Southeastern Asset Management

Gwin:	00:05	Hello, and welcome to the Price-to-Value 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. 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 by Josh Shores, Co-portfolio Manager for our Non-U.S. strategy and John Woodman, Senior Analyst based in our London office.
Gwin:	00:41	Today, we're going to discuss the opportunity presented by European conglomerates, and we'll dive into EXOR as a prime example in our portfolios. On our last podcast, Ross referred to European conglomerates as something that have always attracted our interest and fit our style of investing well.

Gwin:	00:59	John, could you start us out by talking about why's that the case. Why have conglomerates always been a good fit for our investment style?
John:	01:06	Sure, so conglomerates are interesting opportunities for us, largely because there's often hidden value opportunities within conglomerates. For an investment philosophy which is based on bottom up fundamental research, we look at companies based on a number of different methodologies, but sum of the parts is one of the key ones that we look at. Within conglomerates, you can often find assets which are being misvalued by the market or where issues have overtaken the fundamental value of the assets within the business.
John:	01:40	From our approach, which is based on the fundamental long-term asset value within a business, conglomerates often provide an opportunity to recognize the additional value that the market might not be attributing within the share price.
Josh:	01:55	A conglomerate structure really magnifies the characteristics of the people at the top. If you have really good capital allocators and business operators at the top of the company, being in a conglomerate structure can provide them opportunities to create and release excess value. But if you have bad people or people who don't think and act like owners of the business at the top and the conglomerate structure makes it something where you don't even want to go close to it - and you see that in the markets where at one of end of the spectrum, you can have holding companies in Hong Kong for example, that perpetually trade at a 50% discount to NAV, because the market is convinced that the owners are never going to unlock that value.
Josh:	02:38	They have different interests, different incentives for why they're behaving in such a way, whether it's reputation or protecting their own position. But, it's not about creating value per share. Those rightfully trade at a gigantic discount to the asset value or the discounted cash flow value.
Josh:	02:54	On the other side of the spectrum, if you use a conglomerate par excellence of Berkshire Hathaway, it is a huge magnifier of the extraordinary capabilities of the people at the top of that organization, and Warren Buffet and Charlie Munger and the team that's been put together,

such that it trades generally at a premium to any sort of asset value or book value conventionally defined because they're able to take advantage of that structure to allocate capital in a tax efficient way across different opportunities, and because they're better capital allocators than the market would be.

Josh:	03:28	Therefore, it trades at a premium. On one end of the spectrum, you have the magnifying structure of a holding company or a conglomerate that is a gigantic discount because there's two more costs than it creates and then on the other side, there's the example where it creates more opportunity.
Josh:	03:43	It's not accidental that, that's somewhat geographical. In an immature capital market, where there's not easy access to equity or credit, corporate governance maybe is somewhat lacking, the structure of a conglomerate actually plays a very critical role in setting standards of corporate governance and control and death of capital market access to weather volatile times.
Josh:	04:09	That's why in parts of southeast Asia, you still see predominantly conglomerate structures in a lot of those markets because they're just a little less developed and mature. The cost of the conglomerate more than pays for itself in providing the structure and comfort, and the families who are behind most of them, the vehicle of control and market access.
Josh:	04:34	On the other side, if you use the US or the UK as the most mature kind of western style capital markets, there's much less need for the governance or capital market's access that the conglomerate provides because there's ample fixed income, bond access, credit market access or banks or equity market access, and corporate governance standards are very well defined and understood and accepted.
Josh:	04:59	So, you don't need the conglomerate structure to serve that purpose. In the US, there's very much a trend towards conglomerates being out of favor. You've seen us be involved most recently with United Technologies and other companies that are going through the process. They're splitting to become more efficient and more focused on their end markets. Now, that doesn't alter the fact that an exceptional individual like a Buffet or a Berkshire Hathaway or other examples like Prem Watsa at

