Southeastern Asset Management

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Gwin: 00:00 Hello and welcome to the P/V podcast with Southeastern Asset Management, where our Global Investment Team will discuss the topics that are most top-of-mind for our clients, from our Business, People, Price point of view.

Gwin: 00:16 We at Southeastern are long-term, concentrated, engaged, value investors, and we seek to own high quality businesses run by capable people at a discounted price to intrinsic value, or P/V.

Gwin: 00:29 I'm Gwin Myerberg, Global Head of Client Relations and Communications, and I'm joined today by Ross Glotzbach, our President and Head of Research; Staley Cates, our Vice-Chairman; Ken Siazon, our Head of Asia Research and Portfolio Manager on our Asia-Pacific and Non-US Strategies; and Josh Shores, Portfolio Manager on our Non-US Strategy.

Gwin:	00:49	Today, we're going to be discussing a particularly timely topic of tariffs and what impact a potential trade war could have on our portfolios. Staley, could you start us off by talking about FedEx, which I know you view as a great indicator for the economy, and talk about how this macro factor might practically impact the business?
Staley:	01:08	Well, FedEx is probably the best barometer on all things free trade, and of course they are massively in favor of all things free trade. So, day-to-day their business is less impacted by many of the goods that are either being hit by tariffs or threatened to be hit by tariffs. In other words, they're doing high value goods that are not yet in the gun-sights of all the trade warriors. So, while it's not hitting their numbers, they of course worry about secondary effects for all of world trade.
Staley:	01:39	The best thing that we would have going for us with FedEx in particular is that their ground business is more valuable than the Express Division. So, while we see risk here, this does not worry us about our overall appraisal or unhinging their total corporate value if it does get even worse.
Gwin:	01:59	So, stepping back, Ken, can you just walk us through what has unfolded with the US-China tariff tensions in the past quarter.
Ken:	02:06	There's been a lot of talk about trade war and tariffs for the last six months. But in July and August, the initial salvos of this trade war actually came into effect, where the US and China both levied tariffs on $50 billion worth of imports. This got elevated again in September, when the US levied tariffs on an additional $200 billion of Chinese imports, and China levied tariffs on $60 billion of US imports.
Ken:	02:39	So, that's what's been happening, and as a result the capital markets in Asia have weakened significantly. The Chinese Yuan has devalued around 7% since May, so this has affected the equity capital markets in Asia. In China in particular, the Shenzhen-Shanghai CSI 300 Index is probably down 13% in Chinese Yuan and about

17 %in US dollars. Part of that is reflecting the fears of the effect of the trade war on Chinese growth and economic prospects.

Ken:	03:37	Obviously, the Chinese exporters are the ones that are bearing the brunt of the pain. Whether it's the furniture exporters, like Man Wah, or even the Chinese packaged meat guys - for example, WH Group owns Smithfield, the US pork producer - they've been hit by imports as well. So, anywhere along the value chain where people believe that they are being impacted by tariffs, we've seen significant weakness in the stocks. And in many cases, we believe that the price reactions of the capital markets is significantly more than the economic damage that they will see from tariffs.
Ken:	04:36	In Macau, we've seen prices for the sector come off significantly, as much as 50% year to date. Certainly some of that is due to fears about the trade war, and, because Macau sits right next to Guandong Province, which is the export capital of the world, there is a perception that Macau will suffer significantly as a result of that as well.
Ken:	05:07	So, again, we believe that the price reaction has been significantly higher than the economic damage to these businesses. Especially as you look at it from a three-to-five-year perspective, rather than a next-twelve-months perspective.
Gwin:	05:27	Josh, I'll ask you to weigh in on what you're seeing in Europe. And then maybe talk through an example in our portfolio.
Josh:	05:35	Yeah, on top of the FX (foreign currency) exposure, which certainly shows up immediately, the biggest impact has been on sentiment, thus far, and uncertainty. Where we have situations that there may be strategic issues at play, or mergers and acquisitions (M&A) options that are being evaluated, greater degrees of uncertainty on trade certainly have an impact on the willingness of cross-border deals to happen and on the ability of buyers to transact. So, you see some of that in

the capital markets, as far as discounts on holding companies expanding or just discounting potential timeframes on scenarios. I'd say the uncertainty is the biggest thing.

