Value Investor INSIGHT

The Leading Authority on Value Investing

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Investor Insight: Metropolis Capital

Simon Denison-Smith and Jonathan Mills of the U.K.'s Metropolis Capital describe the situations they find most conducive to market mispricing, why they gravitate to investing in larger companies, why their partnership has endured as long as it has, and why they see unappreciated value today in Hargreaves Lansdown, Andritz, Progressive and Gruma.

INVESTOR INSIGHT

Metropolis Capital
Simon Denison-Smith *(l)*, Jonathan Mills *(r)*

Investment Focus: Seek companies that meet strict criteria for revenue and margin sustainability while also trading at significant discounts to estimated intrinsic value.

Having met as Bain & Co. consultants in 1990, Jonathan Mills and Simon Denison-Smith went on to successfully run non-investing businesses before launching London-based Metropolis Capital in 2008. While sharing portfolio and firm-building responsibilities has been a long-term challenge for many, Denison-Smith cites one simple strength of their partnership: "You want diversity of thought, undoubtedly, but you also need to have sufficient marrying of minds so you can actually do something together. We've always had that."

Now managing $2.5 billion, the firm has earned a net annualized 9.3%, vs. 6.7% for MSCI's All Country World Index. Casting a global net, they see upside in such areas as car insurance, online brokerage, industrial equipment and tortillas.

Describe how and why you went from buying and selling private businesses for Metropolis Group to buying and selling public equities for Metropolis Capital.

Jonathan Mills: Metropolis Group was very much patterned after Warren Buffett's strategy in buying for Berkshire Hathaway entire businesses with strong market positions and sustainable business models at attractive prices. We made over 30 private acquisitions over roughly a decade from the beginning of the 2000s, almost all in unsexy businesses that dominated their industry niches and were meant to stand very much on their own two legs.

What I enjoyed most about the acquisition process was the analysis piece, which involved about 10% of the work. After that you had to agree to terms, the lawyers got involved to work up all the paperwork, and then you had to actually oversee the new business with all its employees, properties and systems. After doing 30 of these I concluded the operational grind wasn't really what I wanted to do, or where I added the most value.

When Simon sold his business in 2006, we started to lay the groundwork for applying our experience in private markets to investing in public markets with very much the same analytical mindset. Search for businesses with strong franchises in their particular markets which may have fallen out of favor due to perceived short-term problems or market risk. Make investment decisions based on the company's ability to deliver consistent long-term returns. Make conservative assumptions and buy only when there's a significant margin of safety to our estimate of intrinsic value. That's what Metropolis Capital tries to do.

You've tended to gravitate to larger-cap companies. Why?

Simon Denison-Smith: Much of it goes back to our time as consultants at Bain, where most of our work was focused on how companies should define their market opportunity and then execute in a way to remain or become market leaders. We put considerable emphasis on market leadership, which is closely tied to revenue and margin sustainability, higher returns on capital and management quality. The best businesses in the world with the best managers tend to be the largest as well, almost by definition.

We also realized early on that we seemed to have better success in companies where we had more data to assess. We think we're pretty good at distilling data to arrive at the key elements that are going to drive a company's long-term performance and value creation. It's hard in general to have an analytical advantage, but we've found our chances are better when we have the type of independent data that you often have available with big companies. With small companies, in many cases we just think you end up being too dependent on what management tells you and on where they direct you to find more information.

How do you define your geographic circle of competence?

SDS: We'll look anywhere, but there are certain markets we struggle with at the moment. We aren't comfortable with the variable interest entity (VIE) structure for Chinese companies listed outside of China, for instance. With a 20-stock portfolio, it's too big a risk that a change in government attitude toward what is essentially an illegal structure could wipe out shareholder value. We just can't have 5% of our portfolio in a business that could go to zero. We have had a similar attitude toward stocks in Russia, thank goodness, and Saudi Arabia as well.