		Fairfax, we believe in Canada, fits that mold as well, that they can create excess value above and beyond whatever cost there might be to the conglomerate.
Josh:	05:33	Europe sits somewhere in the middle. 20 years ago, Europe was a less mature capital market, broadly. It's a gross generalization to talk about Europe and the 20-odd capital markets in each country as one, big homogenous whole, but for our simplistic purposes now, I'll do that.
Josh:	05:55	That broadly has evolved into more of a mature, deep capital market where the conglomerate structure is less needed and you're seeing, as a result, lots of what we call de-conglomeratization happening across Europe. And, as John mentioned before, there's often lots of hidden value and opportunity to unlock when the right people at the right time can get involved at maybe a lazy or inefficient conglomerate structure to unlock and release a lot of that value.
Gwin:	06:29	So, just stepping back, can you define de-conglomeratization? It's quite a mouthful.
Josh:	06:36	De-conglomeratization. Potentially not the proper word for it, but what we've started to use internally in talking about the process. It's really when a conglomerate structure has reached those days like we referenced earlier, of not adding value anymore for whatever purpose for governance, capital allocation or efficiency reasons. There's either a changing of management or changing of the guard that starts to alter how that business is being run, and they start to rationalize non-core businesses via spinoffs or via sales, focusing in on the core, competitively managed parts of the business and essentially traveling from what was a sprawling conglomerate down to a focused operating business.
Josh:	07:19	That's broadly the term that we use: De-conglomeratization.
Gwin:	07:23	So, you talked about de-conglomeratization. Is that necessary or does that have to be part of your case to invest in a conglomerate?
John:	07:37	It's a good question. I would say no, not necessarily. What we fundamentally look at is the underlying economic asset value itself. Does that have to be a direct route to crystallizing the asset value? Obviously, it’s helpful, but

		what we've seen in some circumstances is that you have such a significant margin of safety on the underlying economic asset value that we're participating in, that actually having a route to crystallizing asset value is not the be-all and end-all to making the investment case.
John:	08:05	As long as you have the right capital allocators in place in the management team, and you trust that they're going to make the sensible investments, then naturally, de-conglomeratization should follow as a subsequent part of that decision making process and how to allocate the investment capital of the firm, including potentially disposals.
John:	08:25	That's what we would expect and part of why we look at the people side of conglomerates so closely, is to make sure that if there's an argument for diversification, that it actually makes sense, that there are synergies with the existing business.
John:	08:36	If there aren't, we would expect them over time to do the right thing. But, taking advantage of the right market opportunity as well to crystallize the full value of those assets. A lot of this debate, though, goes to "What is a conglomerate?" You talk about de-conglomeratization in terms of a diversity of business mixes or a diversity of brands or a diversity of assets within the estate itself.
John:	08:58	You can have hidden value in companies that doesn't necessarily speak to a completely disparate, separate part of the group that you could argue doesn't belong with the other assets, to non-earning assets or real estate.
John:	09:12	One of the biggest successes that I've seen in terms of building conglomerates is within the same business, but consistently adding brands. You see this particularly in the luxury space, in the drinks space as well. They've had a lot of successes, as Josh said, in terms of it's almost a Berkshire Hathaway type of model: You stick to the assets and the markets that you know, but you'll bring on board additional brands.
John:	09:33	You get the scale synergies from doing that, but running them very much independently, keeping the fans on board, make sure they're centralized to continue to deliver. It becomes more of an asset management process within obviously a broader, single structure, but in a way, creating value and that is where conglomeratization

