Vantage Investment Research

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"The Intelligent Investor's Unfair Advantage…"

Investor Vantage Report

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China...Does It Really Matter?

"There's too much emphasis on macroeconomics and not enough on microeconomics. I think this is wrong. It's like trying to master medicine without knowing anatomy and chemistry."
Charlie Munger

Since the recent correction, we've seen a bevy of reasons why the market is falling: interest rates might increase, China is falling off a cliff, here comes 2008 again. I thought it would be an important discussion and, at the very least, clear some things up regarding China as a "reason" for the U.S. market decline.

Media reporters are just doing their job, however, it causes them to 'latch-on' or try to find certain "things" to justify any recent move in the stock market. Essentially, their job is to stay busy for the sake of being busy. If they can't' find a news story to talk about, they are out of a job. They are forced to talk or write about something (regardless if there is a legitimate news story or not). I have a simple reaction to almost any reason for a broad market pull-back —- *it doesn't matter!* And it's a waste of time to try to figure it out. An investor's time is better spent on things that can bring about tangible results to your investing. Leave the sound bites and headlines for the media. Know where you might be in the cycle and focus on your businesses and their competitive positions in their markets. The businesses will tell you what is going on in the world and whether (or not) they are worthy of your investment.

Lets get back to China being the reason for the U.S market pullback. Nearly every headline we've read lately has put a sense of panic in the air that China's economy is falling off a cliff. This just isn't true! China is actually growing. It may not be growing at the rate it once was (10%). Instead it's growing dismally at 7%. I know, what a horrible economy. The U.S. may never grow at 7% again and we're complaining about ONLY 7% growth. I understand that Chinese numbers aren't the most trustworthy in the world, but, despite the conspiracy theorists, the truth probably lies somewhere close to this number.

ON STAYING FOCUSED
"Know where you might be in the cycle...Leave the sound bites and headlines for the media. Focus on your businesses and their competitive positions in their markets."

But what if the Chinese slowdown continues?

It doesn't matter. Less than 1% of our Gross National Product (GNP) is in sales to China. China is an incredibly small percentage of U.S. exports, however it's a much larger percentage for other counties. This again puts the U.S. at a major advantage, not disadvantage.

Obviously, if China disappeared tomorrow, it could be a big issue. But alas, China is growing. We will actually go out on a limb and put a fairly high probability on China being around for some time to come. Not only that — we'd even be willing to bet that they continue to grow well into the future as their lower class citizens make their way to the middle class.

If China doesn't matter, why is the U.S. Stock Market in correction mode?

I don't know (no one does). It could be a whole host of reasons. Maybe, the Chinese market selloff brought to light that U.S. earnings peaked months ago, we were on the upper echelon of historical and absolute valuation levels. In addition, the market hasn't had seen a bear market since we bottomed in 2009. The market moves in cycles and we're probably closer to a deleveraging cycle than not. The pullback we are experiencing shouldn't be a surprise to anyone.

Should we be buying hand over fist right now?

I don't know (no one does). Regardless, I am using this opportunity to add to my favorite ideas slowly. We could easily go lower and I hope it does so we can buy more of our favorite businesses at bigger discounts to their intrinsic values.

Happy Labor Day!

Christopher P. Bloomstran — Semper Augustus

Chris Bloomstran explains his evolution as an investor, his daily rituals, how he views Berkshire Hathaway as his opportunity cost of capital, one of his biggest investing mistakes, and why he sees upside in Orkla, Subsea 7 and Berkshire Hathaway.

Chris Bloomstran

Chris Bloomstran, CFA, founded Semper Augustus in 1998. Chris employs a value-driven research methodology. He evaluates businesses just as a private investor would do when buying an entire company. Semper Augustus is a fundamental investor managing concentrated equity portfolios of well-run, well-capitalized businesses with share prices trading below their conservative appraisals of intrinsic value. They go where the value is.

Currently, Chris is finding opportunity abroad, with two interesting investment ideas in Norway (Orkla and Subsea 7). He's also finding value in Berkshire Hathaway. All three companies featured are all exceptionally well capitalized and high quality businesses trading at discounts to their intrinsic values.

Tell us a little about Semper Augustus?

Chris Bloomstran: We founded Semper Augustus in late 1998. Massive bubbles in portions of the stock market were obvious, to us anyway, and we were acutely aware that launching an investment firm at that time might go down as akin to building golf courses in 1929. Specific to the late 1990's, a replay of the 1972-1973 Nifty Fifty had developed, with the bluest of the blue chips attracting huge capital flows while smaller company shares were being liquidated. The 'tiering' within the market was profound. A parallel and longer lasting bubble in TMT names (Technology, Media and Telecom) was underway as well. The era's insanity was ultimately marked by a hyperbolic mania for everything Internet. To subtly announce to the world that we "got it", that we recognized the folly around us, we named the firm after the most highly valued of the tulip bulbs in 1637 Holland. I had read Charles MacKay's Extraordinary Popular Delusions and the Madness of Crowds years earlier and loved the historical and modern day significance of the Tulipomania and other manias over time. It seemed the destined to fail Internet names would go down as the Semper Augustus of the day.

It ultimately turned out to be a great time for our approach. We had clients at the outset who had portfolios of blue chips which had been purchased in the wake of the 1929-1932 stock market crash by a very smart individual. His is a great story in and of itself. This particular client liquidated his family's stock holdings in early 1928, as well as those of his brokerage clients willing listen to a twenty-something investor preaching about a growing stock market bubble. While painful to watch the market nearly double over the next year and a half, he was ultimately right and waded back in in 1932 and 1933 when England and the U.S. went off the gold standard, buying companies like GE for less than their unlevered cash on hand. He managed his family's capital for the next six decades, picking up new companies like Wal-Mart along the way. I had the great pleasure of meeting Mr. Smith; he had heard I had serious reservations about equity valuations and a building debt bubble. We spent lots of time together discussing the markets, our respective thoughts on the businesses we each owned, and our respective approaches to investing capital. We shared such a common outlook and philosophy that he ultimately hired me as the first outside advisor to the family, turning over the reins to help intelligently liquidate the low-basis, very overvalued portfolios and reinvest the proceeds in the shares of smaller, better run businesses that were getting cheaper as the market narrowed. He was getting older and wanted someone who could help preserve and grow his family's assets as he had done for so many years.

With some tax efficient strategies we were able to cull out businesses that had grown less attractive over the years, many with inferior returns on capital and operating in staid industries. Selling businesses like Kodak and the RBOC's for huge multiples to profits and buying smaller, well-run, well-capitalized and growing companies was a no-brainer. It was a great time for us. We managed to have cash at a time when many managers were facing ongoing redemptions for failing to keep up with the mania. By the market peak in 2000, we pegged fair value on the S&P 500 at just under 600 (market price was over 1500). The rest is history. We, like many value oriented investors, saw our portfolios significantly rise in value over the next couple years while the markets tanked by 50% for the S&P and 80% for the Naz. It was a privilege to spend lots of time with a great man until his passing in 2002. He was a saint of a man and an outstanding investor. Hearing about his experiences navigating a century of financial and world history was a career and life highlight.

ON DAILY RITUALS:

I try to offset the structure of running the firm with an unstructured research process! One thing I've done ritualistically is keep most mornings free of meetings or calls and read in depth...All the while I think I'm building cumulative knowledge that is required when opportunity presents itself.

Has your view of investing evolved over time?

CB: I think my view of investing has evolved pretty similarly to that of many value investors. It's funny to read Mr. Buffett's history of his evolution, beginning with things like candlestick charting. I was a "serious" candlestick charter at the tender age of 20. I had switched to the business school from mechanical engineering when I fell in love with reading the Wall Street Journal. Differential equations didn't spark the same interest as the business paper. I really don't even remember why I started reading the Journal but it probably had to do with thinking I better figure out how to invest the billions I would make playing in the NFL, a dream that never panned out thanks to a broken foot. I had a tiny surplus from a scholarship, which seemed like a fortune at the time. I was heavy into charting and had recently become a devotee of Bill O'Neil's CANSLIM method.

A tip from the Heard on the Street column sounded like easy money. I remember doing "primary research", which involved looking at a series of quarterly earnings per share numbers and noting the stock of interest had "broken out" and was at a new high. All signals were go. I walked into a small retail brokerage office in Boulder, found a broker willing to let me put half of my money in my little Norwegian oil shipping company called Nortankers. He advised against it - but still gladly collected the commission which totaled more than 10% of the purchase price. As it turns out I never had to pay the back end of the commission. Shortly after buying Nortankers, the Iraqi army rolled into Kuwait and commandeered two of the company's four VLCC's (Very Large Crude Carriers). The company quickly failed. It was probably the best thing to happen to me. Instead of blaming the Journal, Saddam Hussein or the sophomoric CANSLIM system, I rolled up my sleeves and dug in for the why.

I obtained and read several years of the company's annual reports and other filings and was quick on my way to becoming a fundamental investor. Over the next few years I read every book I could find on investing, working through the CU business library and new releases at the Tattered Cover, Denver's then great independent bookstore. At a point I found *Security Analysis* and *The Intelligent Investor*, which ultimately led me to Mr. Buffett.

Ultimately after several years of reading everything about investing I could get my hands on, I developed what I guess you could call a relational perspective. After hours and hours of thinking and reading, a light went on and it made sense that everything in an economy, in an industry and in a company had to relate to each other and had proportional limits and bounds. It sounds simple and it is. At the top, individual country GDP's combined to make up global GDP. But deeper, corporate profits ranged over time and not only had to be some fraction of GDP but had to be a logical proportion. The market value of a country's stock market had to relate to its GDP. Individual industries grew and shrank as a percentage of the broad economy over time. I needed to know why. On a company level, the various expense lines of an income statement had to make sense and tie out to the balance sheet and cash flows. The world's financial components to me all not only needed to fit together but did. I developed a proportional sense of the components of an economy. I became a better company and industry analyst for that and developed a pretty good view of the macro along the way.

What does your day normally look like (from beginning to end)? Do you have any daily rituals that help you keep your investing edge?

CB: Every day is different but there are certainly routines. I try not to keep a regimented daily plan but instead keep the research day free to work on whatever makes sense or comes up. It's very much an ADD approach but it gives me the freedom to look at lots of things or to sit and work long hours, or a day, or a week or longer on an industry or an individual business. My process undoubtedly drives Chad crazy. He's cut in the public accountant / auditor cloth and organizes his schedule and that of our staff by what seems the minute. Very task oriented. For that, we run an extremely efficient and thorough back office.

I try to offset the structure of running the firm with an unstructured research process! One thing I've done ritualistically is keep the first part of most mornings free of meetings or calls and read in depth the Journal, the FT, the Times and skim the local sports page. I have a couple news assimilation sites I read every morning as well. Jim Bianco's is terrific. I usually spend a few minutes with Zero Hedge, which is a little out there. From there I'm into my routine of working on whatever makes sense or pops up. Most of my time beyond the newspaper portion of the morning is spent working on companies and industries. My company specific reading runs the gamut from K's and Q's, quarterly earnings call transcripts and presentations. I utilize various industry specific filings and publications. Value Line company pages, both the large cap and small cap weekly editions, are an easy way to keep up on lots of public companies and industries and the competitive landscape of the businesses we own. These rituals build cumulative knowledge that is required when opportunity presents itself.

Are you able to "shut-down" your investing brain or separate it from your normal life on the weekends?

CB: My weekends are completely different today than they were in the BC years, that is before children. We have a high school freshman and a sixth grader. Both are very involved in their respective sports and activities.

ON LESSONS LEARNED FROM SPORTS:

I was fortunate and blessed to have the privilege of learning from a few men not the game of football but the values of team, commitment, hard work, overcoming adversity, bravery, honesty, sportsmanship and fun.

I spent their younger years coaching a myriad of their teams and have thankfully retired from coaching all but my son's football team. The kids sports are involved enough to allow for the investing brain shutdown you mention. But between games I still spend the majority of most weekends reading.

Over the years I have learned to compartmentalize my reading. I do most of my company research at the office. I spend my weekends reading the candy, the fun publications I love to read but have to set aside for the weekend so as to not distract from the real business research. My weekend reading list hasn't changed much for more than twenty years, though the leisurely Saturday morning reads over coffee and a bagel at the cafe are long gone. Barron's is a great read. The Journal launched a weekend edition many years ago, so I'm now compelled to read that too. The weekday would have been enough, though Peggy Noonan has a column in the weekend edition which is terrific. I skim the FT weekend and the Sunday Times too.

Other general reads are the *Economist,* which would be better as a monthly, and the *National Review*. There are a handful of newsletters which I have faithfully read forever and which are indispensable to keeping up. I love Marc Faber's *Gloom, Boom and Doom Report*, Jim Grant's *Interest Rate Observer,* Jack Ciesielski's *Analyst's Accounting Observer,* and Fred Hickey's *High Tech Strategist*. Joe Koster has a blog he calls *Value Investing World* which is wonderful. One of my favorite reads, including all of the extras she has every couple weeks, is Kate Welling's *Welling on Wall Street*. I'm guessing your format is similar to Kate's. Great in-depth interviews with investors worth listening to are worth every cent. I also try to keep up with the periodic writings of various investors and strategists. The best are Van Hoisington and Lacy Hunt's quarterly letter at Hoisington Management, which is an ongoing treatise and refresher on economics and common sense, Jeremy Grantham and his group's work at GMO, Jeff Bronchick and Ben Claremon's letters at Cove Street, as well as John Hussman's letters. Seth Klarman's letters are always great when I see them.

Chad is a voracious reader of business and non fiction books. He reads something like 30 or 40 books a year. I'm lucky in that he sends me his top five or ten so that's a nice filter there. That's really the bulk of my weekend reading. I never really formally segregated the weekend candy from the weekday company work, but that's the way it needed to evolve, lest the former intrude too much on the latter. I suppose when the progeny head out into the real world I'll get my Saturday mornings back at the cafe...

What's a little known secret about you that no one knows?

CB: This has absolutely nothing to do with investing but it's funny, at least now it's funny. The most impressive mascot in college sports is of course Ralphie at the University of Colorado. The famous buffalo leads the football team onto Folsom Field for every home game. She also travels to bowl games, which sadly hasn't happened in years. But back in the day she was on the road every year, including 1989 when we played Brigham Young in the Freedom Bowl in Anaheim. Southern California has a funny kind of grass. Golf broadcasters call it kikuyu grass, known for being thick and spongy.

Well, the end zones had been recently painted with each team's name, and the paint had hardened and was like a shell on top of what must have been kikuyu. We had longer cleats to deal with the thick, spongy grass. You can probably guess where this is headed. With a national TV audience, I made sure I was near the front of the team following Ralphie onto the field. I was of course the idiot who got his cleats caught in the black and gold crust, and not only did I go down, but my epic fall created a huge pileup of at least twenty teammates. Nobody that fell with me thought it was very funny because it was on National TV. We laugh about it today. Thank goodness it was before YouTube!

Who are the people that inspire you the most? And why?

CB: Of course you have to appreciate and be thankful for your parents. Growing up I saw little other than work, and learned the importance of outworking everyone. We didn't really do weekends. We did have our sports, but leisure activities weren't part of the Bloomstran household. My step-father to this day runs a successful elevator manufacturing and service company on the west coast and still works all day, every day. He invented 24/7/365. My memories of Christmas Day are opening presents by the tree while my Dad manually wired electric control panels for elevator cabs at the dining room table. I'm also inspired by my wife's compassion and also by the joy with which my kids live life.

