

BARRON'S Hedge Funds

A Monthly Report

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3G partners Begun (left) and Bailey share a devotion to hockey as well as value investing.

Talking With Pavel Begun and Cory Bailey

Co-Founders, 3G Capital Management

They Shoot, They Score

by Neil A. Martin

WHEN HE WAS GROWING UP IN MINSK, CAPITAL OF THE then Soviet republic of Byelorussia (now Belarus), Pavel Begun dreamed of being a capitalist entrepreneur. At age 11, he started selling strawberries and apples at a local farmers' market. By 14, he and a friend were buying steel bars wholesale and selling them at a mark-up to makers of steel-reinforced concrete. And at 17, he launched an accounting newspaper and built it into one of the leading trade publications in the country. He sold it three years later, at a nice profit.

Begun's early success fueled his ambition. After reading about famed value investors Benjamin Graham and Warren Buffett, he decided he wanted to become one. "That meant finding some way to the West, where I could learn more." So he applied for, and won, a scholarship to Western Kentucky University in Bowling Green, Ky.

In 1998, at age 20, Begun left Belarus to begin his new life in America. "It was a dream come true," he recalls. "I was pretty confident I could make it work."

Over the next five years, Begun earned a business degree from Western Kentucky and an MBA from the University of Chicago; became a chartered financial analyst; and worked as a research analyst with investment advisors Fiduciary Asset Management and broker A.G. Edwards, both in St. Louis. In July 2004, he co-founded 3G Capital Management with Cory Bailey, a colleague from Fiduciary Asset who shared Begun's passion for value investing and ice hockey.

With assets of \$50 million and offices in St. Louis and Toronto, 3G is a global, value-oriented hedge fund that doesn't hedge and shuns commodities, options and derivatives, seeking instead to make money the old-fashioned way—by investing long in what Begun calls "bread-and-butter" companies with solid *continued on page 43*

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business models and then waiting for long-term capital appreciation. Begun and his partner, both of whom are 31, keep most of their net worth in the fund.

"We really operate more like a private-equity firm than a hedge fund, preferring to buy a 'stake' in a company rather than just buy its stock," says Bailey. "We want to feel like partners rather than just investors."

That philosophy is embodied in the firm's name—3G stands for good business, good management and good price.

"We look for well-managed businesses that are competitively entrenched, generate high returns on invested capital and carry little debt," Begun explains. "Equally important, we are seeking to purchase these businesses at a significant discount to their intrinsic value. Normally, that entails purchasing those equities at 8 to 11 times their normalized sustainable free cash flow."

This strategy has worked well for 3G since it was launched in July 2004, generating solid returns and attracting some high-profile investors, including several professional hockey players such as New Jersey Devils defenseman Bryce Salvador and Toronto Maple Leafs forward Jamal Mayers.

Since inception, the fund has averaged annualized returns of 9.5% and 9.7% over three and five years, respectively, versus the Standard & Poor's 500's loss of 5.4% and gain of 1% over these periods. Although the fund suffered a 23% loss last year, 2009 is shaping up as a winner. Through Sept. 30, it's up 52.3%, versus a 19.3% gain by the S&P.

The fund invests in just 10 to 15 positions, of which five core holdings account for about 60% of the portfolio. The five names are: LSL Property Service (LSL.U.K), Britain's second-biggest real-estate agency; AlarmForce Industries (AF.Canada), a leading Toronto-based provider of residential alarm-monitoring services; Germany's WashTec (WSU.Germany), Europe's largest maker of vehicle-washing equipment; U.S. banking giant Wells Fargo (WFC); and Baldwin & Lyons (BWNA), which provides property-and-casualty insurance products, primarily for the trucking industry.

One of the fund's "best ideas," according to Begun, was LSL, which is also England's biggest property-surveying business. "The company boasts a superior competitive position, operating margins in the high teens, limited capital requirements and a solid balance sheet," he says. "In addition, LSL is run by an excellent management team that owns over a third of the company and is savvy both in terms of operations and capital allocation," he says.

