Value Investor INSIGHT
The Leading Authority on Value Investing
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Investing in Crisis

Warren Buffett captures an essential truth about investing when he says, “It's only when the tide goes out that you learn who's been swimming naked.” The market tide has certainly delivered its share of eye-opening moments over the past two months. Here, 12 best-in-class investors from around the world describe how they're navigating the roiling seas.

INVESTOR INSIGHT

Mason Hawkins, Staley Cates, Ross Glotzbach
Southeastern Asset Management

One-At-a-Time Investing

Few active value investors have a longer and more storied pedigree than Mason Hawkins of Memphis-based Southeastern Asset Management. Now working through the eighth bear market of his investment career, we caught up with Hawkins and colleagues Staley Cates and Ross Glotzbach to find out the ways in which this time around has been different, how it's been the same, and where they're finding opportunity as a result.

Describe generally how you were assessing the investment landscape leading up to when that landscape started to change dramatically in February.

Mason Hawkins: We're one-at-a-time business investors, focused in each particular case on whether potential investments meet our qualifications with respect to business quality, the skill of the people running the business, and the price we have to pay against our conservative assessment of intrinsic value. At the end of 2019 we were finding little that met those qualifications, primarily due to price, so across our portfolios we had a material amount of cash. We were not forecasting or predicting, we were pricing, as Ben Graham used to put it. We had sold or reduced a number of positions and we were waiting patiently for new opportunities that met our criteria. Cash increased as a residual of that, into the teens in the United States and somewhat less than that in international portfolios, as we'd been finding better bargains outside the U.S. than inside the U.S.

Roll forward and the world changed almost overnight. The markets went down more significantly and quicker than at any time in my life. Our views regarding the future were altered somewhat, but more significant for us was the discounted pricing now available in a number of companies we already owned or knew we wanted to own at the right price.

Ross Glotzbach: We put cash to work fairly quickly, especially as we got into the second and third weeks of March. It happened faster outside the U.S., where we already thought stocks were less richly priced. There we were soon in more-ideas-than-money mode, so we were prioritizing attractive options and using it as an opportunity to upgrade the portfolios.

We also put cash to work very quickly in U.S. small cap as there was an incredible pullback in the Russell 2000, based on the prevailing view that small companies are disadvantaged in a bad economy versus large companies. In a number of cases we thought the concern was overdone, to the extent that earlier this month we reopened our small-cap fund to new investors for the first time since 1997. In U.S. large cap, because many of the companies we already owned or wanted to own held up better in the decline, we didn't get as much of the cash invested.

To put money to work quickly, do you have to have a basic hypothesis on how the coronavirus pandemic plays out?

MH: Again, it's pricing for us, not timing. What we can be certain about today is that this is a very adversarial business environment. But we do believe we will return to some degree of normalcy. If a company is priced in the market at 30 cents on the dollar against our assessment of intrinsic value, for the most part all we need to assume is that normalcy will generally return in order to find that an attractive opportunity. We'll be the first to admit that we don't know exactly when revenues and free cash flow are going to be generated in a normal way again, but when discounts are that steep we can be patient and expect to benefit not only from intrinsic values growing again, but also from Mr. Market weighing those values much more fairly when things eventually improve.

As risk-averse capital allocators – and this comes from the largest investor in the Longleaf Partners' funds – what we are most concerned about is not losing permanent capital. If we are very confident

in our rough appraisal of value and that it will normalize in the near future, we're willing to step up aggressively.

RG: To Mason's point on not losing permanent capital, we are not at all blind to the short-term impacts of the current crisis. We go down the list on each of our holdings and ask the hard questions about the company's cash flow in a severely challenged environment. How long can it withstand that? What flexibility does it have on the income statement and balance sheet to come out stronger on the other side? What I'm saying is that if we need the impact of the virus to only last five months for our investment case to work, that's just not something we're going to do.

Can you give an example of something on the smaller end of the market-cap spectrum in the U.S. that came into buying range last month?

RG: Empire State Realty Trust [ESRT] is a stock we've owned before, buying it in 2013 at its initial public offering, which is rare for us. Its number one asset – accounting for a significant majority of the value – is the Empire State Building, which was essentially being sold in 2013 by Leona Helmsley's dog, who was the beneficiary of the trust Leona had set up to hold it upon her death.

That first time around we really got to know Tony Malkin, the company's chairman and CEO, as a conservative, focused value creator. When he took over management of the Empire State Building earlier in the 2000s, it was certainly a famous address, but as a real estate asset it needed a lot of work. He set about improving the property, which had a very positive impact on rents and occupancy. He also saw considerable untapped potential in capitalizing on the building's history and name recognition, making the observatory at the top of the building a far more profitable tourist destination.

