



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

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

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- ▶ Screening for bargains owned by superinvestors
 - ▶ Latest holdings of 50+ top investors
 - ▶ 20 companies profiled by MOI research team
- ▶ Proprietary selection of Top 3 candidates for investment
 - ▶ Plus: Exclusive interview with Simon Denison-Smith
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Inside:

**Exclusive Interview with
Simon Denison-Smith,
Founder of Metropolis Capital**

*With compliments of
The Manual of Ideas*

Exclusive Interview with Simon Denison-Smith

We are pleased to bring you our recent interview with Simon Denison-Smith, co-founder of London-based value investment firm Metropolis Capital.

The Manual of Ideas: Please tell us about your background and the genesis of your firm. What have been the major influences in your career, and what are your goals for the Metropolis Valuefund?

Simon Denison-Smith: The Metropolis Valuefund has a two-person investment team – Jonathan Mills and me. Jonathan and I met when we were strategy consultants with Bain & Company in 1990. I left Bain to join an ex-Bain manager to help him with his family business in Bangalore, India and Jonathan went to work for Schroders for a couple of years. In 1994, we both set up separate businesses. I set up an offshore software services business and Jonathan a publishing business, Metropolis International Group. I invested in Metropolis and joined the board from inception.

In the late '90s, Jonathan and I ran a small investment club, inspired by studying the success of Warren Buffett. We developed a valuation process and an early checklist to identify quality characteristics within potential investment opportunities. After attending our first Berkshire Hathaway AGM, we decided that Metropolis should look at a growth strategy based on acquisitions with a focus on finding strong but unloved businesses, which we could acquire at low prices. We re-purposed the valuation model from the investment club and used the checklist to create our first set of due diligence questions. From 2002 to 2011, we completed 23 acquisitions, with each business having a strong and long track record of generating cash flow. In each case, we paid a price that provided us a significant margin of safety. This strategy resulted in returns to shareholders of over 40% per annum over a 17-year period.

“Our best decision in 2008 was to exit our largest position in Lloyds Bank at a 24% loss when Lloyds announced the HBOS acquisition at price of £2.80 (today they are £0.30-0.40).”

The success of the buyout model had led to frequent discussions within the Board as to how and when we should apply the same models back into the equity markets. The sale of my software business in 2007 gave us the bandwidth to look at this in more detail. In early 2008 we put together a significant enough pot of money from my own funds, spare capital from Metropolis, and cash from an investment partner. We had come full-circle from the days of the investment club, taking the valuation model, which had worked so well in buying whole private companies, and the due diligence disciplines to create an extended checklist, we started looking for high quality but misunderstood value opportunities of any size within the equity markets.

We started investing in May 2008 as a full-time activity and were 70% invested by the time Lehman collapsed. Our best decision in 2008 was to exit our largest position in Lloyds Bank at a 24% loss when Lloyds announced the HBOS acquisition at price of £2.80 (today they are £0.30-0.40). Our returns over the first 3.5 years have averaged 15% per annum whilst the market has been flat.

Following on from our success and at the urging of investors who wanted to invest alongside us in a regulated fund, we finally launched an open-ended fund, the SF Metropolis Valuefund, in April 2011 and started taking on outside investors. For me, this last four years have been by far the most interesting, fun and rewarding period of my career. Our aspiration is to run only one fund, to do so for the next 30-40 years and to never stop learning.

MOI: When it comes to stock selection, what are the key criteria you look for in potential investments?

Denison-Smith: Metropolis is a value investor. Our strategy is simple to articulate, though perhaps psychologically difficult for most investors to carry out as it involves fishing in unpopular waters.

In summary, we believe the best returns are generated from finding gaps between the enterprise value that the market attaches to a business and its intrinsic value. We look to invest a meaningful proportion of the portfolio in a few very good opportunities where such gaps are significant and then to wait for the market to reappraise the value of the business in question. We expect that the majority of our returns will come from the closing of the “value gap” rather than from internal growth by businesses that we buy. However, as we are buying companies on earnings yields that are often 10% or more, the underlying value of companies we invest in will typically increase at something close to this rate through dividends and growth of cash or reduction of debt.

The value gap we identify, while providing the majority of our expected return, also acts as the margin of safety which protects us should our view of a particular company’s future turn out to be optimistic.

In order to estimate intrinsic value we forecast as accurately as we can the flow of post-tax free cash flow a business will generate for shareholders over its remaining life (on average through the business cycle) and then discount these.

