ValueInvestor INSIGHT

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Far Afield

Pavel Begun and Cory Bailey of 3G Capital Management describe how "doom and gloom" translates into investment opportunity, how they research far-afield companies, how they manage risks investing in ostensibly dicey markets, and what they think the market is missing in Excellence Commercial Property, Victoria's Secret and LSL Property Services.

INVESTOR INSIGHT

3G Capital Management
Pavel Begun (*l*), Cory Bailey (*r*)

More so than most investors who say they "go anywhere," Pavel Begun means it. When we last spoke with him [VII, September 29, 2017], the companies discussed included those in Turkey, Estonia and Tartarstan. "Markets in turmoil can create exceptional bargains," he says. "We're very selective about the businesses we'll own, but we never say never based on geography."

Since adopting a mostly non-U.S. approach in 2009, Begun's 3G Capital Partners Fund has earned a net annualized 11.3%, vs. 5.7% for the MSCI All-Country World Index (ex-U.S.). Finding many turmoil-induced bargains today, he and partner Cory Bailey see mispriced value in such sectors as property management, mortgage services and intimate apparel.

You describe your strategy as looking far and wide for exceptional bargains. What makes a bargain exceptional to you?

Pavel Begun: It's really the interplay between business quality and price that makes for exceptional bargains. We're generally looking for industry leaders in easy-to-understand sectors where there's an established track record of leadership sustainability. They still have room to grow – our market-cap range is typically $5 billion and below – and have returns on invested capital of at least 15% over the cycle. And they have rock-solid balance sheets: currently three-quarters of our non-financial holdings have net cash, and those that do have some debt could pay it all off with free cash flow in less than five years.

To really make something an exceptional bargain often requires some sort of turmoil in its home market or in its sector. I wish that weren't necessarily the case – that you could find great bargains in markets where everything looks rosy – but that's just not the way the world works. I would emphasize, however, that even though we're chasing turmoil, we're not chasing risk. That's where the quality of the business comes in. If we're right about that, we're looking for large upside available due to indiscriminate selling, but where the company's leadership position insulates it to a significant degree on the downside. We don't find such opportunities often, but with only 10 to 12 stocks in the portfolio at a time, we don't need it to happen that often.

In a world with plenty of turmoil, where are you spending time today prospecting?

PB: Valuations today – for broadly understandable reasons – reflect particular doom and gloom in places like China, Eastern Europe and the U.K. We're not saying the general negativity is unwarranted, but we resist painting entire regions with a broad brush and labeling them uninvestable. You can find businesses that may not be impacted much at all by the political or macroeconomic issues in the market and whose risk profiles haven't really increased, but the stocks are priced as if they might go out of business tomorrow. That's the type of thing we gravitate toward.

I'll give a few examples. While there are many well-known pressures in Chinese real estate, a company like Excellence Commercial Property & Facilities [Hong Kong: 6989] as a leading commercial-property manager isn't likely to be greatly impacted by overall industry difficulties. In the U.K. there's been economic and political turmoil for years, but a company like LSL Property Services [London: LSL] has a distribution platform connecting lenders and mortgage brokers that can drive growth and profitability even through a rough patch in U.K. residential real estate. Another of our holdings, Kaspi [London: KSPI], is well on its way in Kazakhstan to having an e-commerce profile in the market not unlike Alibaba's in China or Amazon's in the U.S. The geopolitical environment in Eastern Europe is terrible, but we'd argue Kaspi's business prospects haven't really been impacted that much.

We'll come back later to Excellence and LSL, but talk more about Kaspi and what you think the market is missing in it.

PB: Kaspi is a somewhat unusual investment for us in terms of the business, but not in terms of why we believe it's attractive right now. The shares trade in London, but it's the largest digital-platform business in Kazakhstan, with properties encompassing marketplace, payments, fintech and travel. These types of digital ecosystems are sometimes referred to as "super-apps," signifying their role as hubs through which consumers engage in a variety of commercial transactions. Unlike most of our companies that operate within a well-defined niche, Kaspi has an excellent track record in continuing to expand its breadth of products and services. Over the past 10 years it has increased revenues and profits – in US$ – by over 35% per year, with minimal capex. Returns on equity are over 75%. The potential for growth remains very high, as the company currently accounts for just 1% of online consumer spending in Kazakhstan, versus 25% for Alibaba in China and around 10% for Amazon in the U.S.