When the stock was at $15 last summer, the sell side was mad at Tony because Empire State didn't have enough leverage, that it wasn't buying back enough stock, that it wasn't paying a bigger dividend, and that it wasn't pursing M&A. Guess what? Those turned out to have been all the right moves to make, and the company is now coming from a position of relative strength.

We came into the year estimating intrinsic value at around $20. That's come down because the observatory is closed, and while the leases generally are locked-in, there's obviously higher risk on payments than there was. But while our value estimate fell to the mid-teens, the stock fell below $7 last month and now goes for around $8.20 per share. The value will remain a moving target for the short term, but we have a great owner/operator at the helm seeing the numbers every day and we think he'll be making the right calls to grow the long-term value per share. At the right price, that was an opportunity to take advantage of.

ON FORECASTING:

If we need the impact of the virus to only last five months for our case to work, that's not something we'll do.

Let's talk about a non-U.S. idea, Prosus [Amsterdam: PRX], that also caught your attention in the downdraft.

Staley Cates: The origin story here is that 20 some years ago, Koos Bekker and his traditional South African media company called Naspers put $32 million into a fledgling Chinese Internet company called Tencent [Hong Kong: 700]. They rode the wave all the way from then to now, and he and various entities currently own about 30% of it.

Holding a stake like that in the context of a publicly traded South African holding company created a lot of problems. For one, it dwarfed the rest of the company. There were calls for more taxation. There was an unfriendliness toward dividends. All this meant that Naspers traded at a giant discount, 30-40%, of the value of the underlying Tencent holding. Given the situation, the discount was somewhat justified so we never thought it made sense to own Naspers.

Aware of all this, the company last summer set up a holding company called Prosus in the Netherlands to hold its Tencent assets and some others. They were able to do it in shareholder-friendly ways, the most important of which is that the value of the Tencent asset could basically triple from here and if they started to sell it down there would be no tax due. In addition, if they distribute it to shareholders there are ways to pass on the basis in the holding, but it won't be taxable at the time of the event.

For a lot of reasons the market met this with a yawn. The company isn't really beating its chest about it. There's serious fatigue around SoftBank [Tokyo: 9984], another company with a powerful stake in the Chinese Internet – in Alibaba [BABA] – that is in the news nearly every day. People seem to think that the Naspers discount that never went away will never go away here either. We disagree.

Our Asian office has known and covered Tencent for a long time, and to our mind it's one of the highest-quality businesses we've ever seen. The main part of the platform, around which everything orbits, is WeChat. It's like Twitter and Facebook combined, with 1.1 billion users who spend an average of 90 minutes on it per day.

That was the first main asset and from there they've built additional businesses around it. Tencent is the world's dominant mobile-gaming company. It has all these people on its platform talking to each other and playing games, so from that it has created a giant advertising business to monetize the traffic. Like Alibaba with Alipay, they've developed a huge payments business that is still very much in growth mode. They saw what Amazon did with its AWS cloud business and have successfully done something similar with Tencent Cloud. They're also building a large music business, selling it like Apple does, and

INVESTMENT SNAPSHOT

Prosus
(Amsterdam: PRX)

Business: Holding company traded in Europe whose primary asset is a long-held stake in Chinese messaging, e-commerce, mobile gaming, cloud services and music giant Tencent.

Share Information
(@4/29/20, Exchange Rate: $1 = €0.92):

Price	**€69.04**
52-Week Range	€46.75 – €77.40
Dividend Yield	0.0%
Market Cap	€112.99 billion

Financials (TTM):

Revenue	€2.86 billion
Operating Profit Margin	(-19.0%)
Net Profit Margin	141.8%

Valuation Metrics
(@4/29/20):

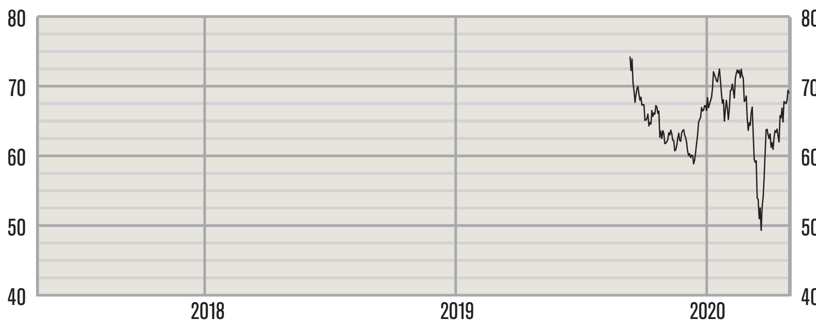
	PRX	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	n/a	21.0