But beyond my family I will forever be indebted to a handful of youth and high school football coaches that taught me the game of life. I was fortunate and blessed to have the privilege of learning from a few men not just the game of football, but the values of team, commitment, hard work, overcoming adversity, bravery, honesty, sportsmanship and fun. Everything I learned from those guys carries over to the investment arena. I mentioned that I coach youth football today. Giving back in that way is as gratifying as anything I have done or accomplished in business and in investing. I'd tell any young analyst or investor, anybody driven and hard working for that matter, to at some point in life reflect on who helped mold you, to emulate those mentors and to find a way to give back to the next generations in a way those role models did for you. I try

ON DUAL MARGIN OF SAFETY

We place a huge premium on business durability and are extremely price conscious. We say our mantra revolves around a dual margin of safety, that of business quality and that of price.

to give back in the investment community for sure, by mentoring a handful of business students. I've been involved with our local CFA Society here in St. Louis for a long time. I particularly love working with college kids.

Security Analysis, The Intelligent Investor and even Margin of Safety are very popular must reads for any investor. What are the top 3 books people don't talk about, but one's that you would recommend to an investor?

CB: Well those are certainly the biggies. If you included Phil Fisher's *Common Stocks and Uncommon Profits* you would have the Big Four! I can't count the number of copies of *The Intelligent Investor* I've given to clients, friends and students. It's the best investing book not only for pros but even more so for the lay. Surely all of the Wiley Investment Classics are worth reading. The best of those are Phil Caret's *The Art of Speculation*, Gerald Loeb's *The Battle for Investment Survival* and Fred Schwed's Where are the Customer's Yachts? But all of the Wiley books are great. I mentioned Mackay's book earlier. Another must read in the same vein is Charles Kindleberger's *Manias, Panics and Crashes.*

One book that gets little mention outside of Austrian Economic circles, but is one of the best books ever written, is Henry Hazlitt's Economics in One Lesson. It's up there in my opinion with *The Intelligent Investor.* The book should be required reading for not only anybody charged with shepherding client capital but, perhaps more so, for any appointed Federal Reserve Director, Fed regional bank president, staff employee, janitor, anybody in central banking really, and certainly for any elected official headed to Washington or to a state capital. It's an easy read and is the best book on economics I've ever read. Like Graham's Classic, I've also given away countless copies of this gem. You also can't leave out the compilation of *Mr. Buffett's Chairman's letters* - required reading in my opinion. I think a series of bound editions can still be ordered on Berkshire's website. They are also on the website as individual PDF's.

A couple of other great business books are Amity Shlaes' *The Forgotten Man* and Arthur Herman's *Freedom's Forge*. Both books span the Great Depression through the period leading up to World War II and both are a testament to the necessity of limited government. FDR's control administration is examined for what it was and not as the revisionist's champion of the strong state. Both books are impossible to put down.

What is your philosophy and process to investing? How do you search for investment opportunities and what are your criteria for investment?

CB: The approach and the philosophy are very much value driven, recognizing that growth is an integral part of the value equation. We place a huge premium on business durability and are extremely price conscious. We say our mantra revolves around a dual margin of safety, that of business quality and that of price. Measuring the intrinsic value of a business or asset is what it's all about. We run concentrated portfolios of generally not more than 30 names. We often concentrate heavily at the top. Berkshire has been our largest holding since our early 2000 initial purchase. Subsequent well-timed purchases at nice discounts to fair value, plus the growth of the business and naturally of the share price make that single holding quite large.

Our turnover averages less than 20 percent annually, though in 2008 it was manic, for us at least, at around 80 percent. We are wary of leverage and the balance sheets of our portfolio companies are in aggregate far superior to that of the broad market. Many of our businesses maintain net cash and are not good clients of the investment bankers. We highly value quality management and look for managers that understand the underlying intrinsic value of their businesses. Free cash returns on capital drive the bus. We read very little sell side research, instead relying on a fundamental, bottom-up process.

The search for investment opportunities is really just the byproduct of years and years of reading. We have an idea of what a great business looks like and have the patience to wait for the right price. The downside of the price discipline is that we often fail to own some businesses we have admired for years, for decades even. I guess those are the errors of omission. We've also sold some businesses just for price reasons that we regret selling and not buying back.

Is there a portion of your investment process or philosophy that you would consider unique?

CB: I don't know how unique it is but the thing that stands out to me is how uncomplicated we make the research process. I maintain an intrinsic value estimate for each business we own (or close to owning). That's where the heavy lifting and thinking comes in. We normalize free cash returns on capital. It's an involved process. We are very careful about cleaning up GAAP or IFRS earnings for things like aggressive pension accounting, merger accounting, write-offs and write-downs and for non-cash compensation. We think about whether depreciation schedules make sense and try to get a realistic estimate of long-term normalized maintenance capex.

Estimating the rate at which our businesses grow is hugely important. We're trying to get at organic growth and how much growth comes from retained capital and how profitable that retained capital is over time. Share buybacks are measured against our

ON PRO FORMAS AND DCF MODELS:

We don't maintain financial statement models but we spend countless hours thinking about them...I've found over the years the modelers adjust the inputs to suit their desired outcome.

appraisal of the business and go to the quality of management. We reconcile net profits to capital and then operating profits less maintenance capex to enterprise value. It's staggering how many professional investors talk about net income, earnings per share, quarterly earnings misses, profit margins to sales and things like that but have no clue how much real capital is employed in the business or how levered the equity of the business is. It's staggering, shocking, but I think it gives us and our ilk a huge competitive advantage over time.

The process requires hard work and critical thinking to be sure, but it doesn't need to be complicated. It's far from it. We don't maintain financial statement models but we spend countless hours thinking about them. We don't run DCF models but we deeply understand the inputs of valuation. Terminal growth rates ten years out? Give me a break. I've found over the years the modelers adjust the inputs to suit their desired outcome. Go back and look at Alice Schroeder's 1998 report on Berkshire. It was a joke. She had no clue how to value a business. It's the simplicity of the approach but the focus on the right things I think that make the process here unique. It doesn't require an army of analysts or even a committee. It requires tons of reading and thinking about the right things. You have to ask the right questions to get the right answers.

Do you have interest or expertise in a particular industry that you would call your "circle of competence"? Or are you more of a generalist in search of value or market inefficiencies?

CB: I've always said we're generalists and we are. We don't limit our universe by market cap, geographical boundary or industry. At times, like the late 1990's, we owned largely small and mid-cap domestic businesses because that was where the value was. By 2007, we were more large-cap oriented, again, because that was where the value was. We have a sizable investment today in Europe. Are we spreading ourselves too thin, reaching beyond a circle of competence? I'd say definitively no. Businesses are businesses are businesses. The process I just described doesn't apply to companies of specific size or where they happen to conduct business or have their headquarters. Medtronic isn't a different company because they claim a different home office.

I will say that if you look at a pages long history of our transactions or snapshots of our portfolios over time you will see certain industries far more represented than others. We've absolutely had more of our capital invested in property casualty insurers and reinsurers over time than any other. Berkshire is obviously a big part of that but we have maintained significant positions in a number of other very well run insurers over the history of our firm. Most we have owned for years. The accounting and regulatory conventions are very unique and we have spent years trying to master them and staying current. We do so from a user's standpoint but our grasp here is pretty good, I think, particularly for a non-operator. The P/C industry is comprised of a handful of studs and lots of duds. I think we've been fortunate to mostly own the studs. The beautiful thing about the industry is that it is rarely expensive. Because the aggregate winds up only being mediocre at best, valuations across the swath wind up generally being on the cheap side. At times they get dear and we've done a good job trimming our holdings at those times.

Describe your value discipline once you have arrived at an understanding of the Intrinsic Value of the business? Is there a certain discount from intrinsic value when you start to get interested?

CB: That's a great question, and it really gets to the heart of how we manage capital. Nobody ever asks it. Everything revolves around our appraisal of fair value. I've already waxed on about our dual margin of safety approach, and the intrinsic value is really the price piece. Businesses that are more complicated, more levered, more uncertain as to the permanence or durability of their franchise, or even those that we're not as fully up to speed on, simply get a lower intrinsic value until our understanding and comfort level grows. Everything we do is generally on the conservative side.

Once we've established an affinity for a business and have determined our appraisal of fair value, on principle we never pay more than our appraisal. There's no magic discount at which we start buying, but it's seldom more than 90%. At 90% the upside slightly outweighs the downside. We invariably start small, most of the time at one percent, sometimes at two, and, occasionally in special or unique situations, sometimes far greater. Typically at one or two though. Then, and new clients have a hard time grasping this concept, we hope the price declines absent a deterioration in the fundamentals (and in our appraisal).

We always want to make a small position in a high quality business larger and the most intelligent way of getting there is to buy at a bigger discount. The worst way to get there is to have a really attractive small position accrete immediately to fair value or above. Everyone loves a quick buck but huge returns on small positions don't move the needle much.

As a recent example, we had long wanted to own Precision Castparts, a fantastic business, and loved taking a one percent position about two months ago, readied to increase the position size as the price declined below our $205 per share initial purchase. We rued and lamented Berkshire's announced takeout at $235 per share. It was a nice return in a short period of

ON ZIRP EFFECTS ON THE STOCK MARKET

ZIRP (Zero Interest Rate Policy) and an unwritten mandate to gear monetary policy to the level of t he stock market has necessitated a bending of historical valuation yardsticks but also higher allocation to stocks for otherwise balanced portfolios.

time but way too little, way too soon. We do have certain unwritten guiding principles, (rules are too strict) about keeping positions in smaller businesses or in less liquid securities on the smaller size. In general, however, the higher the quality of the business and the greater the discount the more willing we are to concentrate higher. Berkshire is an extreme case in which we have had on the order of a third of our capital invested in the business. We really use Berkshire as our cost of capital. We measure business quality and upside/downside, effectively the discount to fair value and the expected return over multiple horizons against our long-term expected return in holding Berkshire shares.

Today, at the current price, we expect to earn north of seven and a half percent annually over a long horizon holding Berkshire, so competing investments need to expectedly outpace that threshold. Berkshire's long-term expected return, and that of any business we own, is totally dependent on the current price. As example, Berkshire's shares are down about ten percent this year. The business hasn't seen a ten percent diminution in its intrinsic worth so our expected long-term return is very slightly greater than it was on January 1. Conversely, Berkshire's shares were up 27% last year, yet the fair value of the business grew nowhere near as fast. Thus, our expected return from owning Berkshire over the years was slightly lower at the end of 2014 than at the end of the prior year. Ditto for the two prior years when the stock was up 33% in 2013 and 17% in 2012. If only pension actuaries employed the same approach...

That ephemerally covers sizing on the buy side. On the flip side, we sell or reduce position sizes accordingly based on their intrinsic value, as well as on their expected upside/downside relative to other positions or opportunities. We also sell when we're wrong on the fundamentals. We have classically reduced position sizes as prices approached fair value and were generally gone at intrinsic. With some portfolios we use covered calls to help reduce and scale out of positions approaching fair value, just as we sell puts to initiate or help add to positions. The conservative selling of option premium around our intrinsic value philosophy lowers risk, increases income and allows us to trade around our positions. But our somewhat rigid approach to trimming and selling has necessarily been tempered of late thanks to the Bernank and now the Bank of Yellen.

In the last few years we have allowed some of our positions to trade north of our conservative appraisals. Central bank policies and stimulus measures have thrown a monkey wrench into the valuation engine. ZIRP (Zero Interest Rate Policy) and an unwritten mandate to gear monetary policy to the level of the stock market has not only necessitated a bending of historical valuation yardsticks, but also higher allocation to stocks for otherwise balanced portfolios. Reducing position sizes at, say, 15 or 17 times normalized free cash earnings, or at prices that exceed our adjusted shareholder's return on capital (if you have a floor rate of return of 6%, then don't pay more than twice capital for a business earning 12% on capital), has meant bending the boundaries upward. We've allowed our investments in our global, branded consumer businesses in particular to trade at prices above what we consider normalized valuations.

But discipline is discipline and we have been downsizing these otherwise outstanding franchises at prices that make little sense in any environment other than during hyper-inflationary episodes. In fact, and this will get tangential, but the notion that sustained low interest rates warrant higher valuations requires inspection. I'd argue the "terminal multiple", which would be the price paid for the terminal growth rate from the DCF academicians, is lower, way lower, like single digit, in a world that won't and can't grow sans increasing debt levels. But expanding on this tangent would require a conversation into tomorrow at least.

What was the worst investment you've ever made? What happened, and how could you have kept it from happening?

CB: That's a fun question! Really, all of this talk about how wonderful our process is would have you believe we're devoid of mistake — Hardly. This business teaches humility. I mentioned that seventeen years into doing this as Semper Augustus we have pages and pages of transactions, despite pretty low turnover. On those pages you will find a number of mistakes. The number is fortunately a fraction of the "winners", but their existence is the nature of the beast. The great thing is that, I think due to the process and our conservatism, nearly all of our mistakes have been small. The small handful of biggies not only jump out but also have left an indelibly bad taste in the mouth that never goes away. Until the last couple years I would have told you an ill-fated investment in Williams Communications during the unwinding of the tech bubble was far and away the worst investment I ever made. Williams Communications was a fiber network which had been spun out of Williams Companies. Williams had built and was still building a vast fiber network with the advantage of being able to lay the network alongside their vast system of pipelines. Competitors similarly used their railroad rights of way. The energy business had previously sold their telco business, WilTel, to LDDS, which eventually became Worldcom. They retained a small piece of the fiber network which they set to expand and ultimately rebuild the WilTel business after a non-compete ran out. I attended an investors meeting in Tampa with the top brass from both the energy business and the fiber business at the time of

ON LEARNING FROM YOUR MISTAKES

...we're going to make mistakes, but not only should we learn from those mistakes, but, should use those mistakes to remind us to stay within our circle of competence.

the IPO in 1999. We had a position in the energy business and that's really why I was there. In the room were the managers from the Janus Funds, all of them, keenly interested in the fiber business. That was a red flag. The company had amassed something like $7 billion in debt to build out the network, and all of the math I did on the company convinced me they would never, ever produce a return on capital of any kind.

The IPO came at something like $40 per share, and the business had revenues of about $2 billion and cash of $1 billion to go with the $7 billion in debt. We seriously laughed at the fools destined to lose their money — and they did. Later the next year the stock had dropped to $4 a share, a 90 percent haircut. That's when we decided to make a quick buck on a dead cat bounce in the wake of the bursting of the tech bubble and joined with the fools. We looked at the cash in the bank, $1 billion, next to the cost of building out the network, and decided we had plenty of time to catch an upward spike and make a quick buck. I won't bore you with what I think was a massive fraud perpetrated at the hands of management.

Needless to say, we endured a permanent loss of capital, selling our stake for a small fraction of our cost. It's important to recognize that $4 to zero is the same as $40 to zero in percentage terms. As a footnote to the story, Berkshire actually entered the picture later on behalf of the energy business which had gotten upside down. Berkshire extended credit to keep Williams Companies afloat at the usury rate of 34%, and as a kicker picked up the Kern River Pipeline, now a crown jewel in Berkshire's regulated utility business. As a second footnote, Leucadia purchased the assets of Williams Communications out of bankruptcy, and with the deal inherited the company's vast tax loss carry forwards. I take some solace, little really, in having owned both Berkshire and Leucadia and thus ultimately redeeming some value from the experience. The pain still stings, however.