We like businesses which are easy to understand and have “wide moats,” i.e., a strong competitive position in markets with high barriers to entry, providing security over future revenue streams through, for example, long-term contracts, a unique brand, infrastructure which is difficult to replicate, patents or licenses. This moat helps to ensure that they are able to continue producing free cash flow with some degree of predictability for many years to come. There are many businesses and indeed sectors we do not even try to value because either (i) we do not understand them and are therefore not able to form a strong view as to the likely free cash flow they will generate over time, or (ii) we do not believe that they have a business model strong enough to give predictability to their long-term free cash flow.

A business does not have to have fantastic economics for us to invest in it, but it must have economics which are good enough that we can estimate with a reasonable degree of accuracy what its free cash flow will be through the business cycle, and there must then be a big gap between the sum of the discounted cash flows and the current enterprise value.

We avoid companies with high levels of financial debt, large earn-out payments uncovered by cash in the business or significant pension obligations because they increase the risks implicit in a business. We like businesses that would generate high returns on equity without employing large amounts of debt.

We like smart low-ego, risk-averse managers who are growing their business by executing a well-articulated and proven strategy. We look for managers with either significant equity stakes in these businesses or who have a track record of transparency and acting in the best interests of shareholders.

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MOI: How do you generate investment ideas?

Denison-Smith: We get our ideas from two sources:

1. A proprietary screen that we have built with assistance from Thomson Reuters which works off their Reuters Knowledge platform. This model processes over 80 historic financial variables and uses these to calculate a first-cut intrinsic value, from which we derive a first-cut margin of safety for each company that we run through the screen. We use cash flow and debt filters to further refine the screen.

2. Reading widely in business magazines (e.g., *Investors Chronicle*), newspapers (e.g., the *FT*) and various online sources – to see if there are any companies that we have missed, which we then analyze.

MOI: Would you outline the summary thesis behind one or two of your best ideas at this time?

Denison-Smith: Two investment ideas – very different in their nature:

Tesco (London: TSCO)

Tesco has been a stock we have looked at off and on since we started the private fund, but have never been able to get comfortable with the high capex requirements of the business, coupled with a lack of transparency with respect to how disciplined the company was in ensuring that there would be a good return on the capital invested.

Tesco's share price has hardly moved in the last 4.5 years but the business is generating 35% more profit. This puts the business on a trailing P/E of ~11x, inexpensive for a business which has grown its after tax earnings at 13% per annum for the last ten years and is still achieving this growth rate.

Its market share in UK groceries of over 30%, combined with the location and size of its store infrastructure gives Tesco a powerful moat, which underpins its future cash flows and provides a strong degree of predictability. We were able to speak to several people before we invested: a former senior employee in IT, a supplier, and a property partner of Tesco. In each case, they had experience of working for or with other UK grocers, and it was clear that Tesco stands head and shoulders above their UK competitors on a number of levels: relentless focus on costs, professionalism, and capability in everything from buying, property management and IT procurement. Despite its low-cost culture, it has continued to be the most innovative of the retailers – building Clubcard into the most powerful loyalty programme in UK retail and leveraging this through Dunhumby, a high-quality CRM business it acquired. Tesco has reduced its real cost per square foot in the last ten years by 12%, and by keeping its margins constant, it has passed these savings onto customers.

The market frets that Tesco cannot grow much further in its home market and that store expansion plans by all the grocers will lead to increased competition and margin erosion. We spent some time analyzing this bear case and trying to figure out the impact the space growth plans would have on the UK retail landscape. Stripping out the non food, the planned increased of 19 million sq ft over the next five years represents a 6-7% increase in grocery space. We believe that there is room for the multiples to take this kind of market share over the next five years driving up the share of the big four towards 80%.

“[Tesco’s] market share in UK groceries of over 30%, combined with the location and size of its store infrastructure gives Tesco a powerful moat, which underpins its future cash flows and provides a strong degree of predictability.”

The Tesco story is also about growth internationally. Crucially, in the last eighteen months, management has significantly changed its focus towards improving return on capital. Until recently, the emphasis was firmly on top-line growth. Today ROCE [return on capital employed] is a key strategic objective, and in typical Tesco style they are incentivizing their top management layer directly on ROCE performance. Their historical track record is patchy with UK, Thailand, South Korea, Malaysia, Ireland and Hungary performing well (ROCE>15%), but the Czech Republic, Poland, Slovakia and Turkey well under 10%, and Japan, China and the U.S. losing money. Their focus on improving this and putting a hold on further expansion into new countries makes them more attractive to us. Tesco has recently shared ROCE analysis for mature stores in some of these underperforming countries showing that ROCE in these stores is at acceptable levels. Management is convinced that with time and focus, they can bring all of these businesses to acceptable returns. The business plan is to focus on building on their existing platforms, leveraging much of the innovation from the UK market (e.g. loyalty cards, web/home delivery) to build higher profitability in the countries that have underperformed.