		actually works as a strategy, rather than de-conglomeratizing to release value.
Gwin:	09:56	So, then that places the emphasis still on the importance of the people, but on the ability to build the business, rather than to take apart, spin off, or sell the business.
John:	10:07	Yes, but it goes back to the same theme, which is really smart capital allocation.
Josh:	10:10	Yeah, people think and act like owners. So, really we're looking for inefficiencies, cracks in the market, where there's not an appreciation for some of these easy to miss sources of long-term value per share creation.
Gwin:	10:26	So, Josh you talked about through the history of the market and how the European market has progressed over the past 20 years. Can you talk a little bit about Southeastern's history in investing in these European conglomerates where we've seen that value being created?
Josh:	10:40	We didn't come to this as a "big thesis" 20 years ago on predicting that it was going to happen. It's been more, as we invested in Europe and saw where we had success and where we felt like we were seeing opportunity from a backward looking point of view, saying, "Wow, this is a common denominator."
Josh:	10:59	One of the earliest examples of that has been Philips which we've owned several times over the last 20 years. The initial entry was very much because of CEO named Cor Boonstra coming in and starting to rationalize this gigantic, sprawling, inefficient conglomerate structure that Philips had inherited from a 100 years of random business acquiring and building.
Josh:	11:30	And his professed strategy was to focus in where they had a competitive advantage, exit businesses where they didn't, and then use that capital to buy back stock if the shares were trading at a discount. This is one of the interesting factors you see in holding companies and conglomerates is that often the market will put a discount on those businesses, and we generally do too, put on some type of market discount - particularly for somewhat non-correlated holding company businesses if you will.
Josh:	12:02	But, that can provide an opportunity for the right management team who think and act like owners and are

		able to take advantage of the discount when the market gets too pessimistic to repurchase their own stock, retire those shares, or hold them until they're fairly priced and use them creatively in the future to choose value per share creation.
Josh:	12:23	Having people who think and act the right way is critical. One of the key things that we saw was that change in mentality, and so over the last 20 years, you've seen Philips go from a sprawling conglomerate to a focused healthcare company, most recently when they spun off the lighting division.
Gwin:	12:42	One of the largest holdings in our Non-U.S. and Global portfolios today is EXOR, which is a unique blend of a European family holding company and a conglomerate. Josh can you talk about our history at EXOR and the case for the business.
Josh:	12:58	Sure. Well, we started following the predecessors to EXOR all the while back in the 90's but really EXOR itself came together in '08, '09 with the combination of the two different public Agnelli holding companies and the appointment of John Elkann to be the Chair and CEO of that business.
Josh:	13:22	So, I started really paying attention in 2010 when the Fiat Auto and Fiat Industrial, which was what became the agricultural side and truck side in Case New Holland of Echo, split was announced. In 2010, I thought it was getting very interesting.
Josh:	13:41	As we have alluded to, the people at the top are absolutely critical in these types of situations. Just cheapness is not enough. Just a discount to a sum of the parts. You need to have people who think and act like owners and take advantage of the opportunities in front of him.
Josh:	13:57	We patiently watched what was happening and started following the company more closely. In particular, we were struck by the annual letters that John Elkann wrote in 2009, 2010, 2011 and the way he talked about competitive advantages, the way that he talked about buying at a discount, intrinsic value and margin of safety. The way he talked about thinking and acting like an owner. The way he was taking advantage of the deep discount on the sum of the parts to buy back stock.

Josh:	14:26	It ticked all of the boxes on indicating that he was thinking and acting like an owner and in running this business. That was a big change from the way that the EXOR predecessors had been run in the past, which had been much more traditional, preserve the family wealth, defensive crouch type of mindset that is maybe more similar to the Asian conglomerate that should trade justifiably at a 50% discount because they're never going to go out there and get the value.
Josh:	14:59	At the time, Fiat, the auto company, was particularly challenged. That was a combination of a challenged headline business that had a lot of very valuable parts underneath it that the market was missing because it focused on the big revenue, big headline grabbing predominantly European auto business.
Josh:	15:23	But, it was changing, and that inflection point is what really got our attention because one of the themes that we have not talked about, but we've seen over time, is that generational change can provide really interesting opportunities. And that was what was happening at EXOR.
Josh:	15:37	John had been tapped as the next head of the family holding company. He was putting forward a very different philosophy in how he would be operating and making those decisions. In conjunction with that, the organization had brought on board an excellent, excellent operating CEO for the sub-company, at the time Fiat, in Sergio Marchionne.
Josh:	15:59	When he joined, he was seen as a very high quality executive from his time at SGS and what he had built there, in the testing and inspection space, but wasn't nearly as well-known as he would become. Over the next decade, Sergio managed to address the core European auto part of Fiat that was so challenged in some really creative ways by working with the EXOR management and John, as CEO, and thinking about capital allocation of value creation and value unlocking.
Josh:	16:31	They went on to unlock *extraordinary* amounts of value.
Gwin:	16:37	You talked about a history of value creation over the past decade of the company. Can you talk through a little bit of that in more detail and what we've seen in the past 10 years?