3G started buying LSL shares in late 2007 and early 2008, as the global financial crisis was unfolding. Predictably, the stock tanked, reflecting Britain's deteriorating real-estate market. But the intrinsic value of the business actually increased as the realtor gained significant market share and added earnings streams from its repossession services and property-portfolio-management activities.

Begun and Bailey used the shares' decline to buy more. "As a result," says

Bailey, "we realized substantial gains on the stock when it recovered this year, moving from 64 pence (\$1.06) at the beginning of 2009 to 232 pence in September, versus our cost of 140 pence." Affirms Begun: "It's been a real winner for us."

AlarmForce, Begun says, has a "very substantial advantage" over its competitors because it sells its alarm products directly to consumers rather than via a dealer system. "It gives them the lowest cost structure in the business," he says. "As a result,

they can underprice everybody and still have the best margins in the industry."

The Canadian company's stock is up 25% so far this year and headed higher, Bailey believes. Since 2004, AlarmForce's revenues have grown from 14.4 million Canadian dollars (US\$13.7 billion) to \$34.3 million, a roughly 19% annual growth rate. Sales are expected to grow another 15% this year. As for the stock, Bailey believes the intrinsic value of the underlying business is about \$C11 to \$C12 a share and he expects this value to grow at a mid-teens rate. AlarmForce shares were recently trading at around \$C6.

International Funds on Top

The best-performing hedge funds had a sensational September, with top performer New Russian Generation Limited up 33.33%, according to CASAM CISDM. International funds dominated the winners list.

Best	% Returns					Assets (mil)	Strategy
	Sept.	YTD*	1-Year*	3-Year**	5-Year**		
New Russian Generation Limited	33.3%	108.9%	-64.4%	N/A	N/A	756.4	Sector
Gramercy Distressed Argentina	27.4	229.7	N/A	N/A	N/A	202.5	Single Strat
Firebird Global II	25.6	52.4	12.1	5.8	N/A	127.4	Emerging Markets
BlackRock Emerg Energy Dynamic	23.2	48.8	-28.5	-31.3	3.5	283.7	Sector
Cedar Ridge Investors I	22.9	99.9	60.8	20.9	60.4	41.7	Fixed Income Arbitrage
BTR Strategic Growth	22.7	181.8	N/A	N/A	N/A	60.0	Equity Long/Short
Troika Russia (SUS Monthly)	22.0	165.6	4.5	-48.8	N/A	35.5	Emerging Markets
Prosperity Cub	21.7	167.7	18.2	10.5	236.8	101.6	Emerging Markets
AIS Gold	20.8	130.8	16.8	17.8	163.4	12.4	Sector
Tocqueville Gold Offshore	20.1	128.0	2.4	-38.7	17.3	31.1	Sector
Worst							
Rosemount Global Trade Finance	-9.6	-13.0	-13.0	5.6	N/A	20.9	NA
SC Opportunity	-8.7	-27.6	-28.4	-10.3	N/A	38.6	Equity Long/Short
HAM Short Biased	-8.0	-35.4	-25.1	N/A	N/A	67.5	Short Bias
Arcus Japan (Absolute Institutional)	-7.4	31.5	3.4	-26.0	N/A	81.8	Equity Long Only
Connective Capital II QP	-7.2	-47.8	-33.7	N/A	N/A	18.4	Short Bias
Denholm Hill Russia Arbitrage C Shs	-6.8	-31.7	-34.3	-16.6	N/A	30.1	Single Strat
Crosscourt Partners	-6.3	36.1	6.6	N/A	N/A	29.1	Option Arbitrage
Sibilla Global	-5.7	30.1	33.2	N/A	N/A	22.0	Global Macro
Titan Global Return	-5.7	-13.6	-5.0	45.9	40.2	330.0	Option Arbitrage
Henderson Japan Absolute Rtm (JPY)	-5.3	13.6	20.0	1.2	26.2	186.5	Equity Long/Short
Biggest							
Shepherd Investments Int'l	3.3	7.0	-4.7	-5.3	22.3	3620.0	Multi Strat
Owl Creek Overseas	-0.3	16.4	16.6	55.3	105.1	3324.0	Event Driven Multi Strat
M Kingdon Offshore	3.1	25.4	10.4	20.0	57.6	2263.0	Equity Long/Short
Dexia Index Arbitrage	0.4	2.9	4.3	16.9	24.1	2259.6	Single Strat
Odey European Inc (GBP) A	1.9	48.0	55.6	167.3	191.9	2171.0	Equity Long/Short
Nevisky Limited CI A (USD)	5.1	27.4	20.0	58.6	199.8	2102.7	Equity Long/Short
Wexford Offshore Spectrum CI A	3.9	24.2	15.8	32.0	93.5	1794.1	Global Macro
Pharo Macro	4.3	38.2	31.0	63.8	N/A	1600.0	Global Macro
Elm Ridge Offshore Master	2.0	33.7	26.5	45.6	63.6	1486.8	Equity Long/Short
Bay Resource Partners Offshore	8.6	48.7	29.7	54.8	141.6	1340.0	Equity Long/Short
Waterstone Mkt Neutral Master	0.4	43.7	51.3	72.3	82.0	1221.8	Convertible Arbitrage
Libra	7.8	26.1	16.6	73.7	204.0	1192.2	Equity Long/Short
MKP Credit	1.8	15.9	19.4	46.6	73.1	1182.0	Fixed Income
Long-Term Investment (SIA) Clic CHF	6.7	63.3	-13.3	-26.0	32.5	1103.9	Equity Long Only
UK Emerging Companies Hedge	2.0	5.7	6.3	54.7	112.7	1052.0	Single Strat
Highline Capital Int'l CI A	-0.4	3.5	-2.0	22.8	51.3	1005.0	Equity Long/Short
Ascend Partners II	1.8	12.3	12.2	33.4	66.7	957.7	Equity Long/Short
Balestra Capital Partners	-1.3	2.9	21.1	333.1	434.2	875.0	Global Macro
Prologue Master	0.3	11.3	24.2	N/A	N/A	810.0	Fixed Income
Lazard Emerging Income CI A2	1.6	7.2	-0.5	18.6	38.9	782.6	Emerging Markets