Whichever way we modeled this business, we found significant downside protection. Tesco has property assets with a book value of £26 billion but a market value of ~£36 billion (compared to its market cap of £33 billion when we started investing). Running a hypothetical sale and leaseback model and returning all cash to shareholders would leave Tesco trading on a ~3x multiple of cash flow. We would not suggest that Tesco does this, and it is their stated intention to own 70%+ of their estate, however they are using sales and leasebacks as a low-cost way of funding their growth. On another key measure, cash generation, over 12 years Tesco has generated 112% of its reported profit in cash (after tax and interest). If we assume that it can continue to generate cash at its current rate and strip out the loss-making businesses (U.S., Japan, and China) on the grounds that they will either become profitable or will be closed down, our margin of safety approached 50%.

“Running a hypothetical sale and leaseback model and returning all cash to shareholders would leave Tesco trading on a ~3x multiple of cash flow.”

We started investing in the business in May 2011 and were able to take advantage of the even more compelling margin of safety offered by the market over August, enabling us to build a position to ~8% of our fund. Arguably the business is actually a slightly better investment today than it was in May because management has taken the decision to divest the loss-making Japanese business. This step underlines our view that this management team is now focused on return on capital and their custodial duties with respect to the considerable cash flow the business generates. Since August, Buffett has confirmed that Berkshire has also been topping up its stake in Tesco.

K3 (London: KBT) – a micro cap idea...

We first met the K3 management team in April 2008 at an investor show. Andy Makeham, the CEO, is ~50 years old, energetic, entrepreneurial and a former programmer. He is very sales driven. David Bolton, the CFO, started off at BTR, one of the great 1980s acquisition-driven conglomerates along with Hanson. Andy and David own 3% of the business each and most of their net worth, other than properties, is in the business. The Non-Executive Chairman of the business owns 19%. Following some additional meetings, telephone calls and our usual due diligence on their numbers and strategy, we started building a stake – initially at a price of ~130p.

We believe the two key executives are a good team with complementary skill sets. They are also hard-nosed about the need to keep costs in line with revenues and to manage headcount.

K3's strategy is to buy up small software providers in both of their two vertical markets – retail and distribution, and manufacturing. In the last year, they have added a third arm to the business, buying up Sage resellers, which offer strong support revenue streams. The software that K3 sells is “mission critical” ERP software used by companies to manage inventory, resources and business processes, which makes their customer relationships very sticky. 45% of their revenue each year is contracted support and maintenance revenue, and they generate an additional 43% of revenue from their existing customer base in a range of additional services and products.

“[K3] has an enterprise value of £60 million, generating ~£10 million of pre-tax cash flow. We like the fact that weaker markets are positive for K3 in that they present opportunities to buy businesses at lower prices.”

We questioned Andy and David hard on their acquisition and valuation criteria and were reassured as to their approach, particularly regarding their approach to value, where they pay 4-6x EBIT and look to extract synergies. Having followed the business and built up our position in the company over the last 3.5 years (the shares got down to as low as 60p in the heart of the credit crunch), we have been impressed with the ability and discipline of the management team to buy businesses on low multiples. More recently, K3 has identified an organic growth strategy to offer its clients to move from an onsite hosted solution to an offsite (or cloud based) service solution. The long-term impact of this will be to increase further the long-term contracted revenue.

At a recent share price of ~161p, it has an enterprise value of £60 million, generating ~£10 million of pre-tax cash flow. We like the fact that weaker markets are positive for K3 in that they present opportunities to buy businesses at lower prices.

MOI: Good ideas are only one piece of the investment success equation, with sound portfolio management being another critical component. How do you structure your portfolio and manage risk?

Denison-Smith: We cannot invest more than 10% of our portfolio in any one company (FSA rules for the fund structure). In addition, we seek to ensure that any closely correlated companies (on fundamentals not share price) do not together represent more than 20% of the portfolio in terms of their initial purchase prices.

We have developed a matrix we use to ensure there is sufficient liquidity in the fund. This is for two purposes: 1) to ensure that we could meet any redemption requirements, and 2) to ensure that we are sufficiently nimble to raise cash to be able to buy into new compelling investment ideas.

Other than these rules, we are simply searching for up to 20 companies that have the greatest gap between post tax free cash flow and enterprise value and will invest more heavily in those companies where we are confident that there is the largest gap.

MOI: How do you assess the quality and incentives of management, and what CEOs do you admire most?

Denison-Smith: In addition to the important “moat”, we look for businesses that have a management team that is disciplined in its approach to capital allocation. This can manifest itself in a number of ways:

1. The purest (and lowest risk) flavor is to find a business model that has clear organic growth potential, with a high return on the capital needed to be deployed to secure this growth and where the management has no need to look anywhere else for growth. Finding a business like this at a sensible price is rare.