But as I mentioned, the too long tale of the Williams Communications speculation is probably not the worst. A gold position over the past three or four years has been very expensive and, at least for now, is a real black eye. I started buying gold mining shares in the late 1990's at favorable prices as gold was reaching its nadir near $250 an ounce. We made money and sold two of our three positions, Barrick and Kinross almost perfectly in early 2008. We kept a position in Newmont. As the globe's central banks have gone back and forth with rounds and rounds of QE, we built a position back into Kinross, added to the position in Newmont, and more recently initiated a position in Goldcorp. We have owned the miners as a proxy for gold. The gold position serves as a presumed hedge against central bankers gone wild. All the while we never believed gold mining to be a great business.

To justify owning the businesses you have to do mental gymnastics to justify paying for unknowable cash flows. That's the nature of commodity businesses. Ore grades are lower every year. The low hanging fruit is long gone. The cost of production is never fixed, but rises at times faster than the price of the underlying commodity. Management teams are anything but superior. Add it up and it becomes tough to justify a losing position over what seems an eternity to clients. I really do believe there is no positive endgame to the Keynesian experiment underway. Debt levels remain unserviceable under any normalized yield curve. Weimar seems closer by the day.

If we were running just our families' money I wouldn't sweat the losses in gold to date. But the percentage losses are large enough, especially with Kinross, to wonder if there remains enough upside to even see break even. We're not throwing in the towel at all, but with the position size greater as a percent of capital than with the Williams fiasco, it's fair to say that investing in gold miners over the past few years has cost some real and reputational capital. That said, even though they are down, the systemic risk we are trying to partially hedge remains front and center. We maintain the position and think it's the right thing to do. In retrospect, the common thread between the permanent loss of capital in Williams Communications and the not permanent but not insignificant unrealized loss in the golds is a deviation from the processes we just talked about. We jumped the rails away from buying great businesses at good prices, in one case trying to make a quick buck on a wasting asset, and in the other compromising business quality and even price for what we believe to be a rational and necessary hedge. I guess the upshot is we know we're going to make mistakes, but not only should we learn from those mistakes, but should use those mistakes to remind us to stay within our circle of competence.

What was the best investment you've ever made? What happened?

CB: Thanks for changing the subject! A too easy answer would be a follow-on to your earlier question about great books. I think Mr. Buffett said something similar already, but the return on investment from my original purchase of The Intelligent Investor is nearly infinite and is still compounding. A second lay-up would certainly be our original purchase of a large position in Berkshire in early 2000 at an average cost of $43,750 per A share. But you're probably looking for something more glamorous and sexy. A couple come to mind because they have similar characteristics to the purchase of the book and to the 2000 purchase of Berkshire - the best investments are those with

ON LOW RISK-HIGH RETURN INVESTMENTS:

..the best investments are those with no downside risk and huge upside reward. It's a combination that does exist from time to time and throws the classic risk reward efficient frontier curve as well as the efficient market hypothesis squarely on their respective academic pointy heads.

no downside risk and huge upside reward. It's a combination that does exist from time to time and throws the classic risk reward efficient frontier curve as well as the efficient market hypothesis squarely on their respective academic pointy heads.

You may remember when several of the big private equity guys launched mezzanine funds. Leon Black's Apollo Management was the first to bring a fund to market. Apollo Investment Corporation raised something like $900 million in an IPO in early 2004. The fund priced at $15 per share, which after underwriting fees netted $14.10 to the fund. Well, when the KKR's of the world saw how easily Apollo raised nearly a billion, they and several others quickly filed registration statements to bring their own mezz funds. With substantial immediate competition potentially coming, I think the syndicate that brought AINV public tried to dissuade the competition from going public by allowing the price to not only trade below the IPO price but below the netted value. We looked at the price below $14.10, which obviously was all cash early on, and saw a virtually risk free opportunity. Apollo's plan was to build a two-to-one levered mezz portfolio over time, and to generate early returns by parking cash in senior secured paper. We had no interest in being in the mezzanine lending business long term, but given the timeline of reasonably putting the money to work, the notion that new loans don't generally fail right away, and the overarching fact that the $14.10 was all cash at the start, a short-to-intermediate investment made sense. The stock traded into the low $13's per share. I called Chad and asked him how much cash we had. After explaining that I meant ALL cash in ALL client accounts, we quickly added it up and put most of that cash to work at about $13.10, almost 90 cents on the dollar of the cash in the bank at the fund. It was reasonable to assume that given the anticipated leverage and yields at the time that the earning power was at least $2.00 per share, 90 percent of which would come as dividend. We figured the stock would conservatively trade at least at ten times. The risk free trade played out as expected. We sold all of our shares in less than two years in the low 20's and didn't regret selling early and leaving money on the table as the stock briefly continued higher. In the 20's the longer term risks, namely underperforming loans, outweighed any further upside, and time works against high-yield leverage. The stock was around $6 the last time I looked.

The second low risk, high returner that comes to mind were a series of investments made both on the coattails of Mr. Buffett but also on the other side of Mr. Buffett during the financial crisis. We've never done much with utilities outside of Berkshire's investments in the industry. When Berkshire, through their MidAmerican business, offered to bail out Constellation Energy in 2008 by agreeing to acquire them, we did some quick digging and determined that Berkshire, as has often been the case, was getting a deal far below fair value. Constellation had an unregulated wholesale merchant business in Texas that had gotten upside down in their derivative book. Berkshire's offer to buy all of Constellation, which was the big Baltimore electric, included an immediate $1 billion dollar preferred investment in the unregulated Texas business to shore up the book and wind down the exposure. The work we did on the company had Berkshire buying Constellation for $26.50 per share, and our hastily put together fair value work up had fair value closer to $40. In any event, with the wholesale book now backed by Berkshire, we used a portion of our cash on hand to buy Constellation shares at $24 to just long arb the upside to $26.50. Utility acquisitions can take a long time to close but there was plenty of spread given overall market volatility during the unfolding crisis.

On a daily basis it seemed the market was reacting to news and rumor and fact checking later. Not long after we bought our Constellation position a German news wire announced Constellation was considering filing for bankruptcy due to insolvency in a Texas merchant subsidiary. It was old news that somehow was just being mistakenly released. The stock started tanking. The Constellation sub already had Berkshire's $1 billion. The story was old and wrong. I called Chad and asked how much cash we had. No explanation needed this time. We put the majority of our cash to work in a matter minutes at prices as low as $18, even using the balance sheet of a partnership we managed to buy more shares. We had a big order out at $15 when the stock logically quickly recovered. We reduced the position way back in a matter of hours. Time then passed and our plan was to allow the arb to run its course or until something more attractive came along. That something came from within Constellation. The utility had engaged in a 50/50 joint venture with EDF, the huge French electric, to develop some nuclear plants in Maryland and Virginia. EDF entered the mix with an offer to buy just under half of Constellation which valued the business well above MidAmerican's agreed price and closer to our $40 appraisal. Constellation's board claimed a fiduciary responsibility to consider the higher offer, I suppose goading Mr. Buffett to bid higher. Anyone who knows or has studied Mr. Buffett knows how much he values a handshake. Constellation's contemplation of the EDF bid certainly infuriated him. The upside to Berkshire was a termination clause which gave them 10% ownership of Constellation, plus a conversion of the $1 billion from the merchant business to a 14% secured note, plus a several hundred million dollars as a termination fee. The Constellation stock sold off again by about 20 percent on the news of the EDF offer, and of Berkshire's exit, giving us an opportunity to pick up some additional shares. It quickly recovered and we trimmed the position. After all, it was 2008 and there were lots of things going on and places to

ON ORKLA'S VALUATION:

Orkla's total intrinsic value is somewhere between NOK 70 and 87 per share. Said differently, you are paying about fair value for the BCG businesses and you get everything else for free.

intelligently move money around. But then the trade gets even better. Either because he needed liquidity, which he did, or out of petulance, which may be correct, Mr. Buffett began liquidating his now 10% position in Constellation. The stock sold off again. We bought again. EDF had provided liquidity to replace Berkshire's $1 billion so we reasoned a permanent loss of capital was nonexistent and the upside to the EDF bid was substantial. So back we plowed into a bigger position. We closed 2008 with Constellation as one of our largest holdings and ultimately sold our entire position in the mid-30's. Oddly, Constellation ultimately merged with Exelon after the EDF joint venture failed to move ahead with the nuclear developments as originally planned and the joint venture partners scrapped the merger.

In both the case of Apollo Investment and that of Constellation, a cumulative body of knowledge, a proper definition of risk, and a willingness and ability to decisively move capital around allowed the marriage of low or no risk to come together with outsized upside reward. If only these situations came along every day…

We see you're interested in a couple of Norwegian companies. Can you describe your investment thesis in Orkla ASA (ORKLY)?

CB: Orkla ASA is what I'd call a disaggregating conglomerate unlocking asset value. With it you get a company narrowing its focus on four core branded consumer goods (BCG) businesses, an improving margin structure and an attractive, undervalued currency. The company is headquartered in Olso, Norway, trades on the Oslo Børs as ORK and has a US ADR trading OTC as ORKLY. Shares total just over one billion so at the current price of NOK 60 the market cap is NOK 60 billion. The Norwegian Krone has been crushed over the past year, falling from 6 to the dollar to 8.3 to the dollar. The currency should provide a huge prospective tailwind for US investors and gives you a call option of sorts on a higher oil price over time. 710 million shares float, with investor Chairman Stein Erik Hagen, through a family holding company and other related parties, owning about 25% of the company. At the current price the dividend yield is north of 4%. Orkla reports in the Norwegian Krone using IAS/IFRS. The Krone is really cheap and should be a wonderful currency long-term. Norwegian debt to GDP is only 30%, but net government debt is actually negative. GDP is $500 billion and the country's has a sovereign wealth fund worth around $800 billion. Per capita GDP is the third highest in the world.

Orkla was founded in 1654 as a pyrite miner. They went public in 1929 (great timing), started a separate investments portfolio in 1941, and had shed the mining operations by 1987. They have been a conglomerate for a handful of decades now, but are intelligently moving away from that structure. They bought newspapers and magazines in the 1980's and early 1990's and sold those businesses to Mecom in 2006. They bought pulp and paper businesses, merged them with Borregaard in 1986 and spun that business on the Oslo exchange in 2012.

Orkla found religion in 1995 and began investing in food and consumer staples. They acquired Abba Seafood and Procardia Food, then acquired Swedish brewer Pripps with Volvo. They also bought Baltic Beverage Holdings. They merged subs Norwegian Ringnes and Pripps with Carlsberg in 2000, retaining 40%. They sold Carlsberg in 2004 at a great price. Since then they have added numerous additional staples businesses. They don't overpay and have a great track record integrating new businesses. They bought Norwegian material company Elkem and Swedish Sapa group in 2005.

The four branded consumer goods today consist of four segments - Orkla Foods, Orkla Confectionery and Snacks, Orkla Home and Personal and Orkla Food Ingredients. Those businesses will do about NOK 30 billion in sales, which converts to about 3.6 billion.

To give you an idea about how strong the dollar has been, at last year's exchange rate of NOK 6 to the USD, dollar sales would be $5 billion. The company's core business is largely conducted in Scandinavian currencies so when I think and talk about Orkla's business I use Krone. Profit margins at the BCG businesses normalize at 10.4%, and were 9.1% at year-end. Return on capital for 2014 was 15.2% for 2014 and normalize closer to 17%.

At current margins the consumer businesses will net NOK 3 billion on their NOK 30 billion in sales. The current market cap of Orkla is NOK 60 billion, which is about 20 times. Net debt is a very modest NOK 6 billion.

How did you arrive at the valuation of the business?

CB: On top of the BCG businesses, Orkla has noncore, hidden value assets with a carrying value of NOK 16.4 billion. I peg fair value on those of NOK 25-28 billion. The BCG's alone are worth somewhere between NOK 46 and 61 billion. With barely over 1 billion shares out the math is easy. Orkla's total intrinsic value is somewhere between NOK 70 and 87 per share. Said differently, you are paying about fair value for the BCG businesses and you get everything else for free.

Management has done a great job unlocking value and with ongoing restructuring of their noncore operations, joint ventures and associates. These noncore subs are profitable, but due to a series of write-down and restructuring charges their normalized profitability hasn't flowed through IAS/IFRS numbers.

INVESTMENT SPOTLIGHT: Orkla ASA (ORKLY)

Orkla ASA
(PINK: ORKLY)
Description: Provides branded consumer goods, aluminum solutions, materials, and financial investments.

Price	**$7.32**
52-Week Range	$6.22—9.33
Dividend Yield	4.43%
Enterprise Value	8.4B

Basic Valuation:

P/FCF:	28.54
Forward P/E	22.90
EV/EBIT :	21.88

Notable Owners:

First Pacific	Newton Inv
Artisan Partners	Capfi Delen
First Eagle	Vanguard

INVESTMENT SUMMARY

Shares in Orkla is approaching 52-weeks lows. Chris says, "Orkla's total intrinsic value is somewhere between NOK 70 and 87 per share. Said differently, you are paying about fair value for the BCG businesses and you get everything else for free."

Sources: Company reports (10Ks, 10Qs), other public information

What would make you sell your position?

CB: The best outcome for us would to see the shares sell off precipitously. I'd like our position to be larger with a lower basis! Once we are full it would be great to see the shares accrete to and above our appraisal of fair value where we could sell our holdings and move on to another dollar trading for less than a buck. But I don't think that's what you are asking. You want to know what could go wrong with the fundamentals, and that's something we spend lots of time thinking about with any investment we make.

Probably the greatest concern I have with Orkla over an intermediate horizon would be execution risk in selling off the investment portfolio. Their largest investment is in Sapa, a 50% equity method joint venture with Norsk Hydro. The business is the largest global manufacturer of extruded aluminum profiles. CAFE and emissions standards drive demand. The company has been restructuring for about three years, masking substantial profitability and readying for what I think will be a preliminary IPO as early as next September 1 in which Orkla and Norsk Hydro would each retain a third of the company at first. The company recently did this with a smaller sub called Gränges. They did an IPO in Sweden and a secondary just this spring. Any severe economic downturn, think about what happened to auto sales in 2008-09, could derail the timing or success of a potential sale. Orkla's share of Sapa is carried at NOK 7.8 billion and I peg fair value at 1.5 book, 50 percent of sales and 7x EBITDA, which gets you NOK 11.5 billion. Another longer-term concern is simply the aging and slow growing population in Scandinavia. Norway has been in better shape. They have grown at 1.3% for the past decade due to immigration. Their fertility rate is only 1.8%. Sweden and Finland's population growth has been closer to 1% for a long time, but even there it's been on an upswing due to immigration. Trump probably has something to say about that. At the end of the day, Orkla's markets are mature. You'd rather have booming populations, more mouths to feed. The good news is Orkla's brands dominate in their respective categories.

Also, I would have said oil at $100 was a big risk. Norway's GDP is 25% dependent on energy. Hence the decline in the currency. But oil in the $40's and the Krone at 8.3 really become tailwinds in my opinion. Consumer health sensitivities are a real concern. Look at McDonalds and Kraft Foods. Orkla is heavy into processed foods — the company gets it. They are running fast to improve the health component across their food businesses. The CEO talks about things like lowering the sodium content across the portfolio but can also quantify the cost savings of doing so. Smaller and focused in today's case is better. We'd really like to see the shares sell off a bunch. It's only a decent sized position and I think the quality of the BCG businesses is high enough to be a big position at the right price. But that's the story of my life today...