Josh:	16:47	The value unlock, which in this case, de-conglomeratization hasn't meant as much selling or completely exiting businesses, but has been an unlocking of the hidden assets within the legacy Fiat structure that came together when IFIL and IFI joined in 2008.
Josh:	17:08	Hidden inside that, at the time it was seen as a challenged European small automobile company, were assets like Case New Holland and Iveco and Ferrari and Magnetti Marelli, which has just been sold at a great price. All of these things were being underappreciated, Ferrari in particular if you just look at net value release.
Josh:	17:28	So, the process of Fiat becoming Fiat Chrysler – obviously the acquisition of Chrysler was a huge value creating move - but then the release of Ferrari, the release of Fiat Industrial, that then became Case New Holland out of the legacy Fiat structure, did a phenomenal job in unlocking and creating that value and freeing those companies up to operate more efficiently.
Gwin:	17:55	There's has been quite a lot that has been unpacked there over the past 10 years. Can you talk through more of those details and what John Elkann has been able to do there?
Josh:	18:04	Yes, they've started with a lot of merging and consolidation. First in 2008, 2009 bringing IFIL and IFI together, which were two separate Agnelli family companies that historically operated completely independently and merging those to create EXOR. That was a significant move. And then merging the three different share classes, the ordinary shares, the preference shares and the savings shares in February of 2013. That was a significant consolidation move to make the capital structure more efficient and to deal with what in the past had been seen as an anchor on market appreciation of the ordinary share price.
Josh:	18:47	Then, the two big acquisitions that they've done over our period of involvement were Fiat's getting control of Chrysler in the financial crisis and initially, it was about 40%, but they had control and the unions had the large chunk of the rest of the business.
Josh:	19:07	Then over the next five years-ish, they were able to consolidate the rest of the Fiat Chrysler minorities - or the Chrysler minorities I should say - in a very creative

fashion. That was under Sergio Marchionne. The other big allocation of capital that they've done was the acquisition of PartnerRe in March of 2016, which was done at a very compelling price versus hard book, at least compared to other comparable transactions in that industry.

Josh: 19:41 The consolidation and the two big acquisitions that they've done have helped a lot over the last six years in creating value. Chrysler has unequivocally been a gigantic home run for the legacy Fiat side of the business. Then, the consolidation and simplification of the shareholding structure has been enormous as well.

Josh: 20:03 On the flip side, there have been even more steps taken to unlock and release value and perhaps simplify, in some ways, the story that was all jumbled up under Fiat originally. So, in 2013 again, in June, they sold a 15% stake in SGS, the legacy testing company to GBL at a great price that was a culmination of a decade of involvement at that company and very successful investment.

Josh: 20:34 Perhaps the *most* valuable thing that came out of the SGS investment was the relationship with Sergio Marchionne, who was the CEO of that company and had demonstrated his capabilities to the family such that they invited him to come run Fiat.

Josh: 20:49 Even after selling SGS, that relationship continued to contribute in the form of Sergio Marchionne. Then, in 2015, they sold Cushman and Wakefield, to DTZ again at a very good price. It was a strategic assets. The private equity owner of DTZ needed to have a footprint across the rest of the world. They were big in Asia, they were weak in parts of the Americas and Europe, and so combining those two created a business that theoretically could compete with CBRE and Jones Lang LaSalle.

Josh: 21:23 That was a very good move that released a lot of cash that could then be reallocated. Those two sales essentially provided the firepower to purchase PartnerRe a year later. In the midst of doing all that, they did a small deal to increase their position in *The Economist* as well, which is a great long-term brand and asset in the digital age. But, then it was about spinning out and simplifying. We talked about the Fiat Industrial spin out that became Case New Holland.