JM: Most businesses we invest in are global, so where they trade is neither here nor there. Last year we did incremental research on Japan, not because we had a different perception about what's going on in Japan, but because we found a number of high-quality companies based there that seemed to be potentially undervalued. We haven't bought anything as a result of that yet, but there are several Japanese companies today on our active watch list. We're also looking closely today in a number of emerging markets – the opportunity set is small given our governance and quality thresholds, but valuations in many markets are worthy of a closer look.

How worthy of a closer look is your home U.K. market?

JM: The big companies listed in London are quite international but tend to be biased toward commodity businesses we typically avoid. We do own a couple of pure U.K. businesses. Howden Joinery [London: HWDN] is a leading kitchen-appliance and woodworking company that is benefiting from the fact that people are investing more in their homes through the pandemic and, we think, beyond. Hargreaves Lansdown [London: HL], is the leading direct-to-consumer investment platform in the U.K., similar to Charles Schwab in the U.S. Is it possible the valuations for it and Howden's are a bit better right now because market sentiment hasn't been as favorable in the U.K. as in the U.S.? Yes, but a normalization of that is not going to be a primary driver of our investment case.

Describe the instances of potential market mispricing that tend to catch your eye.

JM: One would be quality companies in industries with generally poor economics. The auto insurance industry is a good example. As businesses, auto insurers don't usually make much money, regularly incurring underwriting losses and trying to make up for that with investment returns that often don't quite get there. There aren't many barriers to competitive entry and customer stickiness is quite low.

ON AUTO INSURANCE:

We often look for potential mispricing in quality companies in industries with generally poor economics.

While the nature of the industry can discourage many investors from taking a closer look, you can find unique companies that are able to stand out. One of our longest-held positions is Admiral Group [London: ADM], which we first invested in ten years ago after seeing it for several years take share in the U.K. auto-insurance market. It was an early pioneer in selling directly to the consumer via the Internet and it has been run in an intelligent and efficient way by the two founders, using its cost advantage to gain share while also making a very good underwriting return. It's essentially a U.K. version of Geico, but it grew up with the Internet, whereas Geico was around well before that and transformed itself.

SDS: One interesting thing about this example is that people often think of customer attachment and stickiness as the prime definition of business quality. In fact, quite fast turnover of clients can be ideal for the low-cost provider. In a market like auto insurance that overall doesn't grow that fast, a low-cost provider like Admiral – or like Geico and Progressive [PGR] in the U.S. – can reliably grow by winning incremental customers on price. As one of the founders of Admiral likes to say, as a disciplined underwriter there are also some clients you're quite happy to lose to your competitors. We're not saying customer stickiness isn't an important measure of business quality, but fixating on it in certain situations can cause you to overlook these kinds of opportunities.

JM: Another area of potential mispricing we look for is quality growth companies where our assessment of future growth is different to the market. These types of opportunities tend to be more common when the market overall falls sharply, as it did following the impact of Covid in March, April and May of 2020. Fairly suddenly the future outlooks for companies like Adidas [Frankfurt: ADS] and Visa [V] were significantly marked down below what we could reasonably expect to be the case. In calm markets these types of companies can be quite highly valued, but in a market downdraft they can come into range for us.

SDS: To add on to that in the case of Adidas, it was a company that had been on our radar because of its leadership with Nike as a global sports brand. We typically favor market leaders – Nike in this case – but in industries where there is a significant gap between the two leading players and the rest of the pack, we're willing to look at the industry's #2. The competitive dynamics often give rise to a stable duopoly, and that stability increases the confidence we can attach to modeling the future cash flows of the #2 player. It's quite striking how remarkably similar the two companies' growth rates and relative market shares have been over a very long period of time.

Both companies benefit from the same underlying growth drivers, which include the decades-long trend towards sports/athletic footwear and apparel, a rebalancing of the under-representation of female customers, and the growth of the middle class in emerging markets. They benefit from similar competitive advantages, through highly respected brands and scale in marketing, supported by sponsorship of the world's leading sports stars and teams. They're also both executing a multi-year strategy to shift a greater proportion of their revenue, at higher margin, to their own websites and stores.