INVESTMENT SPOTLIGHT: Subsea 7 SA (SUBCY)

Qualcomm
(OTCPK: SUBCY)
Description: A seabed-to-surface engineering, construction & services contractor.

Price	**$8.56**
52-Week Range	$7.09—16.16
Dividend Yield	7.00%
Enterprise Value	2.85B

Basic Valuation:

P/FCF:	29.26
Forward P/E	21.19
P/OCF:	3.70

Notable Owners:

DNB Asset	Vanguard
Templeton Global	Blackrock
Danske Capital	

INVESTMENT SUMMARY

Chris says, "with Subsea you need to think about everything in normalized terms because of everything going on in the oil patch...On $500M in normalized profits with 350M shares outstanding, you get $1.42 in free cash flow profitability per share. With the current stock trading at only ~$8.50 per share. A 10x multiple of $1.42 gives a stock trading at ~$14 per share and a 15x multiple gives us a stock trading at ~21.00."

Sources: Company reports (10Ks, 10Qs), other public information

I see you're interested another Norwegian business, energy company Subsea 7 (SUBCY). Can you describe your investment thesis here?

CB: We started buying it about a year ago at a price well off its highs, but at a price well above current prices. Everyone in the energy patch has just been crushed. We had a small position initially, but, as is usually the case, we've added to the position as the stock has gotten cheaper. We have a really nice average cost right now and we believe it's a very interesting story. I think it has some insulation relative to many of the other more levered players to the underlying commodity. They are a very interesting oil service company.

In conducting our research we learned that the Chairman is almost a Warren Buffettesque type guy named Kristian Siem. He's an excellent investor and he's been on the board of Transocean Offshore (RIG). He's spent his entire career in the energy world. Much like the Chairman at Orkla, he has his family's holding company largely invested in this business. This is the crown jewel of his family's empire. And it's a great business that trolls around in the subsea energy space.

Subsea really does seabed-to-surface EPIC (Engineering, Procurement, Installation, and Commissioning) work. They're an engineering and construction firm that effectively hooks up the subsea infrastructure of deep water wells to topside production and gathering platforms. They have some shallow water assets and projects as well. They have a fleet of 39 vessels with five more under construction. Their vessels are the most modern and technically advanced in the industry, where its enablers – pipelay and heavy construction vessels are superior. They have the largest high-spec fleet in the industry. They also have 175 remote operated vessels. Their equipment allows them to contract on both a day rate and a lump-sum basis with the big integrateds and with national oil companies. The largest part of their business is called SURF (Subsea, Umbilical, Risers, and Flow Lines). When you think about where their projects are located, it can be very harsh environments. So they'll also contract to go in and manage the infrastructure over the life of the fields – make sure the flow lines are working, regular maintenance, etc.

How are you looking at valuation?

CB: Subsea has 350M shares outstanding. The current market cap is about $2.8B. The ADR is trading around $8.50. The primary shares trade as SUBC on the Oslo at the multiple of the currency conversion. With Subsea you need to think about everything in normalized terms because of cyclicality and certainly with everything going on today in the oil patch. The entire sector has been disrupted by the decline in crude and the precipitous drop-off in tendering (front-end bid

ON USING BERKSHIRE AS THE OPPORTUNITY COST OF CAPITAL:
We won't put money in something else unless; you have great business quality, the price is right, and your expected return is at least what Berkshire is expected to return.

process to contract with the integrated and national energy companies). Overall, business is just slower and all the margins will be off. So if you have a view that oil prices will stabilize (not necessarily recover to $100), and if we resume a normalized exploration cycle for oil and gas, Subsea is one of three companies that is best in its class. However, there's no one else in the subsea industry that really competes in earnest with the three biggest players. Subsea 7, Technip and and Saipem are the top three businesses in the sector and each have about equal market share.

Let me start with the balance sheet because I think that's where you get a margin of safety. You have total assets of $8.5B. The company wrote-off half of their goodwill last year. Goodwill was about $2.6B, now it's about $1.3B. The goodwill is largely on the books from a big merger between Subsea and Acergy back in 2011. They have current assets now of ~$2B out of the ~$8.5B with cash at $373M and the company is almost running at net-cash, or at least neutral. The only outstanding term debt is converts ~$550. You get total equity of ~$5.5B. Only ~$1.3B of which is now goodwill.

What you have now with the assets on the books are some incredibly attractive vessels, as well as onshore infrastructure (spoolbases and fabrication plants around the world, etc.). The asset value is very tangible and real. The company has been in front of the downturn, quick to identify and sell or scrap several of their older and less technically advanced vessels. There are nine to ten vessels slated for decommissioning right now. They recently reduced headcount by 1,000, from 14,000 to 13,000, but have retained all 2,000 of their engineers. Their engineers, along with their equipment and assets, give them their moat. And once we get through this downturn we have a company with best in class assets that will earn excellent returns on the carried value of the assets on the balance sheet because of recent fleet upgrades (even with the allowance for another $1B write-off). So on a balance sheet with $5.5B ($4.5B of which is very firm), they have maintenance capex of ~200M per year and depreciation runs around ~$400-450M per year. This gives a little more free cash since the fleet is so new. As far as income statement margin structure, I would normalize gross margins at 23%, 18% operating, 12% earnings before taxes, and 8-8.5% on a net basis. We probably won't come anywhere close to those numbers this year, but I believe they are viable over a 10-15 year time horizon.

In recent years, the company generated 19% gross, 13% operating, 8% pre-tax, and 5.5% after tax. That gives us an idea of where they are right now. The company did $6.9B in sales last year, which was a record and will be peak for some time. They'll probably generate $5-6B this year with the downturn. On the low end of the range, I could see them generating $4.5-5B. At the $4.5-5B in sales, they'll still produce decent economic returns. I could see net profits getting down to $200-300M, depending on the utilization of their active fleet. With a market cap today of $2.8B it looks really cheap on depressed numbers (potentially trough earnings). However, if you normalize the cycle, a 10% ROE on $5B in fixed assets gives us $500M in earnings power. The stock today is trading less than 6x normalized earnings and it has a great balance sheet. It is far better capitalized than their two biggest competitors. So they'll have staying power with the best fleet and engineers in the industry.

At today's price, you're paying half book for a business that would produce an ROE of 9-10% on a normalized basis. On $500M in normalized profits with 350M shares outstanding, you get $1.42 in free cash flow profitability per share. With the current stock trading at only ~$8.50 per share. A 10x multiple on $1.42 gives you a stock trading at ~$14 per share and a 15x multiple gives us a stock trading at ~21.00. If you're constructive on your long-term outlook for oil, you can make a lot of money in Subsea 7. You also get the huge currency tailwind prospectively that you have with Orkla. We have a 3% position in the business right now.

From what I understand you've been buying some Berkshire recently. It's been a big position for you for quite some time now. Can you describe your investment thesis here?

CB: Yes, it is our biggest position by far. We had our original 5% position which we talked about in early 2000 and it obviously worked out very well. We've done a very good job of adding to that position absolutely and both for new clients and with new cash flows at, what we believe, are attractive discounts to fair or intrinsic value. With that said, we've also trimmed the position over the last few years with prices approaching fair value. The last time the stock traded above fair value was back in 1998, since then it's consistently traded at a discount. Now it's, depending on the client, ~20-30% of our capital. For newer clients in the last couple of years, we've only recently been buying shares on this recent downturn. We had trimmed it for longer-term clients because it had become such a large position and the shares were closer to fair value than they had been in some time. Almost all of our clients have at least a 5% allocation to Berkshire now and we're close to making it a 10% position for new clients.

Mr. Buffett certainly lays out how to value Berkshire very well. It's a conglomerate and there are a lot of moving parts, but if you do just a little bit of work he tells you exactly how he looks at it. We do individual work on as many of the operating subsidiaries as we can get information on. Many file with various regulators and there is a lot of

INVESTMENT SPOTLIGHT: BRK.B

Berkshire Hathaway
(NYSE: BRK.B

Description: A holding company engages in a number of diverse business activities (insurance, energy, finance, etc.).

Price	**$132.10**
52-Week Range	$125.50—152.94
Dividend Yield	N/A
Enterprise Value	$345.25B

Basic Valuation:

P/FCF:	17.89
EV/EBIT :	11.71
P/B:	1.32

Notable Owners:

Vanguard Group	State Street
Cascade Investment	Bill Gates

INVESTMENT SUMMARY

Berkshire is a huge position for Chris and his firm (~20%). He says, "Current prices are trading at 13x normalized earnings of $25B. That's an 8% return on capital at current prices...you can buy one of the best businesses (if not the best) in the world at a market cap of $325B with a put option underneath it and we think it's worth $450-500B over time.

Sources: Company reports (10Ks, 10Qs), other public information

information available not found in the SEC filings. In fact, we wish there was more transparency as far as the operating subsidiaries go. As an example, we'd love to have a P&L, Balance Sheet and Cash Flow Statement for each sub once a year. Mr. Buffett gets them monthly. Send a set down to St. Louis once a year! It's not easy to determine how much capital each sub carries year-to-year, for example, and we only get topside data on the larger of the businesses within the company. Mr. Buffett does breakout limited summary financial data for what he considers the four key segments of Berkshire, the groupings of the key insurance businesses, the regulated rail and utility businesses, all of the businesses in manufacturing, service and retail, and a groping of a of finance and leasing companies. It's a very useful way of segregating and valuing the moving parts. But the detailed information we gather and long for isn't required to get a handle on how much the whole is worth – it really serves to satisfy our analytical need.

Mr. Buffett simply assumes there are two pieces of the business: insurance operations and everything else. (1) The insurance side has its own insurance accounting and regulatory characteristics, and each insurance company within Berkshire is markedly different from the others. But at the end of the day, what you have in an insurance operation are premiums coming in which are used to run the business, the surplus of which are invested in various investment assets that are used to pay current and future losses and liabilities. To the extent you have the ability to underwrite on a profitable basis over time, you'll have the combination of what the investments will make over time with the underwriting profits. That's essentially it on the insurance side of the business. (2) Then Mr. Buffett gives you the pre-tax earnings on the businesses not insurance related. You apply whatever multiple you want to those pre-tax earnings and add the valuation of the insurance operations. You can make a determination as to long-term underwriting profitability and the degree to which insurance float is really an asset, but beyond that it's really that simple.

The reason we've made Berkshire such a big position, is that we believe Berkshire is our opportunity cost of capital. We won't put money in something else unless; you have great business quality, the price is right, and your expected return is at least what Berkshire is expected to return. Buffett says it himself, if you don't want to be an active investor, just invest in the S&P 500. Go buy a low-cost index fund to save yourself all the frictional cost and expense. The cost savings and the lack of turnover will serve you well.

We always compare the earnings yield in our businesses to that of the overall market. Today, the earnings yield on the S&P is somewhere between 3.7% and 5.8%, depending on the degree to which you think profits are overstated on an accounting basis and due to cyclicality. The earnings yield should be your expected return (unless you get further multiple and or margin expansion). We don't use the S&P as our opportunity cost, because we wouldn't own the S&P. In terms of deploying capital, we use Berkshire.

ON CURRENT MARKET ENVIRONMENT

The financial markets are highly leveraged here in the short-term to the notion that the Federal Reserve has efficacy. I think Ben Graham would have likened Ben Bernanke and Janet Yellen to the voting machine...

And we use Berkshire because within it you have a supremely diversified portfolio of high quality businesses – far better than the aggregate of the S&P. Within Berkshire, you generally have businesses that earn their cost of capital on a free cash basis. Overall, there isn't a great deal of leverage with Berkshire either. I have no problem paying more for a free cash flow stream that's not levered versus what I would pay for the same but levered stream. That's a valuation and investing principle that's lost on the vast majority of investors. It's the combination of the diversification and the nature of the free cash flow generating businesses within Berkshire that are largely unlevered, which allows us to concentrate far more than what academicians or consultants would say is prudent. And we're not giving up the fact that we're active managers. We're not throwing in the towel and handing over the capital management reigns to Warren Buffett – not at all. Our expected return on Berkshire changes every day the current price of Berkshire changes. It's always a moving target. Your opportunity set changes and we've resolved to the fact that we're really comfortable with Berkshire at current prices. It gives us a very satisfactory expected rate of return over time with relatively low risk. We try to buy it cheap and sell it dear.

At the current price the stock is trading at 13x ballpark normalized earnings of $25B. That's a 7.7% earnings yield at current prices. Today, Berkshire has a market cap of $325B and you have Mr. Buffett waiting to buy back shares at 120% of book, which is at $300B. That's essentially only 8% down to where you have a known buyer with lots of cash willing to purchase shares on behalf of the shareholders at a published price and at a return in excess of 8%. So you can buy one of the best businesses (if not the best) in the world at a market cap of $325B with an implied put option underneath it and we think it's worth $450-500B right now. Book value is certainly a moving target - it can go down. However, the risk-reward trade-off for this quality of business is amazing. So why wouldn't you use it as your opportunity cost of capital.

What are The 3 Things an investor should focus on the most to keep their edge or advantage over the market?

#1 - If you're not focused on what could go wrong then your focus is wrong. Manage risk – all risk!
#2 - You're buying return on capital, which means properly understanding return and properly understanding capital.
#3 - Patience and a willingness to run away from the herd allow you to own businesses, not pieces of paper.
Bonus - The financial markets are highly leveraged here in the short-term to the notion that the Federal Reserve has efficacy. I think Ben Graham would have likened Ben Bernanke and Janet Yellen to the voting machine...

Thompson Clark — MicroCap Millionaires

Thompson Clark explains how he gains an edge by staying disciplined on his daily rituals, how he searches in the microcap space to uncover unknown investment opportunities, one of his biggest investing mistakes, and why he sees upside in HC2 Holdings, Tucows, and Tilly's.

Thompson Clark

Thompson Clark is the editor of Agora Financial's *MicroCap Millionaires* Letter. Microcaps are some of the smallest stocks in the market and normally trade for less than $1 per share. Because of this, Thompson is able to find investment opportunities that others ignore (or disregard altogether). Microcaps are notorious for providing investors with asymmetric risk-return investment opportunities.

Thompson graduated from Emory University with a Bachelor's in Business Administration and is a CPA. Formerly, he was a Wall St. analyst at Sidoti & Co in New York where he focused on micro-cap companies. Prior to Wall Street, he worked as an international tax consultant for Deloitte.

Today, Thompson is finding value in multi-conglomerates, technology, and retail sectors, most notably in such companies as HC2 Holdings (HCHC), Tucows (TCX), and Tilly's (TLYS). The three businesses featured offer interesting growth profiles which could trade at multiples of their current price if various catalysts come to fruition.

How did value investing start for you, and has your view of investing evolved over time?

Thompson Clark: I've always had an interest in the stock market, but I didn't always have a framework for investing. I remember when I was a young kid in the late 90s telling my dad to buy a video game stock because I thought they had a great console. The stock subsequently exploded higher. He ended up selling to stock and buying me the game console.

There was obviously no framework and I was mistaking brains for an insane bull market. However, this got me interested in this feed-back loop that you get in investing. In 2009, I got a copy of *Snowball* by Alice Schroeder. This was my first introduction to Buffett and value investing. It was a great book and I remember reading it thinking, 'this guy is fascinating.' Over the next couple of years, I didn't really dive into value investing, as I was more focused on macro investing and economics. Essentially trying to figure out why the whole global economy just collapsed. That's when I fell into the Austrian School of economics. I thought having a better understanding of the macro picture would make you a better investor, but I found that not to be the case. I should've listened to Buffett in that regard.