Largest Institutional Owners
(@12/31/19 or latest filing):

Company	% Owned
Capital Research & Mgmt	1.0%
Norges Bank Inv Mgmt	1.0%
Vanguard Group	0.8%
Dodge & Cox	0.5%
BlackRock	0.4%

Short Interest (as of 4/15/20):

Shares Short/Float	n/a



THE BOTTOM LINE
The market has more or less yawned since the holding company listed its shares in Europe in an effort to shrink the discount they had in South Africa to the underlying value in primary holding Tencent, says Staley Cates. He believes that neglect is misguided and that the discount to underlying value, which he pegs at around 40%, will eventually close.

Sources: Company reports, other publicly available information

they recently took a 10% stake in Universal Music Group, the world's largest music company. These are a lot of businesses with massive moats and user bases, diversified across areas with pretty impressive long-term growth potential – which I'd add, isn't likely to be negatively impacted by the current pandemic crisis.

Is there anything else to say about the other assets Prosus owns?

SC: Over a long period of time, they've also invested in building successful online-classifieds, food-delivery and payments businesses primarily in emerging markets. They will tell you, in a funny phrase they use, that their venture capital model is not "spray and pray" – a not-so-indirect reference to SoftBank – but focused on specific markets they know well and where their companies benefit from network effects as they grow. Some of the holdings are public and some private, but if you take out Tencent, the investment return on the other businesses has been over 20% compounded annually.

What do you think the shares, now trading at around €69, are worth?

SC: The Tencent stake at market – which we believe undervalues the company – is worth right around €100 per share. We value Prosus's other investments in operating businesses at another €15 per share. With €3 per share or so in net cash, our estimate of current net asset value is pushing €120. On an aggregated free-cash-flow basis, if you back out non-earning assets that are still growing rapidly but not cash-flow positive, we're paying a multiple in the low double-digits for a company that is still growing 20% a year.

Management here is as sick of the discount as we are. It's not a vanity thing for them, so we think if the market doesn't recognize the value here, they'll distribute all or most of it out in a tax-friendly way to shareholders. Either way, we expect to come out well.

Has anything surprised you about the market in the last two months?

MH: Our experience at Southeastern goes back to the early 1970s and we've never seen a bear market or recessionary period like this. And I've been through eight of them. Businesses are coming to a complete halt. There's plenty of speculation on when doors will open again and what happens when they do, but the divergence of opinion and uncertainty around almost everything is extremely high and a lot of the modeling and forecasting out there isn't really worth much. That creates extreme volatility. But as difficult as that is, that level of uncertainty and volatility should be the friend of the long-term investor. It's a necessary condition for being able to buy good businesses at 30 cents on the dollar.

SC: One thing I'd add to that: Cruising into all this there were all kinds of existential debates about value investing. Underlying the other side of the argument is very often that the quants and machines and AI bring such efficiency to markets that the value guy won't be able to find

enough inefficiency.

But what happened in this downturn to our largest international position, the Agnelli-family investment holding company Exor [Milan: EXO], is so instructive as to be hysterical. The company has a massive Italian heritage, but the actual Italian impact on its net asset value and earnings is tiny, in the low single digits. The stock, however, has continued to correlate with the Italian market, which starting last month has correlated with the public-health disaster the country has been going through.

While this is going on, the company announced two different asset dispositions, a merger of Fiat Chrysler with Peugeot and the sale of its reinsurance business PartnerRe to Covéa. The deals haven't yet closed, but hopefully John Elkann, Exor's Chairman and CEO who we consider one of the smartest investors of his generation, will soon be sitting on a pile of cash at the right time. That's something as value investors that makes us jump for joy, but the stock gets pummeled along with everything else in Italy. So really, greed and fear have been repealed, and it's all about machines and rationality and efficiency? Greed and fear and stupid correlations have not been repealed. VII

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As of March 31, 2020 Empire State Realty Trust represented 3% of the Longleaf Partners Small-Cap Fund; Prosus represented 5% of the Longleaf Partners International Fund and 4.6% of the Longleaf Partners Global Fund; and Exor represented 9.5% of the Longleaf Partners International Fund and 8.0% of the Longleaf Partners Global Fund.

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