Josh:	21:55	To get at that value and get the structure correctly recognized, they first had to consolidate a minority US listing in that Fiat Industrial business that pre-dated this process and prevented them from having a cleaner, simpler structure, so that took a while. But, in 2013, they were able to clean up that, if my memory serves, 10% ownership of the company which then allowed them to relist CNH [Industrial] with a domicile in Amsterdam, so moving it out of Italy and then listing it on the US Stock Exchange.
Josh:	22:32	It trades there and in Europe. That was a significant move in allowing the market to invest directly in a predominantly agricultural-focused company, Case New Holland, that competes with [John] Deere. And spinning out Ferrari in January of 2016 from Fiat Chrysler was a gigantic release of value. It's something the market just previously had not given nearly enough credit for, and ourselves as well, when it was hidden under Fiat Chrysler.
Josh:	23:03	Spinning that out as a separate company from the Fiat Chrysler level, allowed EXOR to maintain its ownership and control, or in this case, it's about 23%, but they have a shareholder agreement with the founding family that's still owns about 10% and there' are some votes that essentially create voting control of Ferrari.
Josh:	23:27	Ferrari is one of the great consumer brands in the World. The evidence that we've seen since it came public on its own of how desirable those - they're automobiles, but essentially they're the ultimate luxury good in signaling what the buyer of those luxury goods wants to signal. And we've never really seen a business that chooses its customers in the way that Ferrari does.
Josh:	23:57	They essentially decide, particularly at the higher level of offerings, who is worthy, who deserves to own this particular special edition car, what sort of customization they'll offer and more or less, what the margins are. There's a long wait list of people who would love to own these vehicles, and they can decide each year who gets what and how many they're going to make. That business model and cache around it and the whole halo that's been created around Ferrari is just astonishing.
Josh:	24:27	Pretty resilient, I think, even in an economic downturn as the small number, several thousand people who are really responsible for the bulk of their economics are pretty, I

		think, recession resistant, and there's a long list of people to take their slots if any of them prove not to be as recession resistant.
Josh:	24:45	So, Ferrari was an amazing asset that was hidden inside this legacy business, and the spin out and unlocking of that, was a brilliant move.
Gwin:	24:54	Well, then you obviously talked about how there have been really value additive acquisitions in PartnerRe and going back to Fiat Chrysler. How do you look at it today because you said the stock is discounted today? How do you weigh the potential for another acquisition versus share buy-backs, which is something that we often like to see in terms of capital allocation decisions?
Josh:	25:18	The Chrysler acquisition has been a complete home run and the Jeep and Ram brands that it brought in and the scale that it completely created in combining the broadly European, South American business of legacy Fiat with the broadly North American business of Chrysler and the efficiencies and economies of scale that came with that have been hugely significant.
Josh:	25:38	The evidence is very clear on that front. On PartnerRe, it's still in the "too early to tell stage" as far as how good of a deal that has been from a value creation point of view. The reinsurance industry has had a couple tough years, so you haven't seen huge operating progress or headline results, if you will, out of PartnerRe.
Josh:	26:00	We can say that the price they paid and the process they went through to acquire that business in a creative way and the resulting multiple of just a little over 1x hard book versus comps in the industry that are more like 1.5x hard book was very well done.
Josh:	26:19	Whether there's huge value growth to come and value to be created and how that could impact the EXOR structure in years to come remains to be seen, but as far as buying it very intelligently, we certainly can tick that box.
Josh:	26:32	On looking at the discount today and why it remains discounted, we really treat this one as a sum of the parts. It's not an operating business generating a big, free cash flow coupon that can then be capitalized. This is going through and valuing what's PartnerRe worth, what's Case New Holland worth, what's Fiat Chrysler worth and all of