However, I did read one book by an Austrian Economist named Joe Calandro called *Applied Value Investing*. After reading the book and listening to one of his talks, it got me on my path to value investing.

Around that time, I landed a job at Sidoti & Co on the sell-side covering micro-cap stocks. With my introduction to Austrian Economics people in NY, where I lived at the time, I was introduced to Chris Mayer (editor of 100x Club at Agora). That led to where I am today at Agora where I was able to start my micro-cap focused letter.

What does your day look like from beginning to end? Do you have any daily rituals?

TC: I try to collect daily rituals of other successful people. The book *Daily Rituals* by Mason Curry is a great book I recommend. I get obsessive with developing daily rituals sometimes. But they're incredibly important.

Typically, I'm up around 6 or 7 in the morning. Then I'll have coffee and spend the first hour or two reading. Many of the successful people I've modeled over the years tend to do their big mental work in the morning when they are the freshest. After a couple hours of reading, I'll make some breakfast and then head to my office. I'll get to the office around 8:30-9:00 when I'll spend the first half an hour skimming blogs, checking google alerts, SEC filings, and some other feeds through Feedly.

I normally have an idea that I'm working on at the moment, so I'll have a 10-K on my desk. I read the 10-K and work on that till about lunch time. Before I break for lunch, I'll print out research papers or an investment write up to read at lunch. After lunch, I'll finish whatever I was working on in the morning.

Around 2:00-3:00 I turn my computer off entirely and I'll try to meditate for 10-20 minutes. It's usually with headphones which gives it more of a guided meditation. I find that this really refreshes me. Reading and focusing mentally all day can be very draining, so this really helps me

ON DAILY RITUALS:

I try to collect daily rituals of other successful people...I get obsessive with developing daily rituals sometimes. But they're incredibly important.

recharge in the afternoon. After the meditation, I'll get back to what I was working on in the early afternoon. Sometimes I'll return some phone calls, listen to earnings calls or read transcripts. And that takes us to the end of the work day around 5:00-5:30. I play a lot of squash, so I'll head to the gym after work.

The rest of the evening is reading, relaxing, and dinner before I usually go to bed around 10:30pm.

Are you able to "shut-down" your investing brain on the weekend or separate it from your normal life?

TC: I don't know if I have an obsessive personality or if I'm just passionate. On the weekends, I don't really shut down. I'm usually thinking about what I was working on Friday and what's coming up in the week ahead. If I'm lucky, I'll come into the office for a couple of hours and continue reading an annual report or a book. I would say that on the weekends in particular, I spend more time reading books than annual reports or investment research.

Who are the people that inspire you the most and why?

TC: I read this profile on CNBC of Lee Cooperman (Omega Advisors) from 2013. He talks a lot about his daily routine. He lives in New Jersey and works in Manhattan. He gets up every day at 5:00am and he's in the office by 6:30am. And then he basically works non-stop till 11:00pm at night. That inspires me! That level of passion is something I strive for on a daily basis. The whole routine he has and his success as an investor is probably a function of how great his routine is on a daily basis.

Also, Buffett and Munger's ability to read as much as they do has certainly inspired me. As you read more books and learn more about various companies, you're knowledge continues to compound long-term. That's how I think about spending my time – it's the quest to compound knowledge. The fact that Buffett, in his prime, was reading 500+ pages per day is astonishing.

What are the top 3 book people don't talk about, but one's that you would recommend to an investor?

TC: *The Power of Now* by Eckhart Tolle really helped me think about meditation and focus. Along with that, I've recently read *The Rise of Superman* by Steven Kolter. It talks about how athletes get into a state of flow when they are at their peak performance. Value investing isn't an extreme sport by any stretch of the imagination, but the flow concept is important to understand and think about. A more investing related book would be *The Davis Dynasty* by John Rothchild. It's about Shelby Davis and his whole investing career, which is incredibly interesting. He was one of the first to see the real value in insurance companies. During his time people didn't understand or value them correctly, but he understood them well. He backed up the truck on a lot of mispriced insurance companies.

What is your philosophy and process to investing?

TC: My philosophy is flexible. I remember a 2006 write up with Larry Robbins (Glenview) in *Value Investor Insight.* He discussed that every year his firm tries to learn a new strategy. So one year they'll try merger-arbitrage, then distressed debt, and then event-driven situation. So that's how I approach investing. In the beginning, I started with statistically cheap stocks. Now I spend the majority of my time on catalyst driven ideas. The core of what I write about in my letter are microcaps that have an event or catalyst that will close the gap between price and value.

Most of my screening comes from SEC filings. Every 13D that's filed we take a look at. And there are a lot of activists in the microcap space right now.

Do you consider your investment process or philosophy unique?

TC: Typically when people think about microcap investing, they're just looking for dirt cheap stocks that no one cares about. I like that, but I've also seen situations when you can buy a cheap stock and it just stays cheap forever (especially if it's a microcap). A requirement of mine is to always have a catalyst that will close the gap between price and intrinsic value.

Do you consider yourself more of a generalist in search of value or do you focus on particular sectors that define your 'circle of competence'?

TC: When I was on the sell-side of the industry, I did focus on technology companies. However, now I would definitely consider myself more of a generalist. I would say that after years of research that I've become a big fan of subscription based companies. The accounting can be weird and adjustments need to be made to figure out what the stock is worth. It may not be profitable right now because they're plowing money through SG&A to buy more subscribers. The market can sometimes miss these kind of opportunities (especially with microcaps).

ON READING EVERYDAY:

Everyone says it but not everyone does it. You have to read a lot...If you love it, it's great. If you don't, then it's going to be tough and you should probably be in different business. Stick to a process and continue to refine it over time.

Describe your value discipline once you have arrived at an understanding of the intrinsic value of the business?

TC: What I try to do in my letter, under reasonable circumstances, I try to explain how a stock can double. I like for that to take place in 2-3 years (obviously the sooner the better). Generally, I make an analytical case for why a stock has 100% or more upside to reach intrinsic value.

What was the worst investment you've ever made?

TC: It was during 2011 when a lot of the reverse-mergers were going on in the market with the Chinese fraud companies exploding. I thought I was smart and found the perfect one that was going to zero.

At this point I had no framework for investing. But I loaded up on put options in a 'sketchy' Chinese company and they expired before the company went to zero. I haven't shorted anything since then. It was a lesson that shorting isn't as simple as saying, "Hey, this stock is overvalued." You need to factor in how much you're paying to take that position (your cost to borrow).

With the letter, the biggest mistake was recommending an overleveraged gym company located in the Northeast U.S. I probably needed to conduct a little more work understanding the dynamics of the business. And really understanding the capital structure.

A business in a turnaround phase with a bad balance sheet does not have time on their side. Debt payments and other events can cripple a company. This business deteriorated and the stock didn't work out well.

What was the best investment you've ever made?

TC: Aside from buying 10 bitcoins at $10 bitcoins a long time ago…The best personal investment I've made was a small company called *Air T Inc. (AIRT).* I found out about the company after they filed a 13D on a company I was researching. So I decided to dig in and start trying to figure out what was going on with this company. The stock looked really cheap and it was run by an activist investor named Nick Swenson. I think his firm owns 20% or more of Air T. This was about a year ago. Before I invested in the company I needed to meet the capital allocator. So I went to the shareholder meeting in August of 2014. I met Nick and really liked what I heard. A few months later, his firm came out as an activist against Biglari Holdings (BH). They own Steak-n-Shake and it's owned by a controversial investor named Sardar Biglari. As a way to retaliate for Air T going after Biglari Holdings, Biglari indiscriminately bought Air T to the effect of the business doubling in 2-3 weeks. So I thank Sardar for that.

With the letter, *Tucows Inc (TCX*) was one of our more successful investments. I brought it up to readers of the letter in the spring of 2014. I told them at one point, after it had pulled back a little, to make it a large position. We were up about 100% at one point, but it's about 85% now in a little over a year.

I see you like HC2 Holdings right now. With shares down more than 40% off their highs in April, what is your investment thesis?

TC: Along with writing my main newsletter (MicroCap Millionaires), I also contribute as an analyst to Chris Mayer's letter (100x Club). One of the picks I contributed to his letter was *HC2 Holdings (HCHC).* HC2 is run by a hedge fund manager who's had a very controversial, yet very successful career, Phil Falcone. He's the CEO and Chairman of the Board. He takes a no cash salary – only stock. He's using HC2 as a holding company for his investments.

The company has two core businesses that generate all of the revenue and EBITDA, Schuff International and Global Marine Systems. Schuff is basically a specialized steel fabrication business. They're involved in building the Apple Headquarters in California, amongst a plethora of other things. Global Marine is a business that's been around since the 1850s. They actually installed the first subsea cable across the Atlantic Ocean.

Today they're involved in installing and maintaining underwater fiber optic cable for telecom businesses. They will keep their ships in port until a maintenance call and go fix an issue. Even if there are no issues, they still get paid. So it's a very interesting business.

Along with the two core cash generators, HC2 has a bunch of other "venture capital" type of investments. It's a wide range of businesses from companies that cure osteoporosis to sports betting. They just bought a long-term care insurance business at a fire sale price.

Describe how you look at the valuation of the business?

TC: There are many pieces to the story. The way I look at it is if you pay 6x EBITDA for Schuff and Global Marine, you get the rest of venture investments for free essentially. Today the stock is ~$7 per share. I look at the valuation here where if you just include

the other venture investments at cost, it's a $14 stock versus today ~$7. It seems like an interesting situation. Phil Falcone is involved and there are numerous smart shareholders that own the stock in size.

What situation or events would make you sell your position in HC2 Holdings?

TC: Phil has made some aggressive bets that haven't done well to date. If I were to see him put all of his eggs in one basket I'd be concerned. However, right now they're involved in a dozen different companies. So I don't see that as a risk yet.

The two core businesses are cyclical, so I would be concerned if we saw a downturn in construction — earnings would take a hit. HC2 as a whole does have a fair amount of debt, so that could scare me off a little too. Phil is incentivized not to hurt shareholders, so I'm not too concerned about that though.

We talked about Tucows a bit already. Shares have hung in well compared to the rest of the market, what is your investment thesis on Tucows?

TC: Tucows (TCX) is a ~$300M market cap Canadian company. They started off as a domain registration company. Anytime you registered a domain you might go through one of their registrars. It's a commodity business now, but the way they got really good at this business was the customer service. It sounds cliché, but they were very good at taking care of their customers. Now they've been able to leverage that customer service expertise to start a new business called Ting. Ting is a completely separate business and operates as a mobile phone carrier. The FCC requires that all the big four carriers (Sprint, Verizon, ATT, T-Mobile) have to give a piece of their spectrum to wholesalers like Metro PCS and Virgin.

Ting is another one of the wholesalers and they run on the Sprint and T-Mobile networks. It's a pay-as-you-go mobile phone service that has grown to 178,000 devices on their network (end of 2nd quarter). I use the service myself and they charge you per minute, per text, and per megabyte.

So if you really wanted to have the lowest possible phone bill you could have it instead of signing up for the "all you can eat" plans that the big four carriers offer. I think they've done a fantastic job growing this business from zero to 178,000 devices. Which is still very small in the grand scheme of things. Their churn rate has been really low, which is surprising because there are no contracts. This goes to show their overall value-add proposition to the customer.

INVESTMENT SPOTLIGHT: HC2 Holdings (HCHC)

HC2 Holdings
(NYSE: HCHC)

Description: A holding company for various operating subsidiaries mainly in the U.S and U.K.

Price	**$7.35**
52-Week Range	$3.93—13.28
Dividend Yield	N/A
Enterprise Value	$569.58B

Basic Valuation:

Forward P/E:	4.84
P/FCF:	0.21

Notable Owners:

Paul Tudor Jones	TETON
Mario Gabelli	Vanguard
Chareles Brandes	Eaton Vance
WHALEROCK POINT	Hudson Bay

INVESTMENT SUMMARY

Thompson says, "if you pay 6x EBITDA for Schuff and Global Marine, you get the rest of venture investments for free essentially. Today the stock is ~$7 per share. I look at the valuation here where if you just include the other venture investments at cost, it's a $14 stock versus today ~$7.

Sources: Company reports (10Ks, 10Qs), other public information

The third leg of this stool is the offering of fiber to the home for internet. They bought a little company in Virginia called Blueridge Internet Works. They're basically going to apply the Ting model to bring 1GB internet to your home. So you'll have 1GB up and down of internet at a very competitive price. They've only hit one or two cities so far and plan to add many more.

Can you describe how you arrived at the valuation of the business?

TC: They have a net cash position. If you believe the 2015 guidance, which I think they will exceed, then they're trading a little under 11x EBITDA. It's not crazy cheap, but I think there is a long runway for growth within the mobile and fiber business. On top of that, you still have the cash cow in the domain registry business. They still have such a small fraction of the U.S. cell phone market. If they get to 1 million devices, it's only 0.10% of the whole device market. So it's not a huge market, yet it would be a massive driver of earnings for the company.

They've done eight Dutch tender offers and that's something you don't see every day. It's very rare. I think if there was a second edition of the *Outsiders* that the CEO Elliot Noss would be included.

You have to make some assumptions as to where the business is going, but I believe it's a great business and it's something people should look at.

Tily's has really taken a hit of late as it sits more than 50% off its highs in April. What is your investment thesis here?

TC: I found out about Tilly's (TLYS) from reading *Value Investor Insight*. Tilly's is a teen retailer that is primarily concentrated in California. You can think of it as a Pac-Sun or Zumiez. It looks like they'll end the year with 200 stores. It's an interesting business.

If you think about teen retailers, you can usually group them into two buckets: (1) the 'Abercrombies' and 'Aeropostales'. They are more of a fashion company because they have to make a bet on what teens want for the next season. And if they hit, they hit it big. But if they miss, they have to liquidate all the inventory and it becomes a huge mess. (2) In the case of Tilly's, they don't really have their own brand. They're a brand aggregator. They're selling Vans, QuickSilver, and lots of other surf and sports related brands.

They've done a great job of growing this business from no stores to 225. The founder and CEO is still involved and owns a big portion of the company.

INVESTMENT SPOTLIGHT: Tucows (TCX)

Tucows Inc.
(NAS: TCX)

Description: Provides simple useful services that help people unlock the power of the internet.

Price	**$25.84**
52-Week Range	$13.50—32.23
Dividend Yield	N/A
Enterprise Value	$268.98B

Basic Valuation:

Forward P/E:	30.21
P/FCF:	30.27
EV/EBIT:	20.33

Notable Owners:

Renaissance Tech	Driehaus
Osmium	Bogle
IsZo Capital	Marathon
Bridgeway Capital	O'Shaughnessy

INVESTMENT SUMMARY

Tucows is hovering around $25 per share. Thompson says, "They have a net cash position. If you believe the 2015 guidance, which I think they will exceed, then they're trading a little under 11x EBITDA. It's not crazy cheap, but I think there is a long runway for growth within the mobile and fiber business...They still have such a small fraction of the U.S. cell phone market. If they get to 1 million devices, it's only 0.10% of the whole device market.

Sources: Company reports (10Ks, 10Qs), other public information

Describe how you arrived at the valuation of the business and what catalysts you see to help close the gap between price and intrinsic value?

TC: The stock is trading at ~$8 per share, which is less than 4x trailing EBITDA. They have a net cash position. It's certainly interesting on a relative valuation basis.

The hope is they can grow their store base at a reasonable rate. They have a keen focus on ROI for each store. So they don't build stores for the sake of building stores and growing. They have to hit a hurdle ROI.

