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ValueInvestor INSIGHT

The Leading Authority on Value Investing

Nooks and Crannies

As a teenager in his native country of Belarus, Pavel Begun always had a business or two going, from selling strawberries, to distributing steel rebar, to publishing an accounting trade journal. None of those, however, had the makings of a career: "I lose interest unless I'm able to learn something new every day," he says.

After coming to the U.S. for college and later earning a University of Chicago MBA, Begun in 2003 concluded investing was his true calling. His 3G Capital, launched the next year, has since then earned a net annualized 11.8%, vs. 8.3% for the S&P 500. Today he and partner Cory Bailey see far-off-the-beaten-track opportunities in such diverse areas as banking, energy and underwear.

3G Capital
Pavel Begun, Cory Bailey

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Investor Insight: 3G Capital

Pavel Begun and Cory Bailey of 3G Capital describe why they have broadened their investing universe, why they don't equate "difficult" with "risky" in investing in non-Western markets, why they typically own fewer than 10 stocks at a time, and why they see mispriced value in Turkey's Halkbank, Estonia's Silvano Fashion and Tatarstan's Tatneft.

While your field of play as an investor has changed quite a bit over the years, what you're fundamentally looking for hasn't. Describe the types of companies that attract your interest.

Pavel Begun: We're looking for businesses that generally fit the following criteria: They occupy leading positions in their respective industries and those industries have long track records of leadership sustainability. They generate returns on invested capital in excess of 15%, can pay off their debt with cash flow in less than three years, and are run by management teams that are both skillful operators and intelligent capital allocators. Last but not least, their stocks are available at single-digit – the lower, the better – multiples of normalized free cash flow.

We have changed our field of play. We initially only invested in the U.S., but over time we concluded that to reliably find unusual bargains in high-quality companies we needed to broaden our investing universe. While there's no shortage of intellect in the investment profession, most managers by inclination or mandate don't even look at the nooks and crannies of global markets – which is where we think the most-attractive bargains are.

Aren't those nooks and crannies also prone to greater risks?

PB: We frequently hear that underwriting the quality of businesses in non-Western markets is difficult, making such investments risky. We don't disagree with the notion that research in these markets is hard. It can take considerable effort to get at all the relevant information you need to understand a company, its business and the political and cultural context in which it operates.

Equating "difficult" with "risky," however, is inaccurate. As a result of that difficulty, far fewer intelligent value-oriented investors who like to apply a rigorous research process invest in many of the markets we do. This in our experience gives rise to a higher likelihood of market inefficiency, which on occasion allows us to purchase assets with much higher margins of safety than we can find in the domestic market.

That's not to say that businesses located in non-Western markets aren't subject to a broader array of risks – the legal protections may be weaker, the political climate may be precarious, and the economic environment may be more volatile. While that may make the intrinsic value of the non-Western business lower than it would be if it operated in a Western market, what we care about is the discount to the conservatively estimated intrinsic value that we have to pay. Buying a "safe" asset at a price in excess of intrinsic value carries much higher risk than purchasing a "risky" asset at a price well below intrinsic value.

ON GOING FAR AFIELD:

It's not ideological, but for some time we haven't found enough in Western markets that is price appropriately.

What's the Western/non-Western mix of your portfolio today?

Cory Bailey: Defining "Western" as the U.S., Canada and Western Europe, less than 10% of our assets are in Western-market companies. There's nothing ideological about that, though. We could have all of our assets in Western companies. But for some time we just haven't found enough in those markets that is priced appropriately for us.

How do you source ideas?

PB: Very often we'll identify an industry that's out of favor across geographic markets, or a specific country that's going through a difficult time, and dive in to assess what's going on with the market leaders and see if any opportunities surface.

In 2015, for example, when Brazil's economy and political situation started to unravel, we looked at a broad range of ideas but zeroed in on banks, which we believe we understand and whose competitive advantages have historically proven long-lived. We ended up buying – and still own – Banrisul S.A. [Bovespa: BRSR6], the largest bank in the Brazilian state of Rio Grande Do Sul. It has the premier competitive position in its region, resulting in net interest margins that are more than double peer levels and returns on equity and on assets that are roughly triple what competitors earn. Because of all the upheaval in Brazil, however, we were able to buy the stock at 2x our estimate of normalized EPS, 35% of book value and with a 14% dividend yield.