Josh:	06:16	That doesn't mean we won't see, particularly as the rhetoric heats up and tariffs grow and expand, possibly, that there won't be actual, bottoms-up impact. Thus far, actual material cost impact to something like an industrial capital goods company sitting in Europe having to pay more for steel in the US has been pretty minimal. But, the sentiment impact has been greater.
Josh:	06:43	One example that we have in Europe of a company that has been negatively impacted but also, oddly, positively impacted that really underscores the Southeastern conviction that people should always keep in mind - that we are not macro-prognosticators; we do not have a perspective on forecasting the direction the trade war is going to go, and there are other people who are better qualified to opine, rightly or wrongly, on those things. But, we are always going to be looking at situations like that to try to find the mispricing, as Ken mentioned, where companies are being priced like they're X but we think they're actually Y, either over our time-horizon or because the market is just wrong about their underlying exposures, and take advantage of that.
Josh:	07:28	So, we're always gravitating towards the uncertainty, towards the mess, if you will. And certainly the trade rhetoric has caused some opportunities there.
Josh:	07:39	Case New Holland is an interesting example where the share price has been severely impacted by the tariff rhetoric and the perception that soybean and corn tariffs' damaging exports would be really bad for US-based farmers. And, while in some ways that probably is true, it does not take into account the diversity of Case New Holland's global business and how US is only a part of that. It also doesn't take into account the strategic options around Iveco and the commercial vehicles business and some of the other optionality that we see in Case New Holland. It doesn't take into

account some of the mitigating factors that have been announced to help US farmers in the face of that. And it certainly doesn't take into account the overall strength of Case New Holland's ag-business as a dual oligopolistic-type of market with Deere, not only in the US but globally.

Josh:	08:35	But, in the US it's very, very strong, and you can see the disconnect looking at Deere's share price, which has held up a lot better in the multiples that it trades at versus where Case New Holland is, which indicates the level of discount on offer at that company that's got a phenomenal business in its ag positioning. It's got really great people, with John Elkann overseeing the capital allocation and the strategic direction of that company. And, while there is some uncertainty from the market's perspective around executive management, we're confident that that's going to be sorted out under John's leadership and direction. And the share price is severely discounted, such that we're happy to own that on its own because it qualifies on those metrics, not only within EXOR. So, we're able to benefit from that one doubly.
Gwin:	09:20	Josh made the important point that we're not top-down macro-investors, but we invest based on bottom-up fundamentals. Ross, can you talk about how you account for a macro factor like this in your bottom-up appraisal work?
Ross:	09:32	Sure. We always want to just be good old stock pickers and find bottoms-up cases where we can win in a variety of environments. We feel, in part because of the great capital allocation partners we have- we've already talked about Victor Lee at CK Hutchison, Fred Smith at FedEx and John Elkann at EXOR. These are people who've created value in a wide variety of environments over the years and are well-positioned to do so again. Then, again, as good old appraisers, we always look and see where peers are trading.
Ross:	10:11	Josh already mentioned Deere. It is kind of interesting. The market might say that Deere and CNH are at

somewhat similar price to earnings (P/E) multiples, but that's missing out on some non-earning segments that CNH has, and also their upcoming investment-grade rating and what that'll do to their interest expense. So, it's not really comparable, but that's what the market does on its simple look.

Ross: 10:33 Likewise, FedEx-UPS. The P/E premium that UPS had for a while has contracted somewhat, but we would say that's more than merited by, again, a non-earning part of TNT that's going to be coming through over next few years. And then what looks like UPS's too skimpy spending on capex (capital expenditure) over the last few years.

Ross: 10:58 Then, finally, we get over to the aerospace industry, which has been another hot topic on this trade war stuff. We have large investments in GE and United Technologies. We think they are very well positioned in the aircraft engine business. We look, though, at something like a Boeing and where it trades, and we just feel like we own something much better at a way lower free cash-flow multiple. So, that's how we keep our bottoms-up thinking, but remain cognizant of this stuff. We don't want to make some kind of industry bet unawares, and we don't feel like we're doing that here.