We've owned Nike when a short period of relative underperformance gave us a buying opportunity in it, and we had that same opportunity in Adidas in March of 2020. We initiated the position after the share price had fallen more than 45% from its peak in January of 2020 and the P/E ratio had fallen to 17x, very much at the bottom end of its range over the prior ten years.

Would Oracle [ORCL], which you also own, fall in the category of an idea with underappreciated growth potential?

SDS: It's related, but we'd actually more specifically categorize it as an opportunity that comes along because growth investors are switching out of the stock as growth decelerates. The best example of that was when we bought Microsoft in 2010 at a single-digit multiple after it went from being loved by growth investors to being hated by growth investors following the dot-com crash.

Oracle doesn't energize the market in the same way as a Salesforce.com or Workday, which are considered exciting new cloud companies with lofty valuations. But we believe Oracle is carving out a dominant position in cloud ERP (Enterprise Resource Planning) applications, and that the market will increasingly notice this as it makes further material contributions to the company's top-line growth.

Of even greater interest is the potential of Oracle's cloud-based Autonomous Database offering, which not only leverages the infrastructure cost advantages of being hosted on the Internet, but also substantially reduces the labor cost of managing the database. Larry Ellison believes that Oracle can turn a $15 billion run-rate database-maintenance business into a $45 billion cloud-subscription business. If they can achieve even half that, it would be materially accretive to our current valuation. [*Note*: Oracle shares at around $76.50 are nearly 30% below their 52-week high.]

Given your focus on business quality, do you ever try to take advantage of industry cyclicality?

SDS: Quality companies can certainly operate in sectors that are out of favor and we try to take advantage of that. Here we're again focused on market leaders, with genuine scale and margin advantages. When demand falls in a down cycle and there's an excess of supply, prices are set by the marginal-cost provider. In that scenario the market leader tends to continue to generate cash and often comes out of that trough stronger because it can reinvest in things like R&D or targeted acquisitions. Those can enhance product and market advantages with both short-term benefit as the cycle turns and with long-term benefit over time.

A really good example that we don't own today but has been in the portfolio in the past is Deere & Co. [DE], the agricultural-equipment manufacturer. I won't say we always do a great job in timing where we are in the cycle – which argues in these cases for not going all in with your initial position and leaving some dry powder to buy more – but in a company like this if you can reasonably model the normalized earnings power and can be patient enough to wait for a recovery, the upside can be very substantial.

ON ORACLE:

It's the type of idea that comes along when growth investors switch out of a stock as growth decelerates.

Describe your investment case for U.K. online brokerage Hargreaves Lansdown.

JM: This is the largest direct-to-consumer investment platform in the U.K., with about £140 billion in assets under management, 2.5x larger than its next competitor. Scale is important to fund necessary investments in technology and marketing, and because Hargreaves Lansdown has the strongest brand in the U.K. it gets a better return on its marketing spend. All that results in extremely high margins and has led to the company increasing its market share, which has grown from 38% to 43% over the past five years.

The underlying market here has a very good tailwind from people increasingly managing their own money rather than using more-expensive independent financial advisors and/or having company or government pension schemes to rely on. Hargreaves' AUM has increased by 14% per year over the past five years.

SDS: We started looking at the company's stock back in 2020, but it wasn't until late summer last year that the share price had de-rated sufficiently enough for us to be interested. Part of a longer term drag on the share price was the high-profile collapse of investment funds managed by Neil Woodford, one of the U.K.'s best-known money managers, which had been fairly heavily promoted by Hargreaves Lansdown to its customers. The market also became worried, overly so in our opinion, that the company was going to have to lower its fees to meet the levels of lower-priced competitors.