We did something similar more recently in Turkey, after the failed coup attempt in 2016. We actually went through a list of all the public equities in the country and ended up identifying two candidates for investment, one of which, Halkbank [Istanbul: HALKB], we ended up buying. It is one of the best performers of the "Big Seven" banks in Turkey, but at the time we were able to buy it at just over 50% of book value and less than 4x current-year earnings.

Another way we identify potential ideas is by applying what we've learned elsewhere to new markets. The mass-market underwear industry, for example, is a surprisingly attractive business, characterized by products that change little year-to-year and strong consumer brand loyalty, resulting in market leaders tending to stay on top for decades. Many years ago I was visiting my family in Belarus and noticed a particular underwear brand that seemed pervasive, which I found out was made by a company based in Tallinn, Estonia called Silvano Fashion Group [Tallinn: SFG1T], the dominant market leader in places like Belarus, Russia, Ukraine and the Baltics. As we got to know the company better we became very interested in the stock, but at the time and for years after it always seemed too expensive. But in 2014, with all the turmoil in Eastern Europe, we finally got our chance. It's still one of our core holdings.

You've written that as you've broadened your investment universe the look-through free-cash-flow multiple on your portfolio has declined. What is it today?

CB: Our portfolio today trades at approximately 5.5x forward free cash flow, with a corresponding dividend yield of over 5.5%. On normalized numbers, the multiple would be even lower. We haven't paid more than 7x free cash flow for anything for three or four years now.

I would stress that low absolute valuations are central to our investment philosophy. We're not trying to find the next Google or Microsoft, but more to cover our downside by buying with a large margin of safety and then by owning good-quality businesses to have the upside take care of itself over time.

You generally own fewer than 10 stocks at a time. Why so concentrated?

CB: Usually around two-thirds of the portfolio is invested in five names. Given how selective we are, it would be fairly difficult for us to find a much larger number of good ideas for the portfolio. Of course, I don't want to own one stock either. We will make mistakes, but if our batting average stays high, a mistake from time to time in a portfolio with six to eight names should be manageable.

Walk through your more detailed case for Turkey's Halkbank, formally known as Turkiye Halk Bankasi.

PB: The bank was founded in 1938 to serve the needs of tradesmen and artisans, and over time has become the leading bank in the Turkish market in serving small and medium-sized enterprises [SME]. The banking market overall is a tightly regulated oligopoly – the "Big Seven" control approximately 75% of total deposits – and the balance of competitive power is such that all seven banks have solid competitive positions and operating metrics.

Halkbank's position in the SME space gives it a stable, low-cost deposit base, which it over time has complemented with conservative underwriting practices in order to generate low-risk growth. More than one-third of its SME loans are guaranteed by the state pursuant to an exclusive agreement with the government, for example, and more than half of its consumer loans outside of mortgages are structured on a payroll-deduction basis or are made to retirees, with their payments deducted directly from government pension checks.

All that has resulted in above-average profitability. The company's average return on assets over the past five years is 1.9% and its average return on equity is 18%, compared to an ROA of 1.7% and an ROE of 15% for the Big Seven overall. Second-tier competitors are even further behind.

INVESTMENT SNAPSHOT

Turkiye Halk Bankasi
(Istanbul: HALKB)

Business: One of Turkey's "Big Seven" banks, offering a range of commercial and consumer financial services, with a focus on serving small and medium-sized enterprises.