Staley: 11:40 I would add one other derivative effect on all the companies we've talked about - the universe of things we own and that we're looking at, is what this (trade war) is doing to material costs. So, for a manufacturer or for any other consumer packaging-type company or anybody that is using some of these commodities, we are just going to see margin pressure.

Staley: 12:04 Between materials and then between labor getting increasingly tight, we are seeing tougher margins for everything we're looking at.

Ross: 12:13 That's a good point because a lot of these things that might have been on our on-deck lists have kind of been hanging out there. Their value hasn't grown because

some of them, it's turned out, don't have the pricing power they used to have. So, we're just sitting tight.

Gwin: 12:26 Maybe related: One of the fears within the US that we might see, as a result of this, is increased inflation in the near term. How do you think about the portfolio in an increased inflationary environment?

Staley: 12:40 We think about the portfolio building block by building block. Every analyst on each name has to be comfortable that there is either the pricing power, or the gross profit royalty, or the network effect or whatever the tangible result of the business advantage is, to offset those costs. So, we don't know how bad it's going to be, we don't know any specifics around that, but we do expect there will be a testing of franchises and of businesses on who can pass these things along. If we don't have that confidence, we're not going to own it, even if it looks cheap.

Gwin: 13:17 Obviously we're talking about tariffs and trade wars, but we've seen so much more volatility and price-weakness in Asia than elsewhere, certainly than in the US. Is there something else at play there that's driving that volatility?

Ken: 13:33 Yeah, and aside from the trade war, we are seeing some real wealth destruction. For example in China, the stock market, as I mentioned, is down mid-teens-to-20%, depending on the index. So, people have been losing money in the stock markets, and that will have some sort of effect on consumption.

Ken: 13:58 We are seeing liquidity getting pulled out of the system, whether it's enforced by the government. The measures of liquidity that we see - for example, the Total Social Finance Index, or fund-flows southbound from China to Hong Kong - we're definitely seeing outflows. So, as liquidity decreases in the system, we are seeing consumer spending being affected.

Ken: 14:27 The most obvious place that we are seeing that is actually in the automotive sector. New sales of cars are down double-digits in the last couple of months. So, I

think the weakness has more to do than just trade war. After all, we're not really seeing the economic effects of the trade war yet. The first salvo, 50 billion, is somewhat small relative to the GDP (gross domestic product) of the country.

Ken: 15:05 At the end of the day ... You know, I just read a research report where Deutsche Bank says that only 5% of China's production is involved in exports to the United States, yet the stock market has gone down significantly more than that. So, I believe that consumer spending is weakening, and we've started to see that in not just the auto sector, but most recently in Macau.

Ken: 15:34 Macau, until August, was a 17% grower year-to-date, and it also grew 17% in August. But a couple of days ago, the September numbers came out and Macau gross gaming revenue grew by only 3%. Now, some of it has to do with the fact that there was a tropical typhoon that hit Macau, but it's undeniable that there is a slowdown in growth, and probably more on the VIP side of the business than the mass.

Ken: 16:06 And, it makes sense to us that the VIP side of the business should be slowing down because those are probably the guys that have more exposure to the stock markets. These are also probably the people that have more exposure to the export industry in neighboring Guandong Province, and they're probably more concerned about trying to figure out how to export stuff out of the country into the US before the trade tariffs get implemented. So, they probably had better things to do in the last couple of months than to spend their time in Macau, which was also affected by the typhoon.

Gwin: 16:48 We've been here before with volatility and Macau. How does the current situation differ from 2015, when we saw the corruption crackdown?