		its pieces and what could happen there strategically, what's Ferrari worth and what are the rest of the small pieces of the company worth, and adding that up.
Josh:	27:04	As we referenced before, sum of the parts is especially relevant in a broad conglomerate, where the people at the top are positive and have the good, operating capital allocation characteristics that we're looking for. That sum of the parts approach can help from our perspective, help us understand how they can unlock value and create more in the future.
Josh:	27:25	One way that could be done, clearly, is via capital allocation into intelligent buy-backs when the share price is heavily discounted from that underlying intrinsic [value]. The important thing is to have a management team who thinks about that and appreciates the value per share creation potential of sharing the share count opportunistically when its heavily discounted *and* stacks that up against their other capital allocation options.
Gwin:	27:53	You've talked throughout this discussion about Sergio Marchionne and how much value he's created, what a great operator he's been. With his untimely passing, how has that impacted your view on the people?
Josh:	28:07	Sergio Marchionne was one of the great executives of the last decades, hands down. There's no way to replace a loss like that. That said, we've always known he was approaching retirement, and he even announced his looming retirement date from Fiat Chrysler. We thought he'd still be involved at Ferrari and still have his wisdom at the EXOR level, but the awareness that he was in the twilight of his career and that things would be handed off to the rest of the management team, and John Elkann in particular at the top, overseeing capital allocations, the strategic direction of the firm.
Josh:	28:48	We've known that was the end result, we just thought it was a few years out. The loss of Sergio Marchionne is certainly a negative, and he added a huge amount of value, but it didn't really change our case. It just pulled it forward a little bit in allocating responsibility. While yes, his untimely passing is a negative, it's not a deal changer. It didn't impact the value, it didn't impact the philosophy or the potential to create value in the future. It just put it even more on John and his team now, versus what we anticipated happening several years from now.

Josh:	29:26	No one's going to replace Sergio Marchionne. It will be a group of individuals who grow into picking up the various roles that he had and that, over the next year or two, should become apparent. Certainly a loss, and we mourn the passing of a phenomenal executive. Many books should be written about what he has accomplished, but it doesn't really alter the fundamental case at EXOR.
Gwin:	29:52	In terms of the fundamental case going forward, my last question would be, what do you think are the next steps in the de-conglomeratization of EXOR over the next five-plus years?
Josh:	30:04	It's hard to say definitively what that's going to be. This is, again, a good trait of an owner-oriented management team who think the right way. They're going to respond to the opportunity set as it arises. If there's a brilliant thing to do with really any of the businesses under the EXOR umbrella, I'm sure they will look at it, whether it's Fiat Chrysler, in the people have talked over time the combination with that with another OEM, if there's some brilliant value creating move to pursue that at the right time, I'm certain that would be explored
Josh:	30:37	PartnerRe, if there was an opportunity to combine that with a bigger reinsurance company to create more scale and balance sheet capacity to underwrite and invest, I'm sure they would look at that. On Case New Holland in particular, I think you can look at the industry vehicle side of the IVECO business and say that's probably not core over time, in *our* view, to the Case New Holland story.
Josh:	31:03	But again, the confidence comes from knowing that management is going to evaluate the right move on whether it should be kept or whether it's better off in another home, and that business is going to prove to be healthier and more productive under different ownership.
Josh:	31:17	They've demonstrated over the last several years that philosophy, most recently at Fiat Chrysler with the sale of the Magnetti Marelli components business to Calsonic [Kansei], the KKR-backed components business at a price we thought was extremely compelling. The analysis undertaken to look at whether the math worked on should we keep Magnetti Marelli or is it better off being sold and combined with somebody else.

Josh:	31:43	That whole process was extraordinarily sound and resulted in a great outcome. As much as I would love to speculate on all the outcomes that we'll see over the next three-to-five years, it would just be speculation. What's more important is that the philosophy and the process that's been evidenced by the public communications, the public track record and the private conversations and network - work that we have done around this company - demonstrates the correct philosophy and the correct approach to parse all those different opportunities in the best available risk-adjusted per share value creating opportunities.
Josh:	32:20	That's really what gives you great confidence in this conglomerate structure with this company is that the process and the philosophy is right to respond to whatever opportunities arise in the market.
Gwin:	32:30	Thank you, Josh and John. And thank you to all of our listeners for tuning into the P/V podcast with Southeastern Asset Management. We hope that you enjoyed the discussion, and we look forward to speaking with you again soon.
Gwin:	32:40	If you have any questions or would like to share topics that you'd like to see covered in future episodes, please feel free to send us an e-mail at podcast@SEasset.com.