2. Along slightly different lines are businesses in flat or slightly declining markets. These businesses will usually serve their shareholders best by focusing on retaining (and maybe growing) their dominant position within their niche, generating as much cash as possible and returning any excess that their strategy does not require to owners through dividends and buybacks. A good example currently is **Halfords (London: HFD)**, which we have in the portfolio. Halfords already dominates the car repair, car enhancement, outdoor and cycling markets in the UK and therefore has limited opportunities to deploy cash flow to grow the business further within its core markets. They recently spent £73 million (~85% of annual post-tax profits) to buy Nationwide Autocentres, which they have re-branded Halfords Autocentres. This acquisition has, so far, not lived up to management's expectations but we are reassured that they have elected to close down loss-making ventures overseas, pay a 6.8% dividend (based on current market cap), and in addition return over 10% of the current market capitalization through a share buyback program. It would therefore appear that they are not looking to save up their cash (or take on debt) to invest it unwisely in a transformational acquisition outside of their core market.

“[Halfords will] close down loss-making ventures overseas, pay a 6.8% dividend and return over 10% of the current market capitalization through a share buyback program.”

There are currently many of these types of stocks available, some at sensible prices, however too few have management teams who are comfortable to act as disciplined custodians of their shareholders capital. All too often they are looking to roll the dice with their cash flow, by entering “adjacent” markets or through over-priced acquisitions. This is often driven by management over-confidence that they can work magic in industries that they do not understand. Often the incentive structures are of no help – giving the executives a one-way bet on a big “strategic initiative”. We have exited two positions this year because a change of management brought in a new “strategic vision” that would likely result in deployment of cash flow into markets with unpredictable returns.

3. Occasionally, we find a management team that has developed a core competence in growing companies inorganically. Here we look at one key metric – how much are they paying for acquisitions. Two of our small-cap positions are run by management teams who really understand the significant potential to build shareholder value from buying cash flows, which they know how to manage and grow, at low prices – the value investing approach to inorganic growth, one which of course sits well with our roots of building the Metropolis publishing group.

MOI: How has market volatility over the past three years affected your investment process, and have you tweaked your approach in any way as a result?

Denison-Smith: We have always been careful to try to understand the fundamentals of any business we have invested in. Our experience has taught us that when the fundamentals change negatively, for whatever reason, and we feel that we no longer understand them, we should exit the investment immediately. We also learned that there are some businesses, for which the share price is potentially a driver of the fundamentals. In the case of all banks in 2008 (and again in the Eurozone currently), a plummeting share price makes it more

expensive for a bank to fund itself. Traditionally, value investors tend to view a downward movement in a share price as an opportunity to buy more, but there are some stocks where it damages the fundamentals.

Our experience in 2008-09 means that we have slightly increased the level of margin of safety (discount to intrinsic value) we require from less liquid stocks. This is in recognition that in some situations, if there is a change in the fundamentals of a company, then exiting that position needs to be done at a discount to its market price. To this end, we have adjusted upwards the level of margin of safety we look for in small-cap positions.

MOI: What is the single biggest mistake that keeps investors from reaching their goals?

Denison-Smith: We would argue that investors who are not undertaking sufficient analysis and due diligence in each position they invest are taking significant risks. A lack of deep understanding of a position leads to two specific challenges:

1. It is much more difficult to have a conviction of what the fundamental value of the stock is without this, which makes it psychologically more difficult to buy when the market delivers a compelling price and to have the discipline to sell when the market is over-exuberant.

2. It makes risk management much more difficult, particularly spotting when something fundamental has changed within the business. In the last 3.5 years, we have exited three positions at a loss, where the share price fall subsequent to our exit was between 70-90%. In all three cases, we were close enough to the businesses, to fully appreciate the impact of news flow that was in the public domain but had not been fully appreciated by the market.

MOI: What books have you read in recent years that have stood out as valuable additions to your investment library?

Denison-Smith: In addition to the classic value tomes of Benjamin Graham and also the excellent *Margin of Safety: Risk-Averse Value Investing for the Thoughtful Investor* by Seth Klarman, we found Vitaliy Katsenelson's book *Active Value Investing* very interesting.

We also enjoy reading and have learned a lot from biographies of successful businessmen. These often explain the key elements that made them and their companies successful better than traditional business and investment books. We particularly enjoy biographies of business figures from the past which often give a perspective on current developments. For example, *The First Tycoon – the Epic life of Cornelius Vanderbilt* and *Titan – The life of John D Rockefeller* both illustrate how critical it is for a successful company to be the lowest-cost operator in its industry, and the risks and opportunities that occur during financial panics.

MOI: Simon, thanks very much for your ideas and insights.

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