Share Information
(@9/28/17, Exchange Rate: $1 = TRY 3.56):

Price	TRY 12.36
52-Week Range	TRY 8.49 – TRY 15.37
Dividend Yield	1.7%
Market Cap	TRY 15.45 billion

Financials (TTM):

Revenue	TRY 9.70 billion
Operating Profit Margin	47.0%
Net Profit Margin	35.6%

Valuation Metrics
(@9/28/17):

	HALKB	S&P 500
P/E (TTM)	4.0	24.2
Forward P/E (Est.)	3.7	19.1

HALKB PRICE HISTORY

THE BOTTOM LINE

Political turmoil in Turkey has overshadowed the relative stability of the country's banking industry as well as the company's long track record of excellent growth and profitability, says Cory Bailey. At today's share price the stock trades at only 60% of tangible book value, vs. historical levels of 1.4x to 1.8x, and at just 3.1x his estimate of normalized EPS.

Sources: Capital IQ, company reports, other publicly available information

Unlike some of its large competitors, the government is the controlling shareholder of Halkbank. How do you assess the risk of that?

PB: In such cases there is always risk that a government might force a bank to finance uneconomic public projects to the detriment of minority shareholders. In this case, however, we believe the risk of large-scale meddling is fairly low. First, the government recognizes that its hold on power is dependent on having a sound financial system, which could be undermined if it involved leading banks in large-scale uneconomic activities. Second, the government plans to eventually privatize Halkbank and knows that a clean operating history would be necessary to get top dollar in any sale. Finally, while it's not unusual in emerging markets for standoffs between private-sector interests and governments to end badly for minority shareholders in the private enterprise, Halkbank's state ownership makes it relatively immune to that risk.

Is there a growth story here?

CB: The company over time has benefitted from increasing penetration of banking services across the Turkish market, driving 10% compound growth in its book value – even stated in U.S. dollars – over the past ten years. Going forward we expect it to benefit from continued increased penetration of banking services – penetration levels are still only 50% of those in developed markets – and from its leadership in rolling out new products and services. Halkbank's fee stream from complementary banking services such as payment processing, treasury-management services and credit cards is growing 15% per year, double industry averages. It also has plenty of capital to support growth: its capital-adequacy ratio is around 14%, vs. the global regulatory minimum requirement of 10.5%.

How are you looking at valuation with the shares trading at a recent 12.40 Turkish lira?

CB: The stock currently trades at roughly 60% of tangible book value, 3.7x 2018 earnings estimates of 3.35 Turkish lira per share, and only 3.1x our normalized EPS estimate of about 4.00 Turkish lira.

Just looking at book value, the valuation today compares with historical multiples for Halkbank of between 1.4x and 1.8x, and for the Big Seven overall of around 1.2x. Emerging-market peers sell at closer to 2x, and in recent buyouts in Turkey even second-tier banks have gone for 1.2-1.3x book value. No matter how we look at it, the valuation disparity is extremely large for Halkbank and we don't think it is at all justified.

How do you typically address currency risk, which would appear to be a relevant concern here?

PB: In general, we don't hedge using forward or futures markets, which we find too expensive and very difficult to effectively execute. What we do is make sure that in any business we buy there is an implicit currency hedge within the business. That means we want businesses where the top line is dollar-denominated, or where it's easy for the company to pass on to customers the negative impacts of the currency depreciation. Unless we see one of those two components, we generally do not invest.

In the case of Halkbank, as a U.S.-dollar investor we expect minimal impact over the long-term if the Turkish lira depreciates. Since the Turkish economy is highly dollarized, any local-currency depreciation tends to eventually be reflected in higher inflation, which lifts banking assets to pre-depreciation, dollar-equivalent levels while also widening net interest margins. We think that gives us natural protection against any devaluation in the local currency.

You've done well so far investing in underwear-maker Silvano Fashion. Why are you still optimistic about its prospects?

PB: This is a small company, founded in 1908 by a French entrepreneur whose first factory initially produced hair combs. Underwear and lingerie has been Silvano's main business since the 1960s and it is now the largest mass-market underwear concern in Eastern Europe, with more than 700 company-branded stores and strong brands, primarily Milavitsa and Lauma, in places like Belarus, Russia, Ukraine and the Baltics. The next-biggest rival has less than half its market share.

