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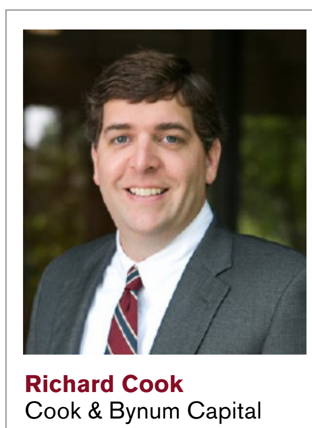
# Value Investor INSIGHT

The Leading Authority on Value Investing

## Liquid Assets

As he looks to expand the analyst corps at the firm he co-founded in 2001, Cook & Bynum Capital's Richard Cook puts a premium on what he calls intellectual honesty. "It's very important in this business not to fool yourself into thinking you understand something when you don't," he says. "If you know something for sure, tell me. If not, don't pretend otherwise."

Cook and partner Dowe Bynum have put their own clarity of thought to productive use, earning since 2001 a net annualized 8.4%, vs. 7.1% for the S&P 500. Finding much more to watch closely than buy at the moment, their eight-stock portfolio today includes bets on soft drinks, beer and regional bottlers.

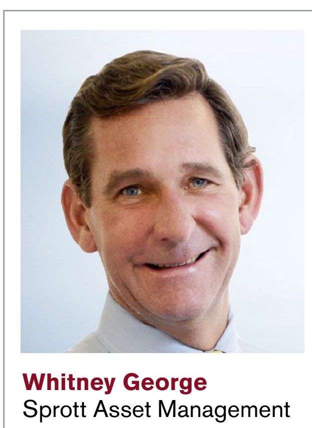


**Richard Cook**
Cook & Bynum Capital

## Adversity to Advantage

Then co-CIO of Royce & Associates, Whitney George in early 2015 wanted a new challenge, ideally one taking advantage of his contrarian nature. "I like situations where a leader in an out-of-favor sector turns adversity to its advantage," he says. "Career-wise, that's where I wanted my next step to be as well."

He joined Sprott Inc., where he's actively involved in managing the precious-metals-focused investment firm while continuing to run Sprott Focus Trust, which in his 15 years at the helm (starting at Royce) has earned a net annualized 11.2%, vs. 9.7% for the Russell 3000. Among contrarian bets today, he sees value in asset management, drilling equipment and semiconductors.



**Whitney George**
Sprott Asset Management

## Attention to Detail

Tom Olsen and his analysts at Swiss money manager Mensarius will make mistakes, of course, but after hearing him describe the firm's seven-step due-diligence process, it's hard to imagine them resulting from research neglect. "We simply want to look at situations from all angles so we don't miss anything important," he says.

Such rigor has paid off nicely for Olsen's investors. Mensarius manages €1.6 billion and its flagship European Value strategy has since the firm's inception in 2008 outearned its MSCI Europe benchmark by 260 basis points per year. In what he considers a rebounding Europe, Olsen today is finding opportunity in such areas as luxury goods, telecom equipment and electric meters.

**Tom Olsen**
Mensarius

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# Investor Insight: Richard Cook

Cook & Bynum Capital Management's Richard Cook describes what's behind the unusual composition of his portfolio, why he's spending so much time in emerging markets, one key "error in psychological misjudgment" he guards against, and why he sees underappreciated potential in Anheuser-Busch InBev, Coca-Cola Embonor and Corporación Lindley.

**You have a rather odd portfolio, with eight stocks and including both the bluest of blue chips and companies we've never heard of. How does that come together?**

**Richard Cook:** We have a broad mandate, which is to find good businesses, anywhere, of any size and in any industry. But the ideas must be in our circle of competence, which for us means that we can see the prospects of the business far enough into the future to get our money back. If you pay 15x earnings for something, you're implicitly saying you know about enough years in the future that the investment will pay off. In addition to that we have an absolute-value orientation; we explicitly project cash flows in perpetuity and then use the current share price to solve for our expected annual rate of return. We don't assume some greater fool will later buy the shares from us at a better valuation. In the current interest rate environment, our expected annualized return has to be at least 10%.

Only a few opportunities meet the criteria of investing in things we can know well enough and that meet our expected-return hurdle. As for the types of businesses that end up in the portfolio, our strategy generally leads us to companies that are either unloved or undiscovered. That's why we have positions in both well-known and not-so-well-known companies.