One big difference in the U.K. market versus in America is that you're not allowed to get paid for order flow like Robinhood and others are in the U.S. Hargreaves Lansdown is typically paid on a percentage of assets under management, and that fee is roughly 10 basis points higher than its lowest-price competitors. We did quite a lot of research into this and concluded not only that the quality of the service and information provided by Hargreaves Lansdown justified the higher fee, but also that even the low-price competitors weren't counting on taking share from it. If you look at the 93% customer retention rate and growing market share, there's no evidence the company's fee level is an issue.

We haven't talked yet about valuation. How generally do you arrive at what you think a stock is worth?

SDS: Our valuations are primarily discounted-cash-flow based, using the same discount rate we've used since 2008. That's the long-term real return of the S&P 500, which after inflation is just over 6.5%. We model specifically what we expect to happen over multiple years, but then assume for most businesses no more than GDP-type growth. Our discipline is to buy at no less than a 30% discount to our estimate of intrinsic value. From earning our discount rate and from at least some closing of the discount gap, our long-term real return target is at least 10%.

After a big hit just last week on a disappointing earnings report, Hargreaves' shares are now sharply off their pre-pandemic level. How are you looking at valuation at today's £11.30 price?

SDS: We originally bought the shares at a price above the current level and haven't materially adjusted our intrinsic-value estimate, so the stock has gotten more attractive to us as the price has come down. We think there's a solid growth story here long-term as online brokers like Hargreaves continue to take share in an expanding market. This to us today is an unbelieved-growth type of idea that may take time to play out, but we still very much believe it will.

INVESTMENT SNAPSHOT

Hargreaves Lansdown
(London: HL)

Business: U.K.-based online platform offering primarily do-it-yourself investors a wide range of savings and investment options, accounts, research services and financial advice.

Share Information
(@2/25/22, Exchange Rate: $1 = £0.75):

Price	**£11.31**
52-Week Range	£10.10 – £17.78
Dividend Yield	3.4%
Market Cap	£5.36 billion

Financials (TTM):

Revenue	£622.6 million
Operating Profit Margin	53.0%
Net Profit Margin	42.8%

Valuation Metrics
(@2/25/22):

	HL	S&P 500
P/E (TTM)	20.1	23.8
Forward P/E (Est.)	20.2	19.5

Largest Institutional Owners
(@12/31/21 or latest filing):

Company	% Owned
Lindsell Train	14.0%
Baillie Gifford	5.0%
BlackRock	3.5%
Vanguard Group	1.9%
Liontrust Investment Partners	1.9%

Short Interest (as of 2/15/22):

Shares Short/Float	n/a

HL PRICE HISTORY

THE BOTTOM LINE

The market appears overly concerned that the company will have to reduce its fees to meet the levels of lower-priced competitors, says Jonathan Mills, neglecting the extent to which it continues to take market share in a secularly expanding market. The shares are even more attractive, he says, after a recent fall in price related to quarterly earnings.

Sources: Company reports, other publicly available information

Why are you high on the prospects for industrial-equipment manufacturer Andritz [Vienna: ANDR]?

SDS: The company builds and outfits very large-scale projects primarily serving the pulp and paper and hydroelectric-power markets. In pulp and paper it's one of only two players in the world – Finland's Valmet is the other – that can build new plants that have price tags of $500 million or more. In power generation, Andritz has 20% of the market for new hydroelectric plants overall, and 40% of the market for pumped-storage hydro plants. These are plants that typically use variable, renewable energy sources in part to pump water uphill, which then keeps the plant going when the sun isn't shining or the wind isn't blowing – it's essentially a huge water battery.

We see a number of positive drivers for the company. In pulp and paper, increases in packaging demand related to e-commerce are now more than offsetting print demand declines, to the point that the overall global market is growing again. With respect to new plants, an ongoing shift of production from North America to South America is resulting in incremental new-plant demand as older plants in the north are shut down. Attesting to Andritz's relative competitive position, it has won something like 70% of the new-plant orders in South America over the past 15 years. It's also a positive that with all of these plants there's a significant ongoing stream of long-term consumables and services revenues attached.

