Price/Book	1.0	

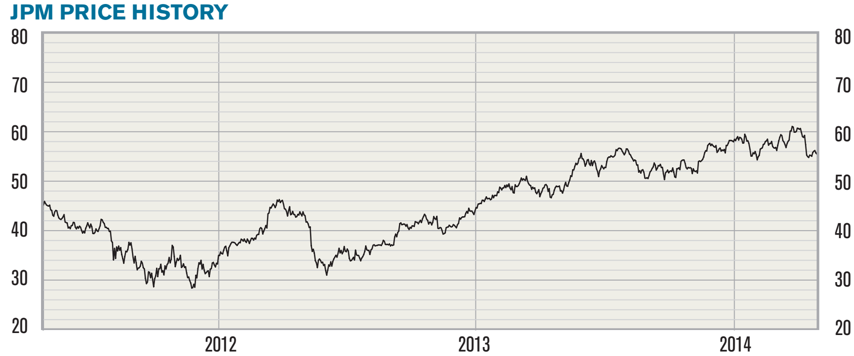
Largest Institutional Owners
(@12/31/13):

Company	% Owned
Vanguard Group	4.8%
State Street	4.5%
Fidelity Mgmt & Research	3.0%
BlackRock	2.6%
Capital World Inv	2.0%

Short Interest (as of 4/15/14):

Shares Short/Float	0.9%

JPM PRICE HISTORY



THE BOTTOM LINE

Despite a number of income-statement pressures on the company today, it retains tremendous latent earnings power, says Tim Piechowski. Among options on the upside from his current $64-per-share intrinsic-value estimate: a normalization of interest rates, an improvement in mortgage banking and a return of freed-up capital to shareholders.

Sources: Company reports, other publicly available information

The company today generates $95-100 billion in revenue and its expense base is running about $60 billion, not including litigation. That leaves it with $35-40 billion in pretax, pre-provision income. After reviewing in detail each category of loans in the $730 billion loan book, we estimate that normalized net charge-offs each year are approximately 1% of loans, or around $7 billion. That results in $28-33 billion in normalized pretax income, which after estimated taxes at a 30% rate comes to $20-23 billion in net earnings, or around $5.15 to $6 in earnings per share. That's kind of the current run rate, on which at today's share price [of $56] you're paying only a 9-11x P/E.

What's a more reasonable valuation to your mind?

TP: Assuming the normalized earnings I described, 2-3% organic growth from specific initiatives management has already laid out and mostly paid for, and a 10% blended discount rate – we use different rates for the banking and investment-banking businesses – we arrive at an intrinsic value of $64 per share.

Key items not in that estimate include a normalization of interest rates, an improvement in the mortgage-banking business from today's 3% return on equity to the 15% management believes is more reasonable, and any upside from freed-up capital being returned to investors. We believe the company by 2016 or 2017 is likely to be able to return around $20 billion of capital above its earnings as assets with a high-risk weighting under the new Basel-III capital regime run off. This adds another $3 to $4 to our estimate of intrinsic value.

You've owned only 52 different stocks since you set up shop 14 years ago. Why so few?

NT: That's a reflection more than anything of the large margin that exists between the price at which we buy and the price at which we'd sell. Intrinsic value is an imperfect estimate, so that's not something you cut close.

If we own a high-quality company whose business we know very well, we may let the price go 15-20% higher than our estimate of intrinsic value if the company continues to create intrinsic value. That can make for a fairly large spread over our buy price, which by definition leads to lower turnover. Our turnover has averaged around 15% per year.

The real issue in selling is doing the right thing when a company isn't performing. I have been guilty of not recognizing discernible changes in a company's business conditions, or of recognizing them but not aggressively enough adjusting down my estimate of intrinsic value. One lesson I've learned over time is to be quicker to sell once I've confirmed there's a real change in a company's fundamental condition.

Is there a recent example in which you've done just that?

TP: One fairly recent one would be Strayer Education [STRA], which we started buying in February 2013. For-profit education companies had suffered massive declines in student enrollments, but our thesis was that a lot of the negative headlines had passed and that Strayer, because it was one of the better-quality competitors in the industry, would start to see enrollments come back. From our purchase price, we thought we could earn a mid-teens annual return on the stock over several years with just 2% sustainable annual enrollment growth. Over the period we owned it, new-student enrollments by quarter declined by 5%, 14% and 17%. Worse, we lost any confidence that management had a credible plan for turning that around. We closed the position by the end of August.

You've over the years incorporated more macroeconomic inputs into your analytical process. How and why?

NT: We've always been bottoms-up stock pickers, but in order to arrive at the right discount rates, the right long-term growth rates, the right cyclical adjustments and the right terminal valuations, you can't stick your head in the sand when it comes to the macroeconomy. Several years ago I developed a network of economists to call on because I wanted more focused, in-house understanding of the macro conditions impacting our companies.

We have a particularly close relationship with Steve Fazzari of Washington University, who actually worked closely with Hyman Minsky. He's helped us understand how the financial crisis would impact the overall economy, and how anemic the recovery was likely to be. One more recent insight of his that was originally counterintuitive to me is how profound the impact of government deficit spending has been on corporate profits. That reinforces our view that earnings are far closer to a cyclical peak than a cyclical trough. When estimating intrinsic values, investors ignore something like that at their peril. VII

This presentation may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.

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