**Give representative historical examples of both the "unloved" and "undiscovered."**

**RC:** Two in the unloved category would be Wal-Mart [WMT] and Microsoft [MSFT]. We paid 11x earnings for Wal-Mart in April of 2010 at a time when the market seemed to think it could do no right and Amazon could do no wrong. The obsession with Amazon was fair, but at 11x earnings we only had to expect that Wal-Mart could continue to get a few things right in order to grow earnings modestly over the next ten years and deliver us a better-than-10% return on our money.

We started buying Microsoft in 2011, when you could hardly pick up *The Wall Street Journal* without reading about how irrelevant it was becoming and how companies like Apple and Google were going to leave it in the dust. But the stock was at less than 8x earnings if you backed out cash, which basically meant they could put the business in runoff mode and we'd easily get our money back. We thought the Enterprise and Office businesses were stickier than the market recognized and had earnings power that warranted much better than a 7.5x multiple. Any upside from things like shipping better consumer products and building out the cloud business were tremendous free call options.

**ON OWNING EIGHT STOCKS:**

**Only a few opportunities meet the criteria of investing in things we know well enough that meet our return hurdle.**

In the undiscovered category I'd put what you'll see as our great interest in emerging-market Coca-Cola bottlers. The first one we bought was Arca Continental [Mexico City: AC], the best-performing position we've ever had. Arca's primary business is bottling Coke products in northern Mexico, Ecuador, Peru (through its controlling stake in Corporación Lindley), northern Argentina and, in a recent expansion to the U.S., Texas, Oklahoma, New Mexico and Arkansas.

We first got interested in the business more than ten years ago. Coca-Cola is the top-selling carbonated soft drink in nearly every market in the world, creating scale advantages for the company's bottlers, each of whom have discrete territories. We found scale to be especially important in places like Latin America, where beverage distribution is very fragmented with informal, mom-and-pop retailers accounting for well over half of the individual markets. Bottlers who execute at the point of sale – and we think Arca is the best in the world on that front – can sell their products at premium prices and still maintain over 70% market shares.

Even with those advantages, when we first invested in Arca in 2008 the company was growing earnings in the double-digits and had net debt of less than one year's EBITDA, but the stock was trading at 7x earnings and a 9% dividend yield. That is not the profile of a well-understood stock. It's still one of our largest positions.

**What's your current take on Coca-Cola [KO] itself, also one of your top holdings?**

**RC:** We bought the shares in the depths of the 2008 crisis when they selling at only 12x earnings. We bought it well, but I would say we've been rather frustrated by the speed at which the company has taken advantage of the opportunities we think it has to improve the business.

The global growth story is still intact: In countries with between $5,000 and $20,000 in annual per-capita GDP, people start switching to ready-to-drink beverages, meaning anything pre-packaged in a can or bottle. A lot of the world isn't yet to $5,000 in per-capita GDP and most of the world earns less than $20,000, so as that changes Coke should be in a good position to benefit for quite some time.

In developed markets, there is a clear need for the company to innovate beyond carbonated soft drinks sweetened with sugar. Management is aware of that, but we'd argue there needs to be a bigger cultural shift toward being a broad-based,

marketing/distribution business with less bureaucracy. We hear terrific things from bottlers about new CEO James Quincy on this front, and we've seen some evidence that he is pushing management decision-making to local market experts and is willing to explore new product categories. At the current valuation we're willing to see how things develop, but it's fair to say our patience won't be unlimited.

I'd add here that, unlike many investors, we don't tend to look at everything through the filter of what the Chief Financial Officer would do to make things better. For Microsoft, it wasn't about how to perfectly lever the balance sheet; the company just needed to consistently provide better and more relevant products and services. The same thing is true of Coke. It's not about what they do to the dividend or how they should save their way to prosperity. It's about providing more and better products that meet the needs and wants of consumers. Whether they can do that or not is ultimately what's going to matter, especially over our time frame in evaluating the company's progress.

**You're often on the road looking for opportunity in emerging markets. Why are you taking that path?**

**RC:** With respect first to getting out of the office, we believe in immersive research. If you want to authentically underwrite a business, you need to understand the actual interactions that happen between that business and its customers. You have to know suppliers. You have to know competitors. You have to see how the company is set up to repeatedly satisfy its customers and whether it's doing so. That means you have to be out in the market.