Of course, there are significant risks. Kazakhstan is actually in Central Asia and is increasingly aligned with China, but it is a former Soviet republic and maintains material economic and military ties with Russia. There's risk from the long-term depreciation of the local currency, the tenge. There's also risk of meddling by the state, although for the most part the Kazakhstani government has treated businesses in the country in a reasonable manner.

Which brings us to valuation, where even with all the risks we believe we're investing with a large margin of safety. The stock today sells for 7x estimated forward EPS and has a 9% expected dividend yield. This compares to international peers that even in the current market sell for 30x earnings and pay no dividends. And that's for a company that despite any near-term macro or geopolitical headwinds, we believe through increased market penetration in its home market and expansion in adjacent geographies can still grow its revenues and profits over time by at least 20% per year. For us, the risk/reward here still makes a great deal of sense.

How do you cover many of the markets you're in from a research perspective?

Cory Bailey: We've been at this for quite a while and work very hard to constantly build out our extensive network of on-the-ground contacts in Asia, North and South America, Eastern and Western Europe, the Middle East and Russia. This network consists of customers, distributors, suppliers, competitors and other industry insiders related to various businesses in which we're interested.

We get to know management in our target companies, obviously through careful study of their track records, but also often through personal contact and vetting with our local network. We also as global managers should be better able than local investors to apply insight and experience from other markets. Our knowledge of the banking business in the U.S. and Canada, for example, should help us understand the strengths and weaknesses of banking franchises in places like Brazil and Turkey.

ON VALUATIONS:

The valuation levels we're seeing today are as attractive as they've been in the 18 years since we started out.

How do you manage currency exposure?

CB: We generally put foreign businesses into two buckets with respect to currency exposure. The first includes companies whose business models have somewhat of an implied hedge against local-currency depreciation. An example would be an exporter, whose costs may be in the local currency but it earns most of its revenues in hard currency. Or it could be a service company that can easily pass on inflationary cost pressures and keep ahead from a revenue and profit standpoint of the impacts of a weakening local currency.

The second bucket would be companies that don't have the same level of pricing power or who don't have an implied hedge from exporting. Here we can use future or forward contracts to hedge exposure, but hedging costs are often quite high and offset too much of the expected return. In this bucket we typically forgo hedging and simply demand such a high discount to value that we believe we're covered even in the event the local currency depreciates.

All in all, we would prefer to invest in businesses from the first bucket, as they provide more predictable protection. Here, of course, we're talking about protecting the long-term business value, not against short-term volatility in the stock price.

How attractive in general would you characterize your opportunity set today?

PB: The valuation levels we're seeing today are as attractive as they've ever been in the 18 years since we started the firm. On a look-through basis our portfolio trades at 4x forward earnings and with an 8% dividend yield. That's against corresponding figures for our MSCI ACWI ex-USA benchmark of 13x earnings and a 3% dividend yield.

Part of that is just the negative macroeconomic environment, characterized by rising inflation and increased interest rates. But part of it also is how pessimistic investors are, and have been, about emerging markets. If you look at a chart of the MSCI Emerging Markets Index over the MSCI World Index, you'll see in the past 30 years long periods where emerging markets outperform followed by long periods where they underperform. I know it's difficult to call tops and bottoms, but an argument can be credibly made that we're close to the bottom and to extreme levels of pessimism when it comes to investing in emerging markets. That's contributing to the exceptional bargains we're seeing out there.

Describe in more detail your investment case for China's Excellence Commercial Property & Facilities.

PB: This is the second-largest high-end commercial property management company in China, with a focus on what's known as the Greater Bay Area, which includes the mainland's Guangdong Province as well as Hong Kong and Macao. Commercial properties account for 90% or so of operating income, with the rest coming mostly from owners of residential, industrial and public properties.

Concerns about the Chinese economy and the real estate sector in particular are top of mind for investors today, but we think the market is applying too broad a brush to Excellence. With a real estate developer you get a cyclical business that's capital intensive and usually highly levered. With property managers it's the opposite. Once the building stock is in place, it has to be managed and that need doesn't go away if construction activity falls off or if vacancy rates go up somewhat. The operation and servicing of a building is down the list of where a property owner looks to cut if times got tough. The company's business is actually quite stable, asset-light and generates a lot of cash.