Ranked by September returns. *As of 9/30. **Cumulative. Source: CASAM CISDM Database

The financial and economic crisis of the past two years has provided other opportunities to pick up high-quality, well-managed businesses selling at significant discounts. Among them is **Portec Rail Products** (PRPX), a century-old, Pittsburgh-based manufacturer of railroad products and supplies. The company enjoys a leading position in most of its product lines, which include rail joints and lubricants and spikes.

"The company generates 30%-plus returns on tangible book values," Begun explains. "The stock was selling at a dirt-cheap valuation of approximately six times forward free cash flow. We bought it at less than \$6.50, and sold it a year later for about \$10, realizing a gain of over 50%," he adds. "Even though we have closed our position, the company has substantial long-term growth potential from the highly fragmented nature of the rail-products industry."

"We closed our position because we had a chance to invest in a more compelling idea," says Begun. That opportunity was WashTec, the German maker of big vehicle-washing systems for trucks and cars.

"WashTec was available at a highly attractive valuation of less than 6 times normalized earnings," he says, adding: "While the stock has not done much since our purchase [up about 10%], we expect to do well in the next three to five years, given how deeply discounted the business currently is."

Other 3G holdings include two South Korean outfits, **AmorePacific Preferred** (090435.Korea), a provider of skin-care and cosmetics products, and **Binggrae** (005180.Korea), a maker of dairy products, as well as U.S. packaged-foods maker **Sara Lee** (SLE).

Despite the continued turmoil sweeping the global economy and stock markets, Begun is upbeat about the future.

"Five years from now," he says, "the recent financial crisis will seem like a distant memory for most people. But for me, it will be remembered as a time of opportunity and a chance to realize my personal dream." ■