This quarter we've been to the Philippines, Indonesia, Chile, Mexico and Brazil, in addition to traveling in the U.S. Part of our interest in emerging markets has to do with demographic tailwinds. It really matters to the growth you can expect if you have a young working population and improving governance and financial systems that encourage capital formation and business enterprise.

Beyond that, Charlie Munger talks about a secret to success in life being weak competition. There are a lot of really smart people, including the entire private equity industry, trolling around every U.S. company. But if you do work in non-BRIC countries and you have value-investing skills, we think you can have a competitive advantage. It's not easy, but there's more mystery in developing markets, and where there's mystery there's potential profit.

**Many global-minded investors have argued that it's better to capitalize on developing-market growth through big Western companies with strong brands and unique expertise. Would you agree?**

**ON EMERGING MARKETS:**

**We're seeing more sophisticated local competitors make it difficult for Western brands to establish themselves.**

**RC:** It's true that 10 or 15 years ago a Unilever, Procter & Gamble or Nestlé could plant a flag in a foreign country and take market share because people understood they had higher-quality products. I would argue that's much less the case today, when we're seeing more sophisticated local competitors make it much more difficult for Western brands to establish themselves in a market and take share. That's informing our views both on the challenges facing some multinationals and on the local opportunities we uncover in our research outside the U.S.

**On the subject of big multinationals, you appear to have concluded Anheuser-Busch InBev [BUD] is a long-term winner. Explain why.**

**RC:** This is a position we started building in March of this year. The company is the world's largest brewer, with an estimated 28% global market share and a wide range of brands, including Budweiser, Corona, Stella Artois, Brahma, Castle and Goose Island. It was formed by combining four major brewers – AmBev, Anheuser-Busch, Interbrew and SABMiller – and is controlled by a consortium of families led by the founders of 3G Capital.

The big story here for us is that we believe AB InBev has among the best demographic footprints in the world, and it is the best on-the-ground at execution. Something on the order of 60% of revenues are now generated in emerging markets, and it's not unusual in countries – particularly in South America and Africa – for AB InBev brands to have 80%-plus market shares. Even in a country like China, as difficult as it can be for foreigners, the company is the largest foreign brewer with a 19% market share.

We can talk about the craft-beer phenomenon in developed markets, but in developing markets craft brews have limited opportunities. Small breweries simply cannot get distribution in the markets in which AB InBev has dominant share. In addition, high-end beers aren't something consumers pay for in countries with low per-capita GDP. In Africa, for example, 40% of beer is still non-commercially produced. So AB InBev's growth potential comes from attracting an emerging global middle class to its value-priced brands that come in a can or bottle. No other brewer comes close to benefitting as much from that shift over time.

**Are the company's market-share problems fixable in places like the U.S.?**

**RC:** For decades consumers' beer preferences were very static, but now roughly one-third of U.S. beer drinkers say they want to try a different beer every time they drink. Bud Light has been a primary casualty of that trend, and the inability of management to stem the decline in the brand led recently to the head of the U.S. business being replaced. Is it all fixable? I don't know, but I do think the company has embraced the craft beer trend well, assembling a portfolio in the U.S. – including brands like Goose Island and Blue Point

– that is growing faster than the craft category overall. That speaks to AB InBev's distribution strength in the U.S., which I wouldn't underestimate as an asset. I'd also mention that many craft brewers are not profitable, and we suspect that in ten years many will have gone away and it will be a much more consolidated segment of the industry.

**With the ADR trading at a recent $111.50, how are you looking at valuation?**

**RC:** In general, we think the problems with the legacy brands are overshadowing the underlying strength in emerging markets. Current earnings also don't reflect the full $3.2 billion of annual cost synergies the company expects from the SAB-Miller deal over the next couple of years.

When we take into account revenue and cost synergies still available, normalization in depressed markets like Brazil and Argentina, and general emerging-markets volume and pricing growth, we believe earnings can grow at a mid- to high-single-digit annual rate. At the same time, at the current share price the yield on our estimate of normalized owner earnings – calculated as normalized operating cash flow less maintenance capex – is about 5%. The sum of the two approximates the low-double-digit annual return we expect on the stock over the long term.