The hydroelectric business has been quite flat, but we also think its growth trajectory is starting to improve, driven by increased climate-change-related demand, especially in the pumped-hydro end of the market where the company has a stronger position. There's also likely to be incremental demand for new plants as aging industry infrastructure is, by necessity, replaced.

Another area that's interesting and more of a turnaround story is the company's business providing metal-flattening equipment to the automotive industry. Andritz has historically had an excellent position at the high end of the market, particularly with the German manufacturers, but has struggled somewhat against lower-cost competition from China in the low end. That business is showing signs of improvement as the company's technology edge provides a good growth opportunity, particularly in applications for electric-vehicle production. EVs tend to have higher metal content per vehicle for things like battery casings.

How cheap do you consider the shares at today's price of just under €41?

SDS: We added the position last June so didn't catch the lowest valuation, but the stock now trades at around our purchase price and at what we consider a normalized free cash flow yield of more than 9%. That to us is very attractive for a business with entrenched positions in growing markets and a conservative, very competent management team.

JM: I would just add a word here on management. We like managers who are owners, or who behave like owners, and believe that is very much the case here with Wolfgang Leitner, who has been the company's CEO since 1994. He's kind of the prototype of what we look for: low ego, very modest, very thoughtful and taking a long-term approach. He's not looking to empire build, but expand on the company's existing strengths. We'll partner with the brash Chairman or CEO as well – I mentioned we own a stake in Oracle – but we tend to prefer understated rather than overstated when it comes to leadership.

You spoke earlier about your positive experience with auto-insurer Admiral Group in the U.K. Explain your current interest in U.S.-based Progressive as well.

JM: It means something when Warren Buffett and Ajit Jain single out a company as a worthy competitor, which was actually the impetus here for our starting to look more closely into Progressive. It is a strong #2 to Berkshire Hathaway's Geico in direct-to-consumer auto insurance in the U.S., where both of them have been relentlessly gaining market share. Each had maybe 4% of the market in 2000 and now they each have closer to 15%. Geico has somewhat lower operating costs, but Progressive has a cost advantage over the rest of the industry and has also proved to be particularly adept at pricing, resulting in combined ratios consistently at 96% or below, much better than industry averages. At a certain price you have to be willing to hand a customer to your competitors and let them lose money on them. Progressive is very disciplined in that regard.

The company sells through agents as well – at similar profitability to its direct-to-consumer business – but in the direct business scale matters a lot and it and Gei-

INVESTMENT SNAPSHOT

Andritz
(Vienna: ANDR)

Business: Builds and outfits large-scale engineering and construction projects primarily serving end customers in the global pulp-and-paper and hydroelectric-power markets.

Share Information
(@2/25/22, Exchange Rate: $1 = €0.89):

Price	**€40.98**
52-Week Range	€37.04 – €50.95
Dividend Yield	2.4%
Market Cap	€4.07 billion

Financials (TTM):

Revenue	€6.41 billion
Operating Profit Margin	5.4%
Net Profit Margin	4.4%

Valuation Metrics
(@2/25/22):

	ANDR	S&P 500
P/E (TTM)	14.4	23.8
Forward P/E (Est.)	10.8	19.5

Largest Institutional Owners
(@12/31/21 or latest filing):

Company	% Owned
Vanguard Group	1.9%
Norges Bank Inv Mgmt	1.7%
Erste Asset Mgmt	1.7%
Schroder Inv Mgmt	1.4%
Polaris Capital	1.2%

Short Interest (as of 2/15/22):

Shares Short/Float	n/a

ANDR PRICE HISTORY

THE BOTTOM LINE
The dynamics in the pulp and paper, hydroelectricity and auto-manufacturing-equipment industries that the company serves are more positive than the market appreciates, says Simon Denison-Smith. He considers the current 9% normalized free-cash-flow yield on the stock "very attractive for a business with entrenched positions in growing markets."

Sources: Company reports, other publicly available information

co outspend competitors dramatically on marketing and technology. Customers in the U.S. don't turn over as quickly as they do in the U.K., and Progressive's retention has been improving now that it also offers homeowners insurance. People who buy a bundle are more locked in and less likely to switch providers regularly.