Even if the broader market slows, we think Excellence has significant growth potential. They're #2 in their market, but only have maybe a 5% share. There are a number of second- and third-tier competitors without the reputation and expertise the company has, and we expect over time for the bigger players like Excellence to consolidate the market much further at the expense of those weaker players.

How would you assess the corporate governance here?

PB: That's clearly an important issue in China, and much of our on-the-ground research in companies like this focuses on building confidence that management and the board are fully aligned with shareholders. Here we believe they are. One key indicator is that the company pays out 70% of its free cash flow in dividends. If you study the history of fraud, companies giving money back to shareholders like that tend not to be the ones to worry about. We also like that two of the cornerstone investors at the company's IPO in October 2020 were Tencent and JD.com, very large and well-regarded Chinese companies that we believe fully share our interests.

The company went public at HK$10 and the stock currently trades at HK$2.20? How cheap do you think it is at that level?

PB: This is where it gets really interesting. Right now the stock sells for 4x consensus next-12-months' earnings, with a dividend yield on the expected payout over the next year of over 25%. But that valuation is even overstated. The current market cap of HK$2.7 billion is actually less than the net cash on the balance sheet, which as of the end of June was HK$3.6 billion.

That type of valuation may not make sense at any point, but we think that's especially the case for a business of this quality and resilience. Even with all the cash, the company is earning 20%-plus returns on equity. We think the dividend payout is safe. We understand that there are plenty of risks investing in China today, but in

INVESTMENT SNAPSHOT

Excellence Commercial Property
(Hong Kong: 6989)

Business: Provider of property-management and other related services to owners and developers of commercial office buildings and residential apartments primarily in mainland China.

Share Information
(@10/28/22, Exchange Rate: $1 = HK$7.85):

Price	**HK$2.22**
52-Week Range	HK$2.19 – HK$5.99
Dividend Yield	11.5%
Market Cap	HK$2.71 billion

Financials (TTM):

Revenue	HK$3.68 billion
Operating Profit Margin	21.2%
Net Profit Margin	15.0%

Valuation Metrics
(@10/28/22):

	6989	S&P 500
P/E (TTM)	4.9	18.7
Forward P/E (Est.)	4.1	17.0

Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
China Southern Asset Mgmt	1.1%
UBS Asset Mgmt	1.0%
BlackRock	0.5%
BNY Mellon Asset Mgmt	0.4%
TIAA-CREF	0.1%

Short Interest (as of 10/15/22):

Shares Short/Float	n/a

6989 PRICE HISTORY

THE BOTTOM LINE

Market concerns about Chinese real estate are overstated in the company's case and underestimate its resiliency, asset-light model and continued runway for growth, says Pavel Begun. At 4x estimated forward earnings and an expected 25% dividend yield, "we're being more than compensated" to take market-related risks in the stock, he says.

Sources: Company reports, other publicly available information

this case we believe we're being more than compensated to take those risks.

It's not often that we speak with you about a U.S. idea. What drew your interest in Victoria's Secret [VSCO]?

CB: We for a long time have followed the global intimate-apparel industry, which we find quite attractive because the market leaders tend to stay that way. They sell essential products and consumers aren't quick to change once they find a brand they like. That leads to a stable replacement cycle, pretty good pricing power and fairly entrenched market positions. That matches up well with our definition of a good business, which we're then on the lookout to buy at a discount.

Victoria's Secret was spun off as an independent company from L Brands in August of 2021, and we took a position in it in June of this year. After a long run of success, the business ran into trouble starting five or so years ago as the brand proposition got fairly significantly out of line with what customers were wanting. That was largely back on track by the time of the IPO, but the company through the spinoff got little attention from the investor community, and what it did get was largely wait-and-see. Since then we've also seen stock-price markdowns in a number of consumer-facing businesses, as concerns of an economic slowdown have been exacerbated by supply-chain and input-cost issues that hurt operating results.

We're much more focused on the fact that Victoria's Secret is the largest women's intimate-apparel brand in the U.S. – exceeding the share of its closest competitor by 3x – and we think it has a number of competitive advantages with respect to brand awareness, customer loyalty, distribution and product-line breadth. As the business normalizes post-pandemic, we expect the company to get back to the 15% operating margins it enjoyed prior to the marketing and other issues of the past few years. If that happens, they'll be generating close to $1 billion in operating income, against a current market cap of just over $3.1 billon.