The brands and the distribution network create high barriers to competitive entry and have allowed the company to produce enviable returns on equity, ranging from 20% to 25% despite a substantial cash position. It generates excellent free cash flow that it has mostly returned to shareholders but, we think, should be increasingly put toward high-ROI expansion opportunities. The underwear market in Eastern Europe remains highly fragmented and there's a long runway of opportunity for Silvano to increase its market share. In its latest earnings report, management said it stepped up store openings in the latest quarter, which we take as an early, but positive, sign.

We also like that management owns roughly 40% of the equity and behaves in a shareholder-friendly manner. The Chairman, Toomas Tool, owns more than 20% of the shares and was with us buying when the stock price fell so sharply in 2014.

How do you handicap the geopolitical and currency risks here?

PB: We'd argue that the heightened geopolitical tension is a benefit to Silvano. This is the local brand in most of its markets, and such brands have gotten a boost both as consumers increasingly buy local and as Western brands pull back.

With respect to the currency, the economics of Silvano's business protect it from the negative impacts of local-currency depreciation. Underwear pricing in its markets tends to remain consistent over time in hard-currency terms, while the bulk of the company's costs are in local Eastern-European currencies. With that dynamic, local-currency depreciation positively impacts the company's margins.

INVESTMENT SNAPSHOT

Silvano Fashion
(Tallinn: SFG1T)

Business: Based in Estonia, leading Eastern-European manufacturer of mass-market underwear, selling through company-branded stores as well as independent retailers.

Share Information
(@9/28/17, Exchange Rate: $1 = €0.85):

Price	**€2.62**
52-Week Range	€2.12 – €3.12
Dividend Yield	7.6%
Market Cap	€97.3 million

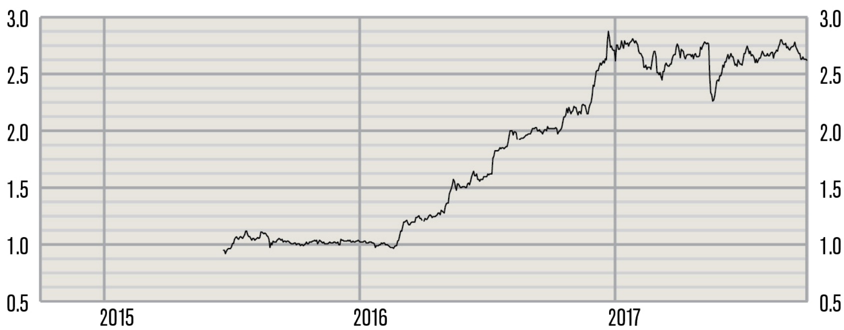
Financials (TTM):

Revenue	€60.1 million
Operating Profit Margin	22.1%
Net Profit Margin	12.8%

Valuation Metrics
(@9/28/17):

	SFG1T	S&P 500
P/E (TTM)	9.4	24.2
Forward P/E (Est.)	8.2	19.1

SFG1T PRICE HISTORY



THE BOTTOM LINE

Pavel Begun believes the market-leading Eastern European company has significant potential to increase share in a mass-market-underwear industry in which leaders over time tend to remain leaders. For that, at today's share price, he has to pay only 5x his normalized EPS estimate, which assumes only modest improvement in the regional economy.

Sources: Capital IQ, company reports, other publicly available information

How cheap do you consider the shares at today's price of €2.60?

CB: The company has roughly 25% of its current market cap in net cash, so the net share price today is actually closer to €2. Against that, estimates of 2018 EPS are around 32 Euro cents and we believe the normalized level of earnings – assuming modest improvement in the regional economies – is around 40 Euro cents.

So for only 5x normal earnings we can own a market leader, with significant potential to increase market share in a business where leaders over time tend to remain leaders. The company historically has traded at 11-15x earnings, while similar companies around the world would trade at 15-20x. That's a significant enough disparity that without putting too fine a point on it you could imagine the shares being worth substantially more than where they currently trade.

In the meantime, there's a 9% dividend yield on the expected payout next year which, given the level of cash flow and the large net-cash position, is likely to be pretty safe.

Tatneft [TATNP], based in Tatarstan, would not seem to fit your typical profile for an investment. Is this a high-quality business?