Ken: 16:58 I think the corruption crackdown really amplified the volatility of Macau. I don't believe that we will see that kind of down-cycle this time around because this isn't a government-enforced crackdown on corruption, which

		had an effect on the behavior of VIP business during that crackdown. There's clearly diminished liquidity, which has been reflected in gross gaming revenues, but I think that this is not a comparable situation to the 2015 crackdown. Therefore, we don't believe that we're going to see that kind of deceleration in gross gaming revenues this time around.
Ken:	17:51	The other difference between today and 2015 is that the companies that we invest in, for example Melco, in 2015 they were still spending capex on construction and their free cash flow was significantly less than it is today. Today, their free cash flow is growing strongly because their last major capex, which is the Morpheus hotel addition, was completed in the first half of the year. Going forward, the free cash flow of this business should be much stronger than it was in 2015, when they still had capex.
Ken:	18:41	So, not only are companies in a better position, but also we think that, just like the last time, when stock prices were down, operators like Lawrence Ho were able to take advantage of the distress pricing to take out their 34%partner at Melco Crown. We think that this time around, they will also be in a position to take advantage of the distress, whether it's by repurchasing shares cheaply or potentially taking out their partner at Studio City.
Gwin:	19:25	Well, looking more broadly across our Asian holdings, have you seen other management teams taking advantage of the tariff price volatility to buy back shares or taking advantage in other ways?
Ken:	19:39	Sure. Cheung Kong is a pretty good example. As you know, Cheung Kong is actually two companies now because they spun off Cheung Kong Holdings and Cheung Kong Asset. So, Cheung Kong Holdings, as you know, has a dominant container port business in the world, and is cheap because of some concerns around that business in the trade war escalation context.

Ken:	20:08	Actually, the fact of the matter is that only about 3% of the EBITDA (earnings before interest tax, depreciation, and amortization) of the company actually comes from their Chinese-oriented container business. Nevertheless, for the first time in probably two years, the company is repurchasing shares.
Ken:	20:25	On the Cheung Kong Asset side, which is a mix of infrastructure and real estate, Hong Kong and China real estate, they've started repurchasing shares and the family itself has started buying shares in the company.
Ken:	20:43	And, at Baidu. Baidu has only bought shares back three times in the past, and each time, when you look back, they've repurchased shares cheaply. They bought back shares in November- December '08; in 2015, twice; and then most recently, in the last quarter, they repurchased shares again. Actually, what they did was they IPO'ed (initial public offering) iQiyi, which is the Netflix-type business. The price has almost doubled since IPO, and they've sold some of that iQiyi holding and used it to fund a repurchasing in Baidu.
Ken:	21:21	So, we are seeing elevated share repurchase, not only in our portfolio but in the Asian capital markets in general.
Gwin:	21:33	It sounds like it's probably safe to say that for every company on a bottom-up basis, we're looking at what the impact might be, but that we haven't necessarily made changes to the portfolio. But, has the price volatility you've seen brought up new investment ideas that have either gone into the portfolio or are on your on-deck list?
Staley:	21:50	It has brought up several on the on-deck list, and it's brought up one new name in particular that's undisclosed, where one subsidiary is definitely in the middle of all the trade war drama, but the biggest, most valuable division has nothing to do with that, and we're lucky to buy it.

Gwin:	22:09	Has the strengthening of your on-deck list varied by region? Are you seeing more opportunities in Asia or in the US, or is it across the board?
Ken:	22:20	The volatility in Asia has been significantly higher because of the perceived sensitivity to trade war. As Ross mentioned, we've added to a number of names that have been affected by this potential trade war, including Cheung Kong and other names that we hold. But, it has also increased the list of potential on-deck names that we're currently evaluating for potential investment.
Gwin:	22:53	My last question is, going forward, are there any areas that we will actively avoid in the near term because of this?
Staley:	23:00	I think there's a natural combination of what we would normally tend to avoid, which is also what is hurt the most in this, which is some of the heaviest commodity, least differentiated things, which are most under the gun right now are the things we avoid the most anyways. So, I don't know if we'd say that's causal, but it goes hand-in-hand.
Ross:	23:21	Yeah, I mean, companies with pricing power, with managers who can go on offense in a variety of environments - that's what we're always looking for. That's what always wins when things get more volatile.
Gwin:	23:30	Thank you, Ross, Staley, Ken and Josh, and thank you to all of our listeners for tuning into the P/V podcast with Southeastern Asset Management. We hope you enjoyed it, and we look forward to speaking with you again soon. As always, if you have any questions or you would like to share topics that you would like to see covered in future episodes, please feel free to send us an email at podcast@SEasset.com.