I'd also say a word here about company culture. Progressive was founded in 1937 and the founder's son, Peter Lewis, was CEO from 1965 to 2000 and remained Chairman until he died in 2013. The company since 2000 has had two non-family CEO's – Tricia Griffith took over in 2016 – and we don't see any decline in what we still consider an owner-occupied culture. The management and employees have been and remain very well aligned with outside shareholders, with bonuses intelligently based on targets for growth and profitability. It's also interesting that this is the only company we are aware of that reports an abbreviated profit-and-loss statement, along with operational metrics, on a monthly basis. That suggests to us a transparent and confident organization.

You often examine the bear case for any potential holding. What is that here?

JM: There are two main bear cases to consider. Some investors are nervous about Progressive's terminal value as autonomous cars eventually impinge on the need for insurance. The question is about timing and what this means for value. As we model out the ultimate inevitability of a transition to autonomous cars, we think that results in the company's revenues peaking sometime in the mid-2030s. In estimating intrinsic value the significant share of that value comes from the next 10 to 15 years, when we don't consider the bite from autonomous to be that material.

The second bear case is that Progressive's combined ratio has been unsustainably low. That's been salient in recent months as there has been an increased frequency of accidents and higher claims costs, not least from a spike in used-car prices. This pressures underwriting margins across the industry and at Progressive. We believe the company will adjust pricing appropriately and that pricing overall will harden to reflect any change in underlying economics. This should support a reversion in underwriting profitability just as it has many times in past cycles.

The shares are up more than 50% from pandemic lows. How attractive are they at today's price of $107.25?

JM: When we first invested, the P/E was 13-14x so it has rerated somewhat, but the trailing multiple today is only about 15.5x. We are happy to be invested in a competitively advantaged business growing at circa 10% per annum when – even adjusting somewhat for higher-than-normal profits during the pandemic – it trades close to the long-term average multiple of the S&P 500 and at a sharp discount to where the broader market is today.

It's not something we build massively into our models, but Progressive would benefit from increasing interest rates. They invest their float quite conservatively and that would translate into increased investment income if rates ticked up.

You mentioned earlier an increasing interest in emerging markets. What's behind

INVESTMENT SNAPSHOT

Progressive
(NYSE: PGR)

Business: U.S.-based insurer specializing in automobile and home insurance lines sold in roughly equal measure directly to consumers as well as through third-party agents.

Share Information (@2/25/22):

Price	**107.24**
52-Week Range	85.50 – 111.85
Dividend Yield	0.4%
Market Cap	$62.67 billion

Financials (TTM):

Revenue	$47.68 billion
Operating Profit Margin	9.3%
Net Profit Margin	7.0%

Valuation Metrics
(@2/25/22):

	PGR	S&P 500
P/E (TTM)	15.5	23.8
Forward P/E (Est.)	21.0	19.5

Largest Institutional Owners
(@12/31/21 or latest filing):

Company	% Owned
Vanguard Group	7.7%
BlackRock	4.9%
Wellington Mgmt	4.8%
State Street	4.6%
J.P. Morgan Inv Mgmt	3.3%

Short Interest (as of 2/15/22):

Shares Short/Float	1.2%

PGR PRICE HISTORY

THE BOTTOM LINE

Jonathan Mills says it means something when Warren Buffett and Ajit Jain single out the company as a worthy competitor, which they've done at Berkshire Hathaway's annual meeting. He sees attractive upside in owning the stock of a competitively advantaged business growing at 10% per year when it trades at a sharp discount to the broad market.

Sources: Company reports, other publicly available information

your interest in recent portfolio addition Gruma [Mexico City: GRUMAB]?