CB: Tatneft is a regional integrated oil-and-gas company that in addition to having an on-shore, relatively low-cost reserve base also owns and operates extensive transportation, distribution, refining and chemicals assets. The company has proven skilled at squeezing more barrels from mature oil fields by applying advanced technologies. It benefits from an industry-friendly taxation system, in which decreases in energy prices are to a meaningful extent offset by lower taxes and duties. It also has tended to benefit from a favorable currency dynamic, with revenues denominated in dollars and expenses incurred in rubles. All that has allowed it to generate resilient 16-18% returns on equity, despite a large cash position, pretty much through thick and thin.

How do you think about corporate governance, including the fact that the Republic of Tatarstan, a subject of the Russian Federation, owns a controlling position in the company?

CB: Tatneft's management has behaved over time in a shareholder-friendly way, strengthening the business by expanding downstream, producing excellent returns on equity and generously sharing the spoils with shareholders. The company last year paid out 50% of profits as dividends and the dividend yield on the expected payout for next year is currently around 11%. So while there's a perception in Russia that minority shareholders often get taken advantage of, that has so far not at all been the case here.

What oil-price assumptions are you incorporating into your analysis?

PB: We estimate that the company's 2018 per-share earnings will come in around $1.10, or about 64 rubles. That assumes oil prices stay roughly at today's levels, and we use that 64-ruble EPS as our normalized earnings estimate as well. In general, however, we try to make sure any investment case like this can work under a wide range of commodity-price scenarios.

So the shares at a recent 290 rubles look fairly inexpensive.

INVESTMENT SNAPSHOT

Tatneft
(Moscow: TATNP)

Business: Exploration and development of oil and gas, and operation of varied transportation, distribution, refining and chemicals assets; based in the Republic of Tatarstan.

Share Information
(@9/28/17, Exchange Rate: $1 = RUB 57.92):

Price	**RUB 290.50**
52-Week Range	RUB 179.20 – RUB 303.50
Dividend Yield	7.9%
Market Cap	RUB 938.38 billion

Financials (TTM):

Revenue	RUB 631.00 billion
Operating Profit Margin	22.2%
Net Profit Margin	19.1%

Valuation Metrics
(@9/28/17):

	TATNP	S&P 500
P/E (TTM)	5.3	24.2
Forward P/E (Est.)	4.5	19.1

TATNP PRICE HISTORY

THE BOTTOM LINE

The company has generated "remarkably resilient" returns on equity through thick and thin, says Cory Bailey, a function of its low-cost reserve base, diversified downstream operations, friendly tax regime and adept, shareholder-friendly management. The stock at today's price, net of balance-sheet cash, trades at less than 4x his 2018 EPS estimate.

Sources: Capital IQ, company reports, other publicly available information

PB: Ignoring the net cash on the balance sheet, the stock trades for 4.5x 2018 estimated EPS. Back out net cash and the P/E is less than 4x. You can also look at what you're paying per barrel of Tatneft's proved reserves in the ground, which today is less than $2 per barrel. To put that in perspective, the company at $50 oil earns about $8 in *net profit* per barrel. At the same time, the stocks of emerging-market peers, with similar or inferior profitability profiles, trade between $9 and $17 per barrel of proved reserves.

If oil prices go back to their lows of 2015, we estimate earnings would take a 25% hit, say to around 48 rubles per share. At that level the multiple today is 6x – 5x excluding net cash – for a company that earns 15%-plus on equity and can sustain a dividend yield of 9-10%. If that's what my downside looks like, I'll take it.

We see that you allow your investors to withdraw money only once every two years, on December 31st. Has that been a tough sell?

PB: One of my favorite quotes about investing is from David Swensen, the Chief Investment Officer of Yale's endowment, who says that, "Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom."

If we're going to maintain an unconventional long-term investment profile – which I think is necessary to outperform – we can't do it with short-term money. It's not going to work and will be stressful for everybody. Our structure isn't for everyone, but it's been a great filter that has allowed us to build an investor base in line with what we're doing. I'd much rather run fewer assets this way than more assets with a shorter-term bias. VII

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