



THE
MANUAL
OF
IDEAS

TM

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing in the Tradition of Graham, Buffett, Klarman

Year IX, Volume XI
November 2016

When asked how he became so successful, Buffett answered:
"We read hundreds and hundreds of annual reports every year."

Top Ideas In This Report

Gilead Sciences (Nasdaq: GILD)	24
Graham Holdings (NYSE: GHC)	28
Iconix Brand Group (Nasdaq: ICON)	36

Also Inside

Editorial Commentary	3
Interview: Alejandro Estebaranz	6
20 "Magic Formula" Candidates	8
Interview: Javier Ruiz	88
10 Essential Value Screens	91
Interview: Roberto Oscoy	101

Highlighted Events — Join Us!

- Best Ideas 2017**
January 10-11, 2017, fully online
bestideasconference.com
- Asian Investing Summit 2017**
April 4-5, 2017, fully online
valueconferences.com
- The Zurich Project 2017** INVITATION ONLY
June 6-8, 2017, Zurich
zurichworkshop.com
- Wide-Moat Investing Summit 2017**
June 27-28, 2017, fully online
valueconferences.com
- European Investing Summit 2017**
October 4-5, 2016, fully online
valueconferences.com

BEST IDEAS
2017

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THE "MAGIC FORMULA" ISSUE

- ▶ 20 Companies Profiled by The Manual of Ideas Research Team
- ▶ Proprietary Selection of Three Candidates for Investment
 - ▶ Interview with Javier Ruiz of Metagestión
 - ▶ Interview with Alejandro Estebaranz of True Value Fund
 - ▶ Interview with Roberto Oscoy of Gerbera Capital
 - ▶ 10 Essential Screens for Value Investors

Companies analyzed in this issue include Avid Technology (AVID), Blue Bird Corp. (BLBD), Cisco Systems (CSCO), Dice Holdings (DHX), Gilead (GILD), Graham Holdings (GHC), Heidrick & Struggles (HSII), Iconix (ICON), Leidos Holdings (LDOS), Malibu Boats (MBUU), Michael Kors (KORS), Motorcar Parts (MPAA), National Health (NHTC), Pitney Bowes (PBI), Strayer (STRA), Vectrus (VEC), Viacom (VIA)

New Exclusions in the MOI M

(log in at www.manualofideas.com
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- ▶ Michael Mellor
- ▶ Adam Crocke
- ▶ PREMIUM: Matthe

Inside:

Exclusive Interview:
Alejandro Estebaranz,
Co-Investment Advisor,
True Value Fund

*With compliments of
The Manual of Ideas*

Alejandro Estebaranz on Insisting on the Right Price

It is our pleasure to bring you an exclusive interview with Spanish value investor Alejandro Estebaranz, co-investment advisor of True Value Fund.

*Alejandro was an instructor at European Investing Summit 2016, where he presented on small-cap value ideas **Umanis** (Paris: ALUMS) and **Neurones** (Paris: NRO). A replay of Alejandro's session is available in The Manual of Ideas Members Area.*

(The interview has been edited for space and clarity.)

The Manual of Ideas: Please tell us about your background and the genesis of True Value.

Alejandro Estebaranz: I started working as a mechanical engineer, discovering value investing in 2008-2009 while looking for books at my local library. I found *The Intelligent Investor*. [Value investing] is a style that fits very well with my personality.

From that point, I became a value investing fanatic. I remember reading a new book every three days, and in six months I was ready to start investing my own money. It was an easy time because the markets were very cheap. I got good results with my personal account and reinforced my learning.

By 2012, I had left my job and was living from investing my own capital. In 2013, I met my partner Jose Luis Benito. He had been an active reader of my value investing blog. We started talking almost every day about stocks and value investing. After a while he said to me, "It would be great to start a new value fund." At that time, he was running the equivalent of an IRA business in Spain.

We presented the idea to clients and started the fund in January 2014 with €2.5 million and 20 clients. Since then we have grown to €16 million and 800+ clients. Cumulative returns have been almost 40% net of fees in the last three years (compared with 17% for the S&P 500). It has been a wonderful experience.

MOI: How do you define your investment universe?

Estebaranz: We invest at least 80% of assets in developed markets. Almost 90% of our investments is focused in small-caps and mid-caps. We came very early to the conclusion that we had no competitive advantage in large-cap stocks, i.e., market caps of €10+ billion. We like to compete with retail investors, passive strategies, and small funds. We like to invest 80% of capital in good businesses that might be able to generate good returns across the economic cycle. The trick is to find good businesses that aren't being recognized by the

market. I can send you a list of a hundred wonderful businesses trading at fair multiples, but it is hard to find good businesses trading at low multiples.

For example, **Fuchs Petrolub** is a wonderful business, but the market didn't realize it until 2003-2004. The market thought it was another chemicals company, making standard lubricants. But one day, the market realized they are the leading player in a good niche, they have pricing power, they are good capital allocators...

We presented **Neurones** at European Investing Summit 2016. It is the best-run company in its sector, it has the highest organic growth, but the stock went sideways from 2003-2010 — seven years! In 2010, it was trading at 3x EV/EBIT, growing 15%, with great management, 75% recurring revenue, and a large cash pile. This kind of situation occurs only in small- and mid-caps.

MOI: How do you generate ideas?

Estebaranz: There's no secret sauce here. We like to track good small-cap managers. We have developed a good professional network into which everyone feeds their best ideas.