JM: The company is based in Mexico but makes over 60% of its operating profit in the U.S., where it sells a wide variety of tortillas, tortilla chips, taco shells, flatbreads, sauces and dips under brand names including Mission, Guerrero and Calidad. In core product categories the Mission brand is by far the U.S. market leader. In Mexico, which accounts for close to 25% of profits, the business is primarily focused on corn flour, where Gruma controls three-quarters of the market.

The story here is relatively simple. The company remains family owned and operated – the CEO is the founder's son and the González family still controls just under 50% of the equity. They have proven over time to be very good long-term stewards of the business, focusing appropriately we think on profitability while also investing in new product and market development. The United States has been an excellent market for the company, with continuing tailwinds from a growing Latino community and from health-conscious consumers seeking out what are perceived to be more healthful snacks and meal items. We also believe that Europe is an attractive growth opportunity.

Why would a company like this be mispriced by the market?

JM: As was the case with a number of sellers of packaged foods, the business did very well in the early stages of the pandemic. Our opportunity to buy came in May of last year when the share price fell out of concern over rising corn prices, obviously a key input cost for Gruma. When we looked at history, higher corn prices initially caused some pain, but the company had traditionally been able to pass on the higher prices relatively quickly. It turned out that they were able to do so even more quickly this time and the shares have recovered quite well.

How are you looking at upside from today's price of 283 pesos?

JM: The stock is up enough that it doesn't currently meet our 30% discount-to-value hurdle to buy, but it isn't expensive at 18x trailing earnings and is still materially below our estimate of intrinsic value. It's particularly inexpensive relative to many bigger, beloved consumer stocks that trade on much higher multiples but that, without inflation, are barely growing at all. This is still a consumer name with genuine growth potential that you don't see in something like P&G or Unilever.

Can you generalize at all about where you've historically made mistakes?

JM: One area where we've had issues is when management simply changes its strategy in what we consider a fundamentally negative way. We've spoken with you in the past about Halfords [*VII*, July 29, 2016], which is most recognized in the U.K. as a bicycle and car-parts retailer, but it also has an auto-repair business that it had diversified into in 2010. While we were quite positive on the retail business, we thought the auto-repair business was terrible, that it would never improve, and that the company should offload it.

INVESTMENT SNAPSHOT

Gruma
(Mexico City: GRUMAB)

Business: Production and sale of corn flour and a variety of tortilla-based consumer products; leading brands in top U.S. market include Mission, Guerrero and Calidad.

Share Information
(@2/25/22, Exchange Rate: $1 = 20.35 pesos):

Price	**MXN 282.96**
52-Week Range	MXN 204.97 – MXN 283.80
Dividend Yield	1.8%
Market Cap	MXN 107.11 billion

Financials (TTM):

Revenue	MXN 94.25 billion
Operating Profit Margin	12.0%
Net Profit Margin	6.5%

Valuation Metrics
(@2/25/22):

	GRUMAB	S&P 500
P/E (TTM)	18.1	23.8
Forward P/E (Est.)	n/a	19.5

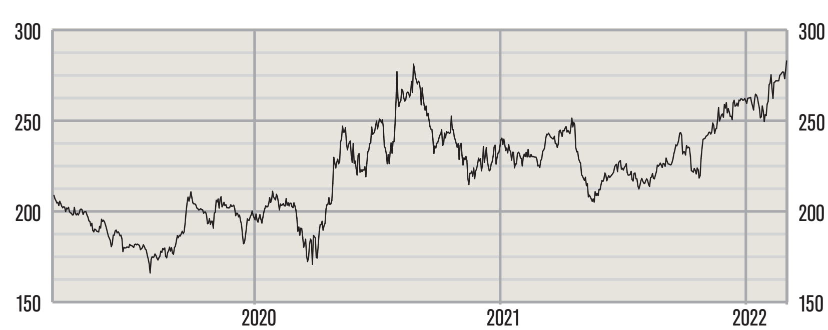
Largest Institutional Owners
(@12/31/21 or latest filing):

Company	% Owned
Southeastern Asset Mgmt	3.3%
Norges Bank Inv Mgmt	3.0%
Artisan Partners	2.8%
Massachusetts Fin Serv	2.1%
Handelsbanken Fonder	1.8%

Short Interest (as of 2/15/22):

Shares Short/Float	n/a

GRUMAB PRICE HISTORY



THE BOTTOM LINE

The company isn't being recognized as a consumer-products leader with genuine growth potential from strong secular demand for its products and from geographic expansion, says Jonathan Mills. The stock today, he says, is "particularly inexpensive relative to many bigger, beloved consumer stocks that ... without inflation, are barely growing at all."