What upside do you see in the shares from today's price of around $38.50?

CB: The stock on consensus next-12-months' estimates trades at 7.4x earnings. That assumes an operating margin of 9%, impacted by items we believe are one-time in nature related to supply-chain and other temporal issues. We think normalized EPS is closer to $7.50 per share, on which the multiple falls to only 5.1x. Global peers typically trade for at least 15x earnings, so we consider this exceedingly cheap.

The gap we see between the business fundamentals and the valuation on the stock hasn't been lost on the company's management. They've bought back $450 million worth of shares in the past year, which is roughly 15% of the total. We think there's a lot of value created in buying back stock at these kinds of prices.

You've owned LSL Property Services multiple times over the past 15 years. Why are you high on the risk/reward the stock offers today?

PB: The company has historically been centered around two legacy businesses,

INVESTMENT SNAPSHOT

Victoria's Secret
(NYSE: VSCO)

Business: World's largest specialty retailer of "intimates," including bras, panties, lingerie and casual sleepwear; spun off from L Brands as an independent public company in 2021.

Share Information (@10/28/22):

Price	**38.58**
52-Week Range	26.14 – 65.20
Dividend Yield	0.0%
Market Cap	$3.13 billion

Financials (TTM):

Revenue	$6.62 billion
Operating Profit Margin	10.0%
Net Profit Margin	7.1%

Valuation Metrics
(@10/28/22):

	VSCO	S&P 500
P/E (TTM)	6.7	18.7
Forward P/E (Est.)	7.4	17.0

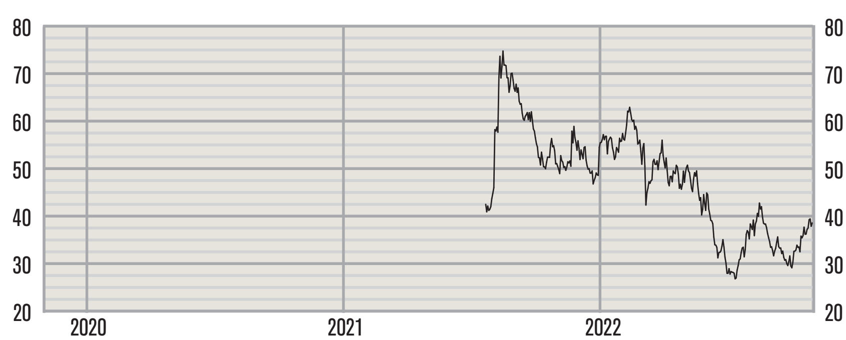
Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	12.0%
Vanguard Group	9.2%
BlackRock	7.5%
Wellington Mgmt	4.8%
Sound Shore Mgmt	3.4%

Short Interest (as of 10/15/22):

Shares Short/Float	9.3%

VSCO PRICE HISTORY



THE BOTTOM LINE

The company was spun off in August of last year and investors have been slow to recognize the benefits of its market leadership and the successful recasting of its marketing approach, says Pavel Begun. The shares today trade at just over 5x his estimate of normalized earnings, "exceedingly cheap" relative to global peers at closer to 15x, he says.

Sources: Company reports, other publicly available information

focused on real estate brokerage and surveying/property appraisal. Both of these businesses have reasonable profitability and satisfactory growth potential, but the story on the company today revolves primarily around Primis, its #1 technology platform connecting mortgage brokers – they're called mortgage advisers in the U.K. – and mortgage lenders. It varies by year, but Primis now accounts for roughly 40% of total operating profit and that's likely to be over 50% starting next year. That's a good thing, given that it's growing faster and is more profitable than the legacy businesses.

As with most platform businesses, there are benefits to being big, particularly around the breadth of product and service options and the number of users seeking out those options. LSL's network makes available to mortgage advisers a variety of mortgage and related products in one place. Primis also provides the advisers with technology infrastructure that helps them with administration, compliance and business development. For all that, Primis keeps a small portion of the referral fee paid by the lender on generated loans and, in some cases, charges the adviser a subscription fee. The fees are generally perceived to be low relative to the value advisers get from using the platform.