There will also continue to be opportunities for management to create value through acquisitions. To give just one example, the largest and third-largest brewers in Vietnam are state-owned and are slated to be privatized. AB InBev would be a natural buyer.

**Do you think there's any credibility to the rumors that AB InBev would try to merge with Coca-Cola?**

**RC:** There would be many operational, financial, cultural and regulatory hurdles to overcome, but from a purely business perspective, the global distribution advantages of combining these businesses would be incredible. It would obviously depend on the price, but in theory the potential for value creation from such a deal would be pretty high.

**Coming back to Coca-Cola bottlers, describe your investment case for Coca-Cola Embonor [Santiago: EMBONOB].**

**RC:** Based in Chile, this Coke bottler serves two primary markets, the country of Bolivia and most of Chile outside of the greater Santiago area. Chile is the wealthiest and most business-friendly country in Latin America, which supports the stability of Embonor's business there, but per-capita income is already relatively high at $14,000 per year so the volume growth potential isn't that high. That's not the case in Bolivia, which has per-capita income of about $3,000 per year and where the company's business has been growing at double-digit rates. Bolivia is now the bigger market of the two for Embonor, which has a better than 80% market share in the country.

**Are changing consumer tastes away from sweet, carbonated sodas an issue?**

**RC:** The trend is far more pronounced in the U.S. This may sound strange, but

### INVESTMENT SNAPSHOT

**Anheuser-Busch InBev**
(NYSE ADR: BUD)

**Business**: World's largest beer producer, with 60% of sales generated in emerging markets. Brands include Budweiser, Bud Light, Michelob, Corona and Stella Artois.

**Share Information** (@12/29/17):

| | |
|---|---|
| **Price** | **111.56** |
| 52-Week Range | 103.55 – 126.50 |
| Dividend Yield | 3.6% |
| Market Cap | $216.68 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $56.05 billion |
| Operating Profit Margin | 29.9% |
| Net Profit Margin | 9.6% |

**Valuation Metrics**
(@12/29/17):

| | BUD | S&P 500 |
|---|---|---|
| P/E (TTM) | 41.6 | 21.8 |
| Forward P/E (Est.) | 21.8 | 20.0 |

**Largest Institutional Owners**
(@9/30/17):

| Company | % Owned |
|---|---|
| Soroban Capital | 10.9% |
| Franklin Resources | 5.2% |
| Fisher Asset Mgmt | 4.8% |
| ClearBridge Inv | 4.2% |
| Bank of America | 4.1% |

**Short Interest** (as of 12/15/17):

| | |
|---|---|
| Shares Short/Float | n/a |

**BUD PRICE HISTORY**

**THE BOTTOM LINE**

Richard Cook believes the challenges facing the company in developed markets inappropriately overshadow its business strength in emerging markets. Adding his estimates of annual earnings growth and the stock's current earnings yield on normalized owner earnings, he expects to earn a low-double-digit annual return on the stock over time.

Sources: Company reports, other publicly available information

consumers in low-income countries often think of Coke as a valuable part of their diet, a source of energy. That said, some Latin American governments are imposing sugar taxes, which has prompted the bottlers to test reformulated products. For example, Coca-Cola Embonor in Chile is testing formulations of Fanta and Sprite with 30-40% less sugar. If those work, margins would improve because sugar – the bottlers' second-highest cost – is replaced by cheaper artificial sweeteners. It would also improve sales volumes, as the cost to the consumer goes down without the sugar tax.

**The company's shares appear somewhat more volatile than the underlying business. How attractive are they at today's 1,710 Chilean pesos?**

**RC:** The shares rose 20% or so recently in response to what was perceived to be a positive outcome in the Chilean presidential election, but we still think they offer an attractive return. Driven by long-term volume growth in Bolivia and the inherent pricing and operating leverage in the business, we think the company can increase earnings annually at a high-single-digit rate for at least ten years. Add to that the current 4% yield on owner earnings and here too we're expecting a low-double-digit annual return over the long term. That's a more-than-fair return given what we believe is a narrow range of possible outcomes.