Sources: Company reports, other publicly available information

We made that case to Halfords' new chairman in 2019 and thought he listened with a sympathetic ear, but three months later they announced they were going to radically increase their investments in the auto-center business and reduce their focus on bikes. We exited as the stock continued to go down prior to Covid, and despite it doing fairly well during the pandemic – because of the bike business, by the way – the share price today is still below where it was five years ago. We think the long-term prospects for the auto-repair business are likely to be a drag on the stock for as long as they have it.

This is the type of mistake you can't necessarily avoid, but we're very sensitive to identifying in our due diligence potential strategic initiatives that would derail our investment outlook. With Hargreaves Lansdown, for example, we think it would be a mistake for the company to reduce prices to match lower-cost competitors. There's no guarantee they won't do that, but in order to invest we had to be very comfortable that it wasn't on management's agenda and we continue to discuss this point with them.

SDS: Another idea we've spoken about with you in the past is Regus, the shared-office-space provider that now goes under the name of IWG. It's a holding we pulled the plug on when we saw the wave of money flooding into the business globally, most prominently from WeWork, but also from others. However ill-considered we thought that capital inflow was, we rightly, as it turned out, saw the negative impact that it was going to have on Regus's pricing and rental volumes.

Our sensitivity to that came from an earlier investment mistake in the long-time dominant grocer in the U.K., Tesco. We did not fully recognize the impact on its business from the growth of discounters, led by the German retailers Aldi and Lidl. That experience has made us more attuned and ready to move if we see excess capital coming into a market that we haven't anticipated. That can change the industry economics very quickly.

ON PARTNERSHIP:

He's more glass half empty and I'm more glass half full when we look at opportunities. That's a healthy dynamic.

JM: We're not ready to call it a mistake yet, but one holding we worry about today is Qurate [QRTEA], the parent company of the teleshopping channels QVC and HSN. The stock was down significantly at the onset of the pandemic, seemingly pricing in the destruction of the business well beyond what we considered likely. The business actually prospered as the pandemic wore on, but the company reported a disappointing fourth quarter of last year and the stock is off 60% from its 52-week high, trading on something like a 2x trailing P/E. It is something we're looking at very closely.

SDS: You could say there's a theme to this particular discussion. Each of the three companies we just talked about are retailers. When it goes well it can go very well, but retail is a difficult space to invest in.

It's not that common in this business to see a partnership like yours last long-term. Any secrets to share on that front?

SDS: Fundamentally, Jonathan and I share very similar values and want to build an organization that reflects those values. While working in larger companies, we both hated the negative impacts of office politics and have tried through the people we hire and the culture we model to avoid all that. Everyone is incentivized through an equity program, not linked to the performance of their specific ideas or how many stocks they get into the portfolio. We have a "no blame" culture and we want people to admit and learn from mistakes. If we didn't have a meeting of the minds on those sorts of things it would be very difficult.

On the research and decision-making side of things, Jonathan is probably more glass half empty and I'm more glass half full when we look at opportunities. That's not always the case, but it's generally a healthy dynamic to have. We also will never make an investment if we both don't agree, and if either of us wants out of a position, we're out. That builds a conservatism into our process that we think has served us very well.

JM: This is a job you can never perfect. Technology changes. Competitive environments change. Market sentiments change. There are always new and fascinating things to learn. That's all very challenging, but it's difficult for either of us to imagine a more interesting way to make a living. There's a shared passion there which is not dissipating. VII