The combination of an attractive value proposition and a still-underpenetrated market – Primis has less than 10% market share – means the company has been able to increase its network members rapidly. Primis' revenues have grown 18% annually over the past five years and, because it benefits from significant operating leverage, last year it earned an operating margin of 22%. We think that could be 35-40% within five years.

How big a concern is the current bleak economic environment in the U.K.?

PB: It is a near-term concern, but the mortgage business is somewhat less cyclical in the U.K. because loan terms are much shorter than in the U.S., providing a more steady stream of refinancings that are independent of the market cycle. Also, we expect the company's ability to take share in the market to offset to a significant degree any short-term industry cyclicality.

How are you looking at valuation from today's share price of around £2.30?

PB: The next-12-months' consensus earnings estimates are at about 40 pence per share, so even ignoring the net cash on the balance sheet the P/E is less than 7x. The latest dividend translates into a yield at the current price of 4.9%.

The stock has historically traded at closer to 15x earnings, which we'd argue is even low for a company with 14%-and-improving operating margins and whose most-profitable business should be able to grow at a mid-teens rate for many years to come. A 15x multiple even on current earnings would provide significant upside, but remember that that multiple when it hopefully arrives will likely be on much higher earnings.

One other thing I'd mention as an option on the upside is that the company has a nearly 50% stake in a joint venture led by its former CEO, Simon Embley, that aims to consolidate the U.K.'s highly fragmented mortgage-adviser market. Mr.

INVESTMENT SNAPSHOT

LSL Property Services
(London: LSL)

Business: Provider of data, technology and services primarily to mortgage originators, servicers and borrowers in the residential real estate market in the United Kingdom.

Share Information
(@10/28/22, Exchange Rate: $1 = £0.86):

Price	**£2.32**
52-Week Range	£2.11 – £4.63
Dividend Yield	4.9%
Market Cap	£238.7 million

Financials (TTM):

Revenue	£321.2 million
Operating Profit Margin	9.0%
Net Profit Margin	14.1%

Valuation Metrics
(@10/28/22):

	LSL	S&P 500
P/E (TTM)	5.4	18.7
Forward P/E (Est.)	6.7	17.0

Largest Institutional Owners
(@6/30/22 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	7.4%
Liontrust Asset Mgmt	6.5%
Brandes Inv Partners	6.0%
GWL Investment Mgmt	5.5%
Harris Assoc	5.2%

Short Interest (as of 10/15/22):

Shares Short/Float	n/a

LSL PRICE HISTORY

THE BOTTOM LINE

As the company's mortgage-services platform business continues to grow more quickly and profitably than its other legacy businesses, Pavel Begun believes its stock will deserve better than the 15x earnings multiple at which it has historically traded. In any event, he believes there's considerable upside from today's depressed forward 7x P/E.

Sources: Company reports, other publicly available information

Embley has created a lot of shareholder value over time, so while it's too early for us to ascribe value to LSL's stake in the venture, we do think it could be a material value-creating opportunity.

Let's come back briefly to Kaspi, the Kazakhstani super-app company. It primarily operates in a country that not that long ago called in the Russian military to quell political unrest. There's a price for everything, but how do you get beyond things like that to invest in a place like this?

PB: That's a fair question. A year ago the stock traded at 15x earnings and we could have made a case that we'd still do well investing at that level. But we didn't want a good price, we wanted an exceptional price, which we got after the political uprising in Kazakhstan and Russia invaded Ukraine. It obviously mattered to wait for the better price.

It is not unreasonable to worry about Russia. Kazakhstan has a sizeable Russian population in the northern part of the country, and its location is strategically important to Russia. So you have to ask what would happen if Russia went into Kazakhstan as well. That also requires judging how likely that is to happen, and we've concluded it's not very likely at all. Kazakhstan's leaders have gone to great lengths to make sure Russia doesn't see it as a security threat and they have also forged a strong relationship with China, which we think makes it much less likely Russia would take aggressive steps.

I know some people would say even the smallest chance of disaster makes something uninvestable. That's not my approach. There is a price for everything and today I think the price for Kaspi – given my assessment of the likelihood of geopolitical disaster hurting its business and destroying my investment – is attractive.

There's always risk in investing. We're not looking to avoid that, but we want to manage it through our research and due diligence, through how we manage position sizes, through how we diversify geographically, and by making sure we expect to be paid appropriately for the level of risk we're taking. VII

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