While we like the business as a standalone and wouldn't anticipate a sale any time soon, Embonor is probably the most attractive acquisition candidate in the Latin American Coke system. Consolidation makes a lot of sense in a business like this, reinforcing scale advantages and accelerating the proliferation of best practices. That's potentially another way for shareholders to win.

**Is the thesis similar for Peruvian Coca-Cola bottler Corporación Lindley [Lima: CORLINI1]?**

**RC:** We started following Corporación Lindley four years ago and were interested both in the demographic backdrop in the Peruvian market and the opportunities we saw for a market-share leader to improve point-of-sale execution, capital allocation and corporate governance. What held us back from investing was a lack of confidence that the controlling Lindley family could take advantage of the opportunities we saw.

That changed in late 2015 when Arca Continental announced that it was buying the Lindley family's controlling stake and planned to implement a series of operational improvements that promised to increase the sales and profitability of the business. To us it was a terrific match of a superior management team with great assets in a growth market. We were also able to buy in at less than half the valuation Arca paid because our shares, while having the same economic interest and right to dividends as Arca's shares, don't have voting rights. Given our long relationship with Arca, that didn't matter to us.

**How's it going so far?**

**RC:** Arca is doing exactly what they said they'd do. They're overhauling and investing in point-of-sale execution to drive

## INVESTMENT SNAPSHOT

**Coca-Cola Embonor**
(Santiago: EMBONOR-B)

**Business**: Produces, distributes and markets carbonated soft drinks, bottled water, energy drinks and fruit juices in Chile and Bolivia under a license with The Coca-Cola Company.

**Share Information**
(@12/29/17, Exchange Rate: $1 = 605 Chilean Pesos):

| | |
|---|---|
| **Price** | **CLP 1,710** |
| 52-Week Range | CLP 1,300 – CLP 1,800 |
| Dividend Yield | 1.4% |
| Market Cap | CLP 826.09 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | CLP 545.16 billion |
| Operating Profit Margin | 12.3% |
| Net Profit Margin | 6.5% |

**Valuation Metrics**
(@12/29/17):

| | EMBONOR | S&P 500 |
|---|---|---|
| P/E (TTM) | 24.8 | 21.8 |
| Forward P/E (Est.) | 19.9 | 20.0 |

**Largest Institutional Owners**
(@9/30/17 or latest filing):

| Company | % Owned |
|---|---|
| Compass Group Chile | 9.9% |
| Moneda Administradora | 8.9% |
| BICE Inversiones | 6.8% |
| BTG Pactual Chile | 5.1% |
| Banchile Administradora | 3.0% |

**Short Interest** (as of 12/15/17):

| | |
|---|---|
| Shares Short/Float | n/a |

**EMBONOR-B PRICE HISTORY**

**THE BOTTOM LINE**

Driven by long-term volume growth in Bolivia and by the pricing and operating leverage enjoyed by Coca-Cola bottlers, Richard Cook believes the company can increase earnings at a high-single-digit rate for at least ten years. From the current share price he expects that to translate into a low-double-digit annual investment return over that period.

Sources: Company reports, other publicly available information

revenue gains. They have materially improved customer service and materially reduced delivery costs. They've also taken out costs by using Arca's economies of scale to lower things like raw-materials costs, insurance expenses and spending on information technology. Looking ahead, we think EBITDA can grow over the next three to five years by 50%, driven by annual volume growth of 4-5%, low-single-digit annual price increases, and per-unit cost improvement from better management and more-efficient production.

**Is the balance sheet a concern?**

**RC:** Net debt to EBITDA is nearly 4x, which is much higher than the 1x-or-less ratio Arca Continental would prefer. One reason for the elevated leverage is debt taken on from the recent construction of a state-of-the-art production facility located 50 kilometers south of Lima. With that major capital expense behind them, we would expect a steady pay down of debt through consistent cash-flow generation going forward.

**The shares, recently trading at around 4.10 Peruvian soles, appear to be quite illiquid. Is that a worry?**

**RC:** We are the third-largest shareholder, behind Arca and Coca-Cola, and the next two largest owners are Chilean families with whom we have relationships. In general, we believe one of the other large owners would be a reliable source of liquidity for us, but we think the shares significantly undervalue the earnings power of the assets in place and expect to hold on for a long time as the value is realized. As Warren Buffett has written, "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years." We feel that way about Lindley.