We do some screening. Once we have developed knowledge in a particular sector we like to seek out small promising companies in that sector. For example, we have had success with **Constellation Software** in our fund; it has always been a top holding for us. By studying this sector, we came across **Enghouse Systems**, **Descartes Group**, and **Opentext**. All turned out to be great investments.

In France, we have had good results with small IT consulting businesses. We started with **Neurones**, but then we found **Infotel**, **Groupe Open**, and **Econocom**. These businesses operate in a secular growth sector, are resilient to crisis, and are run by owner-operators. They didn't have debt, and capital allocation was good. The market was pricing them around 6x EV/EBIT, and less than 10x earnings. This is how you can generate a good margin of safety — buying this kind of stuff.

MOI: What are your key stock selection criteria, and what types of businesses do you favor?

Estebaranz: We look for high ROCE businesses, with a high proportion of recurring revenue or predictable cash flow. The vast majority of our holdings follows a model "owner-operators", which tends to work better. We like to invest in industries where we can see the future clearly. We don't like to invest in turnarounds, because they often don't turn... We also haven't been successful in cyclicals.

We know our strengths, and we focus on those. When you are a small fund, you have tons of stocks to choose from, so why do we need to force ourselves into tricky situations?.

"I can send you a list of a hundred wonderful businesses trading at fair multiples, but it is hard to find good businesses trading at low multiples."

—ALEJANDRO ESTEBARANZ

MOI: When it comes to equity analysis, how do you assess the quality and incentives of management? Which CEOs do you admire most?

Estebaranz: We like to look at what managements do instead of what they say they are going to do. If they are active in M&A, we track what multiples they paid and how the acquisitions have performed. We check if they have accomplished previous goals and strategic plans. Sometimes you find a CEO telling you how cheap the stock is, but they don't conduct buybacks. We don't like that type of behavior.

We like prudent and honest CEOs. We prefer them to have low public profiles. If we see a company presentation where they show trading multiples of their stock, that stock becomes uninvestible. That kind of behavior creates short-term focus.

We also hate stock options.

Mark Leonard from Constellation Software is the prototype of the perfect CEO (leaving aside Warren Buffett). Leonard has created an amazing culture. They have one the most creative incentive systems I have ever seen. It is a system that makes people think long-term, act like owners, and rewards best performers.

Luc de Chamard at Neuronex is also exceptional (see our related presentation at European Investing Summit).

Angus Kelly at **AerCap** is a very smart guy who has created a lot of value for shareholders.

Stanley Ma of **MTY Food Group** is another prototype of a perfect CEO. They don't give guidance, don't use stock options, have modest salaries, don't attend analyst conferences, and don't conduct quarterly conference calls. The business has compounded value at 20% for decades, and I expect they will compound at high rates in the future. Your capital is invested better with this kind of guy than in ten-year bond.

In Asia, it is harder to find good management, but we admire Hong Tianzhu from **Texhong Textile** (Hong Kong: 2678). This CEO has built a \$1 billion business from scratch over twenty years in the textile sector. He is always thinking, always improving, a very smart capital allocator. The business has multiplied sales and profits by 10x over the last decade. They are the largest player in a very fragmented market, and they can continue to compound value at 20%. The market offers you this great business and management team at a P/E of 5x (based on 2017 estimates).

MOI: Do you typically seek dialogue with the management teams of your investee companies?

Estebaranz: We don't like to talk with managers before investing. When you hear their "story" — they have already told the same story to dozens of funds bigger than you. You

rarely discover anything new. In fact, it may corrupt your thought process.

We are a fact-based fund. We like to check their actions, and if we like what we see, we invest with them. We may ask them specific questions about the business, accounts or the sector, but this is different from going to them to hear about a bright future or a pitch.

We don't attend brokers' events. Usually, the best companies don't do these kind of roadshows. If your business is great, you don't need to promote it.

MOI: How do you strike the right balance between being concentrated in your best ideas while remaining sufficiently diversified to keep downside risks under control?

Estebaranz: We are a long-only fund. We don't use leverage. It is very simple structure.

Spanish law forces us to hold at least 20-30 holdings. We currently have 40 holdings, plus some exiting/starting positions. The top ten positions are around 50% of the fund.

You have to be very careful about concentrating a lot in small-caps. Bad news always happens, and if you own a lot of stock, you are going to suffer. We have taken big positions in small-caps, but only when the margin of safety was huge.

MOI: What are your observations on the competitiveness of Spanish businesses on a European or global stage? What changes would you like to see to improve competitiveness?

Estebaranz: Spain has become very competitive inside Europe, after the recent reforms. Labor is cheap, competitive, and flexible compared to the rest of Europe. We

have a lot of skilled people. We have maybe one of the best infrastructures in Europe after the housing boom of the early 2000s.

Real estate costs have come down a lot, reducing costs for new companies.

The main problem is politics. Populism is rising, and that is dangerous, in my view.

I would like to see the government investing into improving the quality of education, technology, and R&D.

MOI: Which one or two recent books have given you new insights into the art of investing?

Estebaranz: *100 Baggers* is a good read if you want to invest in truly great companies. You can learn what has worked in the past and try to find similar stocks.

The Outsiders is a great book on how to find good management teams and what they have in common.

MOI: Alejandro, thank you very much for your insights.

"Sometimes you find a CEO telling you how cheap the stock is, but they don't conduct buybacks. We don't like that type of behavior."

—ALEJANDRO ESTEBARANZ

The Manual of Ideas research team is gratified to have won high praise for our efforts.

"I highly recommend MOI — the thoroughness of the product coupled with the quality of the content makes it an invaluable tool for the serious investor."

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