Once they get to a certain store count, I think you'll see a multiple expansion. Comparable peers trade at 6.5x EBITDA and the stock today is trading at 4x EBITDA. So if they were to get the peer valuation of 6.5x EBITDA, I think the stock's worth north of $15 per share.

In my initial recommendation, I mention that a catalyst on the horizon could potentially be the bankruptcy of PacSun (PSUN). PacSun took on too much debt and started selling their own labels instead of the popular brand names. This was a major mistake on their part and they're paying for it right now. Tilly's could step in and increase store count if PacSun were to close up their stores.

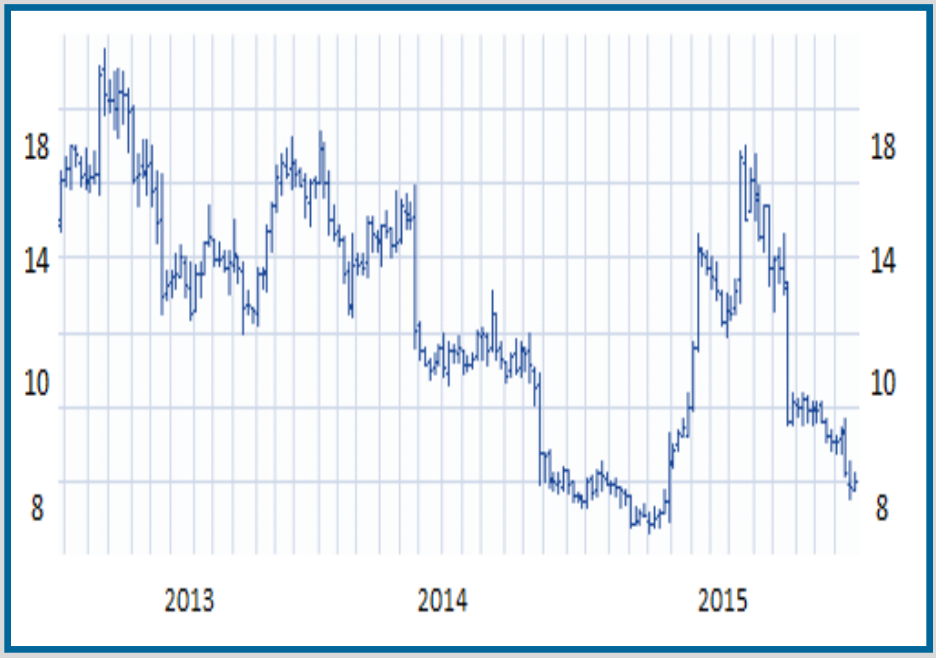
What are The 3 Things an investor should focus on the most to produce out-sized investment returns over the long-term?

#1 *Read and Read Widely* — Everyone says it, but not everyone does it. You have to read a lot. Friends will ask what I do all day and I tell them I read all day. If you love it, it's great. If you don't, then it's going to be tough and you should probably be in different business. Stick to a process and continue to refine it over time.

#2 *Invest Through The Windshield...Not the Rearview Mirror* — You have to think ahead and figure out where things are going, not where they've been. I understand the argument for mean reversion, but sometimes that's not the case. You need to separate when that the case and when it's not.

#3 *Don't Get Obsessed with Numbers and Analytics* — You have to look at the behavioral side as well through the insider ownership and their incentives. It's so important and it's very difficult to do because you can't easily screen for it or quantify it. You can't put it in a model and have it spit out the answer. VIC

INVESTMENT SPOTLIGHT: Tilly's (TLYS)



Tilly's Inc.
(NYSE: TLYS)

Description: Operates a chain of specialty retail stores featuring causal clothing, footwear, and accessories for teens and young adults.

Price	**$8.02**
52-Week Range	$6.65—16.99
Dividend Yield	N/A
Enterprise Value	$149.73B

Basic Valuation:

Forward P/E:	18.45
P/FCF:	9.22
EV/EBIT:	6.20

Notable Shareholders:

Frontier Capital	Greenblatt
Emerald Fund	AST Small Cap
Russell Frank	State Street
NS Advisors	

INVESTMENT SUMMARY

Shares have dropped to 52-week lows. Thompson believes there could be an opportunity here at current levels. He says, "Comparable peers trade at 6.5x EBITDA and the stock today is trading at 4x EBITDA. So if they were to get the peer valuation of 6.5x EBITDA, I think the stock's worth north of $15 per share.

Sources: Company reports (10Ks, 10Qs), other public information

Investing As A Leisure Activity…?

"…If you can buy a few great companies, then you can sit on your ass. That's a good thing."
Charlie Munger

There's no escape!!!

The thought of investing is constantly on the minds of most individuals as they search for ways to boost their wealth. The issue that most investors face is that they don't know how to approach it properly. When it comes to investing in the stock market, most individuals watch the movement of the numbers and the data with a feverish regularity. Many see their efforts in the stock market as a business that must be monitored regularly, "tick-by-tick." They constantly watch for perceived "tell-tale" signs of when they should buy or sell, in hopes of gaining outsized returns through activity.

The problem is activity doesn't mean success. In fact, it's quite the opposite. There's no question that the trickiest part of investing is choosing the right approach and the right system. Even the most seasoned of investors will, at some point, find that their investment choices will not perform as anticipated. This can cause them to become more active in hopes of looking busy or providing value.

Investing is not a static exercise. Achieving investment success isn't just about making one right choice. Not only do you need to make the right choice in your investments, you also need to exercise such qualities as patience and composure. So successful investing is not only choosing the right investment, but also waiting for the right investment and holding on to it. Instead of being on a constant search for stocks that may or may not produce results, an investor should, instead, patiently wait for that one stock that promises to deliver profitable results over its lifetime. These investment opportunities must meet a very specific set of parameters in order to make the grade, and therefore, may be few and far between.

On Leisure Investing:
The problem is activity doesn't mean success. In fact, it's quite the opposite...

As a leisure investor, you want to understand how a potential business actually fits in relation to the rest of the world or an industry. Looking for this unique perspective could give you some insight that others may not be able to glean from just studying a company's specific fundamentals. When you're analyzing a particular stock you want to make sure that it has some type of moat (sustainable competitive advantage) that will make it difficult, if not impossible, for competitors to swoop in and take over a percentage of the market share. You're looking for a deep moat that continues to get deeper as the business continues to grow. This will allow your investment to compound in a leisurely manner.

Great stock opportunities do not come along every day, so you have to keep on the lookout for them and add them to your watch-list when they do come along. Sometimes it may take years for that right pitch to come along, so patience is key when it comes to making the right decision. This phenomenon always reminds me of a quote by the great algebraist Jacobi Pascal, "All man's miseries stem from his inability to sit in a room alone and do nothing."

In short, don't be busy for the sake of being busy. Doing nothing is a conscience choice too. You need to resist the need to trade or transact every quarter just to make sure you're looking busy. Instead, it is better to simply lead a relaxed and leisurely lifestyle while maintaining your watch-list until that perfect opportunity comes along.

Always Have a Checklist

Over the years, we have learned many valuable lessons on how to find the best possible investment options. However, we did not come to that knowledge without making a few mistakes along the way. Even after you've done all the research and analyzed every possible angle you can think of, things can still turn sour. Lessons are to be learned at every turn, and those that lead to losses will remain with you for many years.

The trick is to take those lessons and avoid repeating them. You can do this by maintaining a checklist that will eliminate the risk of forgetting to check for certain circumstances that could lead you down the wrong path. When you study and use your list, you will be able to compare it to other factors in your portfolio and determine what risk factors you would be exposed to. Realistically, any business you choose will have some element of risk, but it will be up to you to decide what percentage of risk you're willing to take based on your checklist and other available opportunities.

Investing in the stock market is not for the faint of heart. It can be quite frightening to put your hard-earned money at risk. However, you'll soon realize that taking some very basic steps can yield some very positive results. There is no need to put all your

money into your investment ideas all at once. It's not complicated, but by applying simple logical measures, your chances for success can be amplified. When you trust your natural instincts and avoid letting your emotions get in the way of analyzing your investment choices, you'll know the great investments from the mediocre ones. At the end of this book you will have top knowledge to build on and compound, which will serve you well over the years.

Playing Within the Lines

Staying away from inside information is another reason for investing as a leisure activity. When you are entrenched in the financial world, there will be times when the lines of legality or conflicts-of-interest become blurred. By being independent and being out of the influence of Wall Street, you can set yourself apart from the crowd. This is another reason I have chosen to invest outside of Wall Street.

Not only does it limit distractions but I never have to worry about the line of legality by mingling and having personal conversations with top executives. Of course without inside information, you will have less information. Between the two options, I prefer investing with less information because I know I won't allow myself to be anywhere near that ethical sideline. I believe that an investor should always take the extra step in staying within the field of the law.

On Developing a Watch-list:

Your watch-list is a critical component of a leisure investor. By accumulating high quality businesses in your watch-list, and constantly maintaining them over time, you will be prepared when the market presents an opportunity to invest in a business on your watch-list.

Seth Klarman, manager of $24 billion Baupost Group, says "If you play near the sidelines, you might stray out of bounds or someone might think that you did," he wrote. "We strive to play in the center of the field." He calls it the "Football Field Test."

Whatever your decision, you would be well served to always stray from running out of bounds. Play in the middle of the field; if you run a properly executed play it is the quickest and shortest distance to the end-zone.

Always Have A Watch-list

Your watch-list is a critical component of a leisure investor. By accumulating high quality businesses in your watch-list, and constantly maintaining them over time, you will be prepared when the market presents an opportunity to invest in a business on your watch-list. Personally, I have developed two proprietary watch-lists over the last 10 years of researching businesses: a high quality business watch-list and a special situation watch-list. I consider these two lists one of my biggest competitive advantages.

Invest Leisurely!

Amaya: Is It Time To Go All-In…?

After purchasing PokerStars, Amaya is seeking re-entry to U.S. market. Does the market have this one right or is this an opportunity?

Amaya Gaming Group (AYA) went from an obscure, unknown company to an owner of the largest and best online gambling sites in the world. Amaya's future was set in motion on August 1, 2014, after they acquired PokerStars for $4.9B in cash (all figures are USD).

Amaya is technology-based gaming solutions company engaged in the design, development, distribution, sales and service of their products. Now their brands include PokerStars, Full Tilt, the European Poker Tour, PokerStars Caribbean Adventure, Latin American Poker Tour, and the Asia Pacific Poker Tour. These brands form the largest poker business in the world with over 60% market share globally.

Prior to being acquired by Amaya, PokerStars had a stranglehold on the U.S. online poker market with a ~70% market share. Globally they have ~60 market share. Currently, they are domiciled on the Isle of Man (British Dependency) to benefit from the 0% corporate tax rate and little-to-no rules regarding accepting casino and poker bets from the U.S. They hold many legitimate gambling commission licenses in France, Denmark, Belgium, Italy, Spain, Estonia, and the European Union.

Online poker took off in the early-to-mid 2000s. Online poker companies growing dramatically and then President Bush signed the UIGEA in 2006, essentially banning online gaming in the U.S. Many of the U.S. poker sites packed up and went overseas. However, PokerStars skirted around this law by arguing that poker was not gambling, but a game of skill.

Under these characteristics, PokerStars would not be subject to the UIGEA. This allowed PokerStars to gain substantial market share in the U.S. as the government did not enforce the law initially or fight PokerStars assertion of the law. Eventually they were ejected from the U.S. in 2011 in what the poker community commonly refers to as "Black Friday." On April 15, 2011, the Department of Justice seized the domain names for PokerStars and FullTilt. Both companies, and their principles, were indicted for money laundering and bank fraud.

PokerStars refunded all U.S. accounts instantly. However, FullTilt player accounts disappeared on Black Friday. It was rumored that management stole all the money.

PokerStars eventually acquired FullTilt through a settlement with the DOJ. As a show of good faith and good will, PokerStars paid FullTilt's portion of their fine and they voluntarily refunded all accounts of former FullTilt players. This gesture produced a ton of good will within the global poker community.

Currently, all of PokerStars revenue is generated internationally (majority in Europe). Their history with the U.S.

INVESTMENT SPOTLIGHT: Amaya (AYA)

Amaya
(NAS:AYA)
Description: Engaged in design, development, distribution, sale and service of tech based online gaming.

Price	**$20.70**
52-Week Range	$18.81—34.50
Dividend Yield	N/A
Enterprise Value	$5.27B

Basic Valuation:	
P/FCF:	11.16
Forward P/E:	10.62
EV/EBIT:	21.00

Notable Owners:	
BlackRock	Tpg-axon
PointState	Odey Asset

INVESTMENT SUMMARY

As Amaya continues to deleverage, we believe the company should garner a higher multiple and trade at least 20x free cash flow given their strong growth, high margins, low Capex requirements, operating leverage, and dominate competitive advantages. Shares appear to be worth at least $34 per share.

Sources: Company reports (10Ks, 10Qs, etc..), other public information

government helps explain why they haven't been granted a licence to operate in the three states that have legalized online gambling (New Jersey, Nevada, and Delaware). However, the recent sale to Amaya should help clear up the "bad actor" status that has kept them from regulatory approval in the U.S.

Many consider PokerStars a risky investment because they essentially went to war with the U.S. over the legality of online betting laws. However, it's our belief that the market is missing critical investment events: (1) PokerStars' re-entry to U.S. market is highly probable and imminent and (2) rollout of sports betting and casino games to existing user base of ~85M registered players. And the market is focused on inconsequential issues: (1) broad-based selling in the Canadian market because the drop in oil, (2) concern of federal and state regulation, and (3) the trading investigation of the PokerStars buyout.

THE BUSINESS

Online poker sites are high margin, incredibly profitable businesses. The business model is very stable and there is significant scalability options. Online poker businesses typical exhibit very high margin and high double digits returns on capital. It certainly fits our model for a high quality business model.

PokerStars earn revenue by collecting "rakes" on each pot played. Rake is a small fee taken from each pot that is played online. These fees can vary based on the size of the games to the types of games. Individual games typically range from 4.5% to <1%. Tournaments usually collect a 5-10% fee. A significant portion of this goes back to the players in the form of loyalty rewards, bonuses, and rakebacks.

Capex is minimal and big Capex is not necessary to grow or maintain the business. Working capital is also not need to grow and its not uncommon to operate with negative working capital because of customer accounts. In addition, taxes are minimal due to the company being domiciled on the Isle of Man.

We believe we have the opportunity to invest in a business in the very early stages of a growth phase, with an extremely attractive business model, a dominant leader with >60% market share, numerous competitive advantages, and extremely undervalued business given it's high quality and future growth characteristics.

Each country (and state) has their own regulatory board that must approve gambling institutions operating in their jurisdiction. The majority of Amaya's revenue is generated in regulated areas in the EU. As new areas and jurisdictions begin to regulate, this can add to the growth potential of the overall market.

WHY THE MARKET IS MISSING THE OPPORTUNITY…?

Markets Hate Uncertainty:

The true profitability and growth of the business in not currently understood. There is a great deal of uncertainty surrounding this business, but as our good friend Mohnish Pabrai says, "Take advantage of Wall Street's handicap by seeking out low-risk, high uncertainty bets...It's all about only participating in coin tosses where 'Heads, I win; tails, I don't lose much." In general, the market has a difficult time distinguishing between risk and uncertainty. They get confused between the two very easily. Intelligent and savvy investors who are able to take advantage if the market's shortsightedness should reap the rewards over time.

As a result, we seek out the 'Heads, I win; Tails, I don't lose too much" conditions because the market tends to heavily discount these situations. Once the market comes to grips with the certainty there is normally a quick re-pricing /revaluation of shares - usually at much higher prices. We believe this will be the case with Amaya, if/when PokerStars gains re-entry to the U.S. markets.

Recency Bias

As much as the market hates uncertainty, it has a difficult time acting on something that's caused pain in the past.

Investors have previously been burned by other publicly traded poker companies in the past. Many of the publicly traded companies in the U.S. were decimated and lost investors a lot of money after the U.S. shut down online betting operations in 2011. Their negative perception of the past has clouded an above average likelihood that certain events are likely to unfold in the next 3-9 months.

Anchoring Bias:

Prices have increased from $5 in 2013 to over $20 per share in 2014. This gives the impression to investors that they've "missed the boat."

Prices have certainly increased a significant amount since news of Amaya acquiring PokerStars. However, a stock increasing 300% doesn't mean we change our ascertion that the stock still has a long run way of growth. Even with the recent run-up in share prices, we believe shares should be trading at much higher multiples.

The numbers and the valuations are not easily computed and, as a result, easily disregarded:

The smaller company acquiring the bigger company has made the company financials messy. This leaves the backward looking filings almost irrelevant in trying to understand and value the business.

Most analysts and research firms can't (or won't) value businesses with limited operational history. And without the ability to value the company, it means there will be little-to-no sell side analyst and brokerage coverage.

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The smaller company acquiring the bigger company has made the company financials messy. This leaves the backward looking filings almost irrelevant in trying to understand and value the business. Most analysts and research firms can't (or won't) value businesses with limited operational history. And without the ability to value the company, it means there will be little-to-no sell side analyst and brokerage coverage.

PokerStars was a private company with no debt prior to being acquired by Amaya. The online poker industry is new to many analysts and many investors are not familiar with the business. In addition, there are no comparable in the north American market.

Because PokerStars was private, there is very limited information available regarding fundamentals, size, and growth prospects. The Q3 report revealed their impressive earnings capability for the first time. So it's still relatively unknown to most of the investment world.

Although we believe the acquisition of PokerStars was a brilliant move by David Baazov, we also acknowledge his future ambitions. A large M&A acquisition spree may not be looked upon by the market favorably. We wouldn't necessarily be opposed to Amaya gobbling up competitors to protect their market share, as long as they were making acquisitions in a savvy manner and at reasonable multiples. The true underlying fundamentals of the business are likely to show through in the next few quarters.

See the section below, "U.S. entry is a major catalyst," for conservative estimates of future revenue and earnings.

Investigation into the pre-deal Price Action:

30 days prior to the announcement that Amaya would acquire PokerStars, shares climbed more than 50%. There were numerous rumors of a merger weeks before the announcement. This prompted an investigation by Canadian authorities into potential wrong doing.

Shareholder recently voted overwhelmingly in support of the board of directors with 96% approval. Amaya was recently vetted by prior to joining the Nasdaq by securities regulators in the U.S.

We view this as a non-issue.

The market is not sold on U.S. re-entry for PokerStars:

Amaya and PokerStars have made all the right moves to put themselves in a position to gain entry to U.S. markets. They already have significant goodwill across the globe and in the poker community.

It's only a matter of time before the U.S. sees it too. As we know, politicians can be slow to act at times (especially during election periods). And many believe the online gambling tax revenues just aren't worth the time and annoyance from various interest groups.

In addition, the market seems to be concerned with the Federal Government banning online gambling in the U.S. altogether. We believe this is unlikely for a number of reasons - the most important being that it's un-American. And we would liken it to the prohibition (I know that's aggressive).

There are split views on the hill as to the acceptance of online gambling in the U.S. Various industry leaders and contacts in D.C., tell us that any bill (even if it made it out of a committee) would have a very low probability of passing. Especially because U.S. states have already started to adopt legal online gambling provisions. In addition, online lottery tax revenues would be at risk.

Personally, I play poker recreationally (online or with friends). It's fun, exciting, and has all the components of value investing that I love - math, probability, behavioral psychology, and game theory. Instead of spending $50 to go to the movies or a ball game, I can buy-in for $50 and have the potential to make money while having a great time in the process. Poker isn't bad for society. Like any card game (and most things in life), if you act responsibly and have fun, it can be a great experience for everyone involved.

We believe politicians will change their tune soon enough. In fact, it's already happening.

Slowly, but surely, online gambling is coming back to the U.S. Three states have already allowed online gambling within their borders - New Jersey, Nevada, and Delaware. And 20 states are expected to allow online gambling by 2020.

It's our belief that New Jersey will start a cascading effect since seeing the Italian market grow 62% year-over-year when PokerStars entered their market. We believe New Jersey sees the potential positive effects of the PokerStars brand, and what they bring with to the table with their one-of-a-kind user network effects and liquidity.

If New Jersey starts generating significant revenue from PokerStars re-entry, we believe you'll see other states start to make provisions for online gambling and allow PokerStars entry. It would be a domino effect of some sort.

Based on our research, we believe significant growth lies ahead as the U.S. allows PokerStars to re-enter the U.S. market. The entry to the New Jersey market will be the catalyst that allows PokerStars to enter the rest of the U.S. market.

Municipalities (and the federal government) need revenue to finance projects and provide for their citizens. The approval of online betting is just another way for the state and the U.S. government to generate revenue. And at the very least, it's better than approving another gaudy casino.

Bottom line: municipalities and the federal government need new sources of revenue. It may not seem like a

great deal of revenue at the federal and state level, but they really need to find multiple sources of new revenue. This is a step to make that happen as the federal government and municipalities continue to run deficits budgets. This makes for a great political talking point as they pander to their constituents. However, we believe it's just noise before the ultimate re-entry in the U.S. market.

INVESTMENT OVERVIEW

Strong Competitive Advantages Internationally via Network Effects and Brand Recognition:

Because it's such a new industry, market participants have a difficult time ascertaining potential competitive advantages in the online poker industry. It cannot be stated enough, that this is a high quality business with numerous competitive advantages. The user base, and the network effects associated with it, is the most important component of a high quality online poker site.

As a recreational poker player, I know firsthand what I look for when picking sites for games: a large user base. PokerStars has, by far, the biggest online poker user base with ~85M players (w/o US). It is a determining factor in how professional and recreational players choose which sites to play and trust. Having such a large user base of players allows players to search for the best game conditions 24 hours a day.

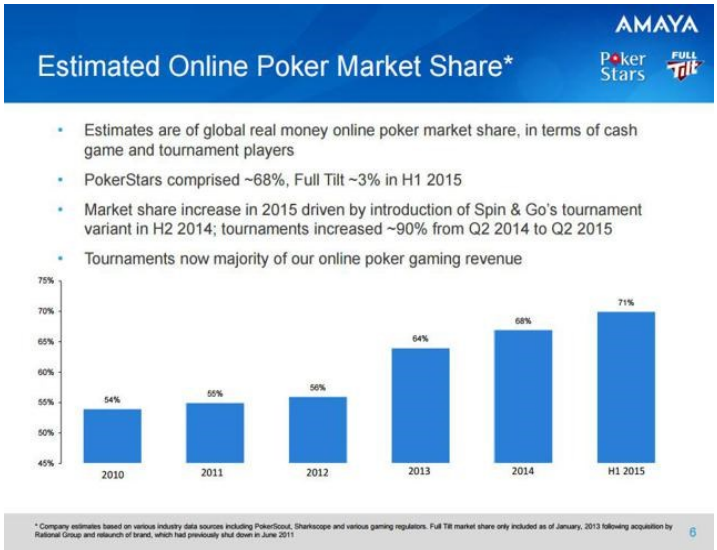
Larger user bases also provide for numerous options for the tournament player enthusiasts. These tournaments come in many forms, such as sit-and-go tournaments, land based events, and the big multi-table tournaments with the massive payouts. Because of its size and player base, PokerStars offers weekly tournaments with payouts over $1 million dollars. They consistently send over 1,000 players to the World Series of Poker every year.

These kinds of network effects cannot be understated in the online poker market. It provides a significant moat. PokerStars has done an excellent job growing that moat through player's growth and marketing campaigns using professional poker players and athletes (similar model to Nike).

As we know, the gambling industry does not have the best reputation. PokerStars would be the exception to this common stereo-type. An example of this would be PokerStars repaying all FullTilt player accounts which were allegedly stolen by FullTilt management -- something they didn't have to do. This has helped them build goodwill while strengthening their trustworthy reputation.

In addition, they have the best software technology in the business and can handle extreme traffic loads (>600k players at one time). This scale advantage allows them to offer lower rakes than their competitors. This is the equivalent to a low cost operator, which helps strengthen their moat. The re-entry into the U.S. market should help strengthen and widen their moat in the online poker and betting market.

Prior estimates of PokerStars' market share in the U.S. pegged them at ~70% total market share (revenue). Here are the most recent global market share estimates for PokerStars:



U.S. Entry is a major catalyst:

Amaya CEO David Baazov stated on June 9, 2015, that he expected PokerStars to be licensed in the U.S. within the next 30-90 days. This timeline may or may not occur. However, we believe it's just a matter of time before PokerStars gains re-entry to U.S. markets.

Online poker growth within the U.S. essentially had its knees cut out from underneath itself in the early stages of a major growth phase.

Let's take a look at some conservative financial assumptions that can act as a potential catalyst for re-pricing of shares. See the potential valuation change when PokerStars gains re-entry into the U.S. markets:

Amaya (current)	
Revenue	$ 1,067.00
EBITDA	$ 408.00
Free Cash Flow	$ 338.00
	*in millions, USD

+

PokerStars (US re-entry)	
Revenue	$ 1,000.00
EBITDA	$ 300.00
Free Cash Flow	$ 240.00
	*in millions, USD

=

New Company Financials	
Revenue	$ 2,067.00
EBITDA	$ 708.00
Free Cash Flow	$ 578.00
	*in millions, USD

Source: Author, with author's own estimates

We assume an average of Morgan Stanley's low-line U.S. market potential ($2.7B by 2020) and Academicon's estimate ($2.2B) will come to fruition over time. We also assume that PokerStars is able to gain a 40% market share, which is well below the 65%+ it garners internationally. And it's also well below the ~70% market share it garnered in the U.S. prior to Black Friday. Free cash should track closely to EBITDA since there have extremely low Capex requirements and little to no taxes. We expect interest payments to subside over time as well. So this should be a fairly conservative number of free cash flow.

Current revenue is 1.07B with EBITDA of $408B and free cash flow of $338B. This gives us an EBITDA margin of 38.40% with free cash at 82.80% of EBITDA. Based on 2 reports of the U.S. online Poker market we average the two estimates of $2.2B and $2.7B. This gives the U.S. online poker market a potential $2.45B market potential.

Remember, PokerStars had a ~70% market share rumors. But let's assume they only capture 40% of the market (very conservative). This gives us a potential revenue boom of ~$1B at a 40% market share. With an EBITDA margin of 30% and free cash flow at 80% of free cash flow, we see a free cash flow estimate of $240M. We believe these margins are well below the actual margins.

This is a conservative 72% increase in free cash flow that the market is ignoring from only one of our two major catalysts.

With these new financials in place with the re-entry to the U.S. markets, it changes the business fundamentals dramatically. If shares were still trading at current levels, you'd have a business trading at ~5x free cash flow, EV/EBIT ~10, P/E ~5, FCF/EV of 10. Very cheap ratios and metrics that the market is not considering. Sell-side analysts will be quick to adjust their valuation models and price targets. We wouldn't be surprised to see a quick re-pricing of shares at ~$50 per share. Ultimately, we believe shares could be worth ~$100 per share with continued growth rates in the next 3-5 years.

Previous U.S. online markets potential and growth estimates were severely overstated. However, recent growth estimates have come down to realistic levels and this provides the opportunity for Amaya and the U.S. online poker market to surprise on the upside. Morgan Stanley has ratcheted down US online gambling estimates from projections as high as $9.3B to $2.7B by 2020. We'd rather step over a 1-foot pole, than try to jump over a 10-foot pole.

The U.S. is the world's largest economy. Access to this country would be a major boost to future revenue and earnings from Amaya. No other country do you see this amount of people with discretionary income and internet access. Full U.S. market value of all 50 states is expected to be around $10B. There is a long wave of growth potential in the future. The market has not come to grips with this yet.

Market is not pricing in vertical and horizontal product offerings:

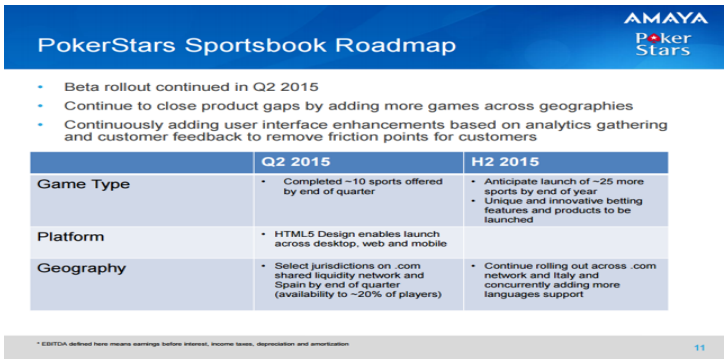
This may be the most important part of our investment thesis. PokerStars is essentially a poker company. Historically, they have not offered other casino table games, online slots, or sports betting. Although online poker is growing, it only accounts for $4B in annual revenue. Online sports betting generates $17B and all other online gaming accounts for $8B. In addition, the margins are higher in sports betting and casino games.

Their 85M player base provides for enormous potential when they roll out the sports betting and casino platforms. There's already tested the strategy on the smaller FullTilt and PokerStars.es platforms, and they've reported double digit cross sell rates already.

This is extremely important for two reasons: (1) increase in revenues at higher margins and (2) they don't need to pay to acquire customers. With a player base of 85M, the cross-sell potential across the entire platform should be seamless.

PokerStars has seen competitors roll-out cross sells successfully. And the data they've compiled over the years shows that a large proportion of their active player base bet on sporting events and/or play casino games. This should allow them to increase earnings significantly over the short-to-intermediate term with very little friction.

They haven't spent a dollar on marketing these products and they haven't launched it on mobile yet. 45% of their users are on mobile. They're already producing $36M in quarterly revenue (11% of total revenue) from these platforms and it's not even close to being rolled out and fully optimized. Just think about that for a second.



Removal of Old Ownership and Leadership should nullify bad actor status and could pave the way to re-entry in the U.S.:

One of the main reason PokerStars was sold to Amaya was because previous owners realized they would have a difficult time gaining approval for U.S. markets because of their "bad actor" status.

The underlying structure of the acquisition was conducted in a way that would exclude PokerStars as a "bad actor" with a new and entirely different management team and ownership. We do believe the Amaya is cheap at current levels without access to the U.S., however, we do believe they'll be approved under new ownership.

This approval will be a major catalyst for market participants to accept and understand their potential growth in the U.S.

PokerStars re-entry will be a major catalyst for the stock and should help to create a domino effect of state approval and acceptance. This could be a game changer for the entire business over the next few years. CEO Baazov, reiterated that PokerStars NJ remains "on track" for approval. It's interesting to note that he made no mention of the New Jersey market in the most recent quarterly presentation in August. We believe this could be for two reasons: the New Jersey approval has hit a standstill or he is trying to temper expectations and verbiage to the New Jersey regulatory authority. We believe it's the later.

The issue of late for U.S. re-entry approval was the discussion around the "bad actor" clause. The argument against PokerStars approval in the U.S. is their past indiscretion with failing to follow the UIGEA. This stamped them as a 'bad actor.' Anyone classified as a 'bad actor' has almost a zero percent chance of operating in any state with that status.

Yes, PokerStars operated in the U.S. after UIGEA. And the purchase of the company with new ownership doesn't exclude them from 'bad actor' status (IMHO). It's their actions and their stellar reputation that exempts that from 'bad actor' status. Their actions since Black Friday have been nothing short of stellar and they've done everything needed to put them back in the good graces of regulatory authorities in the U.S. and Globally.

PokerStars is already gaining momentum and acceptance from various state groups. We believe that New Jersey is a prime location for approval for PokerStars for a few reasons, but the main reason being: they need the money (every municipality needs money for that matter).

NJ online casino revenue has been trending upwards, however it appears casino revenue has stalled at current levels. And online poker revenue has declined from a high in 2013 at $3.5M per month. It appears to be stabilizing around $2M per month right now.

Because of PokerStars brand presence, 85M player user base, and liquidity. They would be able to turn this around almost overnight. We would not be surprised to see online poker revenue jump back to 3.5M per month figure and beyond. We envision that online casino revenue would have a significant jump as well and help NU get back on the path to growth. This would be great for both New Jersey and PokerStars. It's a win-win for both parties.

Organic Growth Internationally

Regulation in the gambling market is always a risk. PokerStars is extremely well diversified across numerous countries around the world. The majority of their revenue is generated from stable governments.

The online gaming market is growing rapidly. Amaya is in the early phase of, what is likely, to be a long wave of growth in the U.S. and abroad. Annual growth rates are almost 15% in the EU. The U.S. is likely to experience similar rates once more states adopt online gaming.

AMAYA

Financial Highlights[1]

- Revenues increased 10% to ~$320 million in Q2 2015 vs Q2 2014 revenues of ~$289 million
  - Casino/sportsbook revenues were ~$36 million (~11%) in Q2 2015; Poker revenues comprise almost entirely the remainder
  - Growth despite headwinds including:
    - Negative impact on the purchasing power of consumer base due to dramatic year-over-year shift in value of local currencies relative to the US dollar (USD), primary currency in which we collect poker rake/fees. On average, there was an approximately 19% year-over-year decline in the value of our consumers' local currencies[2] versus the U.S. dollar in Q2 2015 vs Q2 2014 ("Forex")
    - Began paying Value-added taxes ("VAT") in certain EU jurisdictions including Germany and France in 2015, which impacts revenues, which were not imposed in 2014 (~$6 million)
- B2C business revenues increased ~24% on a constant currency[3] basis and normalizing[4] for VAT (see appendix)
  - Poker revenues increased ~11% on a constant currency basis and normalizing for VAT

1 All 2014 figures are presented on a pro forma basis, which assumes that the acquisition of Amaya's B2C business occurred as of the first day of such financial period
2 Calculated as a weighted average based on jurisdiction of gross deposits
3 For each jurisdiction in which the Corporation's B2C business operates, 2015 dollar figures are adjusted to their 2014 constant currency equivalent by using a factor that is derived from the percentage change in the exchange rate of the applicable jurisdiction's currency relative to USD during the comparative period. The sum of each such equivalent is then compared to IFRS figures for the applicable comparative financial period in 2014. During the quarter, the Corporation estimates the decline in purchasing power of our consumer base was a result of an average 19% decline in the value of its customers' local currencies relative to USD, which was partially offset by the translation into its CAD reporting currency.
4. Normalizing as defined by the Corporation means adding back the particular dollar amount at issue to the referenced financial measure.

13

Regardless of U.S. re-entry, organic growth and the continued growth internationally at 10%+ should provide a wave of profitability over the long-term. In addition, Amaya has targeted other online gaming verticals within the international markets (notably casinos and sportsbooks, and fantasy sports), which complement its core online poker business.

AMAYA

Financial Highlights (cont'd.)[1]

- Adjusted EBITDA grew 24% to ~$138 million (43.5% of revenues) in Q2 2015 from Adjusted EBITDA of ~$112 million (38.5% of revenues) in Q2 2014
  - Margin expansion driven by growth of high margin income streams, notably online casino
  - Growth despite headwinds including:
    - Forex
    - VAT (~$6 million)
    - Recently introduced gaming duties ($4 million) introduced in the United Kingdom and Bulgaria which were not imposed in Q2 2015 ("New Gaming Duties")
- Adjusted EPS grew 43% to $0.43 in Q2 2015 from Q2 2014 Adjusted EPS of $0.30
- H1 2015 Unadjusted Unlevered Free Cash Flow of ~$210 million
- Adjusted Net Debt of ~US$2.4 billion as at June 30

1 All 2014 figures are presented on a pro forma basis, which assumes that the acquisition of Amaya's B2C business occurred as of the first day of such financial period. Adjusted EBITDA, Adjusted EPS, Unadjusted Unlevered Free Cash Flow, and Adjusted Net Debt are non-US GAAP and non-IFRS measures. Please refer to the appendix of this presentation for reconciliation.

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Amaya has continued to grow in Europe and Canada despite both of the economies slowing down over the past few years. We believe the company will continue to grow regardless of the local economies. If local do begin to grow, we believe this will be icing on the cake.

Numerous markets around the world, including Russia, are looking at regulating their respective markets, so that's another factor that helps create a long runway for growth.

Management is shareholder friendly and incentivized properly:

President and CEO, David Baazov, founded Amaya. He's led the company since 2006. Although he is only 35 years old, he has done an amazing job in acquiring PokerStars and has a great vision for the company. Here is a recent profile on Forbes.

He has a large stake in Amaya (12.5%). We think he is plenty incentivized to make decisions that are in the best interest of shareholders.

Recently, the company announced a share repurchase program to purchase up to 5,399,631 common shares by the end of 2015. This represents 5% of the public float. They intend to fund the purchases through proceeds of non-core divestitures and cash on hand. Their philosophy of repurchasing shares at discounts to the underlying value of Amaya should be a welcome sign to all shareholders.

VALUATION

On the valuation front, Amaya sports a P/FCF of 11.68 (FCF yield of 8.56, EV/EBIT of 21.54, forward P/E of 11.00, and P/S of 4.08.

The future is inherently unknown and unpredictable (to any high degree of probability). Because we weren't blessed with a crystal ball, we believe a margin of safety is ESSENTIAL in every investment.

A larger margin of safety is recommended for lower quality investments (larger discount between current prices and the Intrinsic Value of the Business). A higher quality business or investment doesn't necessary require a large discount to intrinsic value if you expect (with a high degree of probability) that returns will be realized shortly or returns of the business will compound over time.

Regarding valuation, the margin of safety can be accomplished in one of two ways (or both for that matter):

1) Purchasing the conservative estimate of future free cash flows of the business at a discount

2) Purchasing a business below its liquidation value with favorable earnings power in 3-5 years.

In the case of Amaya, we will be valuing the business based on its discounted future free cash flows to determine if there is a margin of safety.

In valuing any business, it's important to focus on free cash flow (as well as the durability of its competitive position).

In valuing Amaya, let's start with the FCF number.

Amaya had Cash Flow from Operations of $364M in last twelve months. Capital expenditures for the last year were $26M. The "back of the envelope" net free cash flow was about $338M. We think this is a very conservative number, as recent free cash numbers are already coming in higher.

PokerStars revenues and earnings are just showing up on Amaya's quarterly statements, so it's tough to get a long-term view. However, looking at the TTM we see incredible return on equity and invested capital, 33% and over 250% respectively.

It appears Capex is appears relatively stable in the $25-35M range. We would not be surprised to see this higher over time as they continue to grow.

Amaya operates in a cyclical industry. However, the industry is in very early stages and continues to grow at a rapid rate. Down the line, it may be subject to the wide vagaries of market cycles at times. Given the early stages and expectation of continued growth, we will use TTM free cash flow of $338M.

We'll be conservative, and use a little less than TTM free cash flow, $330M -- just to give us an even bigger margin of safety.

We will use a conservative discount rate of 10%, given the high quality nature of the business.

And even after all the DCF projections, the business is still worth something at the end of the day (all else being equal). So we assume that the business is sold at the end of the year 10 at a conservative 10x FCF plus any excess capital in the business. Amaya had $350 in cash of TTM, so we'll use this as a conservative number of excess capital.

They have embarked on a share repurchase program. However, we want to be conservative in our assumption. So we'll use current 200M shares outstanding in our calculation (although we believe this will be much less over time).

Based on these numbers, and to be very conservative, we will come up with 3 growth scenarios for Amaya over the next 10 years. We'll also give a probability weight based on the likelihood of each scenario. Let's look at the three scenarios below using these various assumptions, and see how we were able to arrive at a fairly conservative estimate of intrinsic value using a range of values and probability of the scenarios playing out:. *See valuations at the end.*

The discounted cash flow values of Amaya range from $23.89 to $42.60. The stock is trading ~$21 per share which gives a large margin of safety to our weighted and high range assumptions. We believe the most likely scenario is 10-15% growth in FCF in the foreseeable future, which is why we weighted scenario #2 and #3 at 40% probability each.

This gives us a weighted intrinsic value of $34.52 per share. With shares

trading at ~$21 per share, it seems like an interesting opportunity at current levels.

REMEMBER: These calculations do not take into consideration PokerStars re-entry to the U.S. markets or the free cash flow jump in cross selling new complementary product lines. As we discussed above, we could see free cash flow ~578M shortly after re-entry. We'll be conservative and use the same estimates above, but we'll use only $500M as Amaya's real free cash flow. This is a very conservative number we believe will be reached in the next 6-18 months.

As you can see, our conservative estimates dramatically changes the future valuation of the business (~50% increase). We get significant economic power at current levels without U.S. re-entry. But we have a kicker -- U.S. re-entry is a significant catalyst that we believe has a high probability of approval. It's a classic case of 'heads, I win; tails, I don't lose much."

As Amaya continues to deleverage, we believe the company should garner a higher multiple and trade at least 20x free cash flow given their strong growth, high margins, low Capex requirements, operating leverage, and dominate competitive advantages.

BOTTOM LINE

We believe the market is missing a big opportunity here when PokerStars is allowed to re-enter the U.S. market and the cross selling of the Sports Betting and Casino Platforms are rolled out in the next few months. We've seen U.S. online poker revenue market estimates between $2-3B for the first year alone (we believe this to be conservative). With PokerStars' previous ~70% market share, you're looking at more than a doubling of revenue and earnings just from the re-entry to U.S. markets alone.

Ultimately, it could be a month or it could be 5-10 years before PokerStars re-entry to the market. Regardless, Amaya looks to be an attractive investment at current levels with its potential to grow organically from new vertical and horizontal product lines being rolled out. PokerStars entry to the U.S. is just icing on the cake.

There are numerous ways to win with this investment at current levels, with these three being likely scenarios: Amaya continues to grow its Pokerstars platform internationally, new product roll outs to existing user base provides an immediate significant earnings increase, or PokerStars gains re-entry into the U.S. markets. Our research leads us to believe that there is a high likelihood of all three.

Investors should do well long-term through their investment in Amaya at current levels (and lower). VIC

Notable Shareholders:

BlackRock | PointState Capital | Capital Research | VA CollegeAmerica | Odey Asset Management | GSO Capital Partners | 1832 Asset Management

**Figures Source: Company Presentation*

***See two market share reports here: Morgan Stanley, Academicon*

Low-Range Scenario #1: 5% growth in FCF for years 1-10

Low DCF Analysis: (in Millions)

Year			Free Cash Flow	Growth Rate of FCF	Discount Rate of FCF	Present Value of Future Cash Flow
	Excess Cash					$ 350.00
1	2015		$ 330.00	5%	10%	$ 300.00
2	2016		$ 346.50	5%	10%	$ 286.36
3	2017		$ 363.83	5%	10%	$ 273.35
4	2018		$ 382.02	5%	10%	$ 260.92
5	2019		$ 401.12	5%	10%	$ 249.06
6	2020		$ 421.17	5%	10%	$ 237.74
7	2021		$ 442.23	5%	10%	$ 226.93
8	2022		$ 464.34	5%	10%	$ 216.62
9	2023		$ 487.56	5%	10%	$ 206.77
10	2024		$ 511.94	5%	10%	$ 197.37
10	2024	Sale Price of	$ 5,119.38		10%	$ 1,973.74
	TOTAL					$ 4,778.88
	Shares Oustanding					200.00 M
	Intrinsic Value					$ 23.89

Mid-Range Scenario #2: 10% growth in FCF for years 1-10

Mid DCF Analysis: (in Millions)

Year			Free Cash Flow	Growth Rate of FCF	Discount Rate of FCF	Present Value of Future Cash Flow
	Excess Cash					$ 350.00
1	2015		$ 330.00	10.0%	10%	$ 300.00
2	2016		$ 363.00	10.0%	10%	$ 300.00
3	2017		$ 399.30	10.0%	10%	$ 300.00
4	2018		$ 439.23	10.0%	10%	$ 300.00
5	2019		$ 483.15	10.0%	10%	$ 300.00
6	2020		$ 531.47	10.0%	10%	$ 300.00
7	2021		$ 584.62	10.0%	10%	$ 300.00
8	2022		$ 643.08	10.0%	10%	$ 300.00
9	2023		$ 707.38	10.0%	10%	$ 300.00
10	2024		$ 778.12	10.0%	10%	$ 300.00
10	2024	Sale Price of	$ 7,781.23		10%	$ 3,000.00
	TOTAL					$ 6,350.00
	Shares Oustanding					200.00 M
	Intrinsic Value					$ 31.75

High-Range Scenario #3: 15% growth in FCF for years 1-10

High DCF Analysis: (in Millions)

Year			Free Cash Flow	Growth Rate of FCF	Discount Rate of FCF	Present Value of Future Cash Flow
	Excess Cash					$ 350.00
1	2015		$ 330.00	15%	10%	$ 300.00
2	2016		$ 379.50	15%	10%	$ 313.64
3	2017		$ 436.43	15%	10%	$ 327.89
4	2018		$ 501.89	15%	10%	$ 342.80
5	2019		$ 577.17	15%	10%	$ 358.38
6	2020		$ 663.75	15%	10%	$ 374.67
7	2021		$ 763.31	15%	10%	$ 391.70
8	2022		$ 877.81	15%	10%	$ 409.50
9	2023		$ 1,009.48	15%	10%	$ 428.12
10	2024		$ 1,160.90	15%	10%	$ 447.58
10	2024	Sale Price of	$ 11,608.99		10%	$ 4,475.77
	TOTAL					$ 8,520.04
	Shares Oustanding					200.00 M
	Intrinsic Value					$ 42.60

	Scenario Probability		Outcome	Weighted Value
Low Range FCF - -5% Growth in Years 1-10 - 10% DR	1	20%	$ 23.89	$ 4.78
Mid Range FCF - 10% Growth in Years 1-10 - 10% DR	2	40%	$ 31.75	$ 12.70
High Range FCF - 15% Growth in Years 1-10 - 10% DR	3	40%	$ 42.60	$ 17.04
Expected Value		100%		$ 34.52

Value Investor Screens (1 of 5)

U.S. Net-Net Stocks

Companies trading below Net Current Asset Value, filtered by EV/EBIT

Company Name	Ticker	Market Value	Enterprise Value	Current Price	NCAV	66% NCAV	P / NCAV	P/TBV	EV/EBIT

COMING SOON

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