**How are you assessing fair value?**

**RC:** If we're right that owner earnings grow and debt is paid down as we expect, we believe the fair value is at least double the current share price.

**Your portfolio doesn't have a lot of positions to sell, but have you sold anything recently and, if so, why?**

**RC:** We've been reducing our position in Microsoft, which is a function of valuation. Today you can hardly pick up the *Journal* without reading about how great its Enterprise business is, or how it's making wonderful inroads in the cloud, or how smart Satya Nadella is. As Buffett says, "You pay a high price for a cheery consensus."

We also in our private partnership very recently sold our entire position in Wal-Mart. I talked earlier about how in 2010 we thought the market's expectations were overly negative, but while it's taken a while, the strength in the share price has made that no longer the case. Especially given the ongoing challenges facing retailers, we just didn't think we had enough margin of safety to hold it.

**You've written in the context of selling about the importance for investors to battle "consistency bias." Describe what you mean by that.**

**RC:** Even highly accomplished value investors struggle with the tendency to ig-

## INVESTMENT SNAPSHOT

**Corporación Lindley**
(Lima: CORLINI1)

**Business**: Production, marketing and sale of Inca Kola, Peru's top soft drink, and production and distribution of packaged beverages in Peru under a license with Coca-Cola.

**Share Information**
(@12/29/17, Exchange Rate: $1 = 3.2 Peruvian Soles):

| | |
|---|---|
| **Price** | **4.08 Soles** |
| 52-Week Range | 2.85 Soles – 4.10 Soles |
| Dividend Yield | 0.0% |
| Market Cap | 2.67 billion Soles |

**Financials** (TTM):

| | |
|---|---|
| Revenue | 2.76 billion Soles |
| Operating Profit Margin | 10.8% |
| Net Profit Margin | 5.8% |

**Valuation Metrics**
(@12/29/17):

| | COROLINI1 | S&P 500 |
|---|---|---|
| P/E (TTM) | 16.6 | 21.8 |
| Forward P/E (Est.) | 14.0 | 20.0 |

**Largest Owners**
(@9/30/17 or latest filing):

| Company | % Owned |
|---|---|
| Arca Continental | 57.0% |
| Coca-Cola Co. | 34.0% |
| Cook & Bynum | 2.5% |

**Short Interest** (as of 12/15/17):

| | |
|---|---|
| Shares Short/Float | n/a |

**CORLINI1 PRICE HISTORY**



**THE BOTTOM LINE**

Now under the control of much-larger and better-run Latin American Coca-Cola bottler Arca Continental, the company is improving its point-of-sale execution, customer service and operating efficiency, says Richard Cook. He believes EBITDA can grow over the next three to five years by 50%, and that that can translate into a doubling of the share price.

Sources: Cook & Bynum, company reports, other publicly available information

nore or misinterpret information that contradicts what they have come to believe. That's obviously dangerous for investors, so we try to be as explicit up front as we can about identifying the things that if they went wrong we would rethink why we own the stock.

I'll give you an example. We like a lot of value investors five or six years ago bought Tesco, the British retailer that was losing market share and margin in its home market because it had ill prepared for new competition, primarily from discount grocery chains Aldi and Lidl from Germany. Our thesis was that if it could improve the in-store experience, that would stabilize the ship enough for us to make money on shares for which we only had to pay 8x earnings.

In this case the keys were, first, that the company could improve the in-store experience, and second, that if it did improve the experience that would actually make a difference. So we knew exactly what to look for that would confirm or disprove our thesis. After 18 months it was becoming clear that the in-store experience wasn't really getting better, so we got out. We actually made a little money, but had we fallen in love with the original thesis and pooh-poohed the contrary evidence, it would have been a big mistake.

**You've been adding to your analyst team. What are some of things you're looking for in people to hire?**

**RC:** The primary thing is we want people with integrity both in how they conduct themselves and in how they understand information and data. We want analysts who are willing to say "I don't know" whenever that is true. Intellectual dishonesty is quite detrimental to successful investment research.

Curiosity and a love of learning are also important to us. Investing has been called the last liberal art, which I really believe. In that spirit, we want people who are thinking about a broad range of things and how they all work together, and they need to be willing to work really hard to figure things out. Hopefully every now and then all that helps us predict the future